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(Translation)

MINUTES*

OF THE 233rd 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 MARCH 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; 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. Crockett and Mr. Price; 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. 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.

The Chairman opened the meeting by welcoming Mr. Andrew Crockett, Executive Director of the Bank of England, who was participating in the Committee's work for the first time, and by calling the Governors' attention to the fact that the European Monetary System was celebrating, or rather had the previous day celebrated, its tenth anniversary. He added that he

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* Final text, identical to the draft, approved at the meeting on 11th April 1989.

had not had the privilege of being present in that same room ten years ago at the signing of the agreement between the central banks, but that some of the founding fathers were there today and must indeed feel that they had taken part in an important event in the monetary history of Europe.

On the previous day, Monday, in Brussels, the ECOFIN Council had marked the occasion of the first ten years of the EMS. President Delors had presented an interesting and positive assessment of the system and the Chairman of the Committee had made a few remarks emphasising the major role played by the EEC central banks in its successful development. A written version of the Chairman's statement and copies of the Commission's communication were distributed at the meeting.

Mr. Delors observed that since the ECOFIN Council was meeting on 13th March, ten years to the day after the European Monetary System had entered into operation, it had wished to mark the occasion. In its communication the Commission had emphasised the role of the EMS as a stabilising factor and one which had contributed to economic convergence, though the process of convergence was not yet complete. Three phases had been identified in the ten years of the system's existence. A first phase, from 1979 to 1983, during which realignments had been frequent because divergences in economic performances had been very marked. A second phase, from 1984 to 1987, during which convergence had improved but the EMS had been, as it were, bombarded from outside by the sharp fluctuations of the dollar. The communication stressed the importance of the Basle Agreement of September 1987 concluded by the Governors, which had made it possible to strengthen the system's defences. In effect, the system had stood up well since the autumn of 1987, in particular in the face of the dollar's decline. Some even thought that it had entered a phase of great calm with no further realignment. However, it was as well to be cautious about the future while recognising that the EMS had made a large contribution to the European structure and that, without its success, it would have been more difficult to gain acceptance for the prospect of a single market without frontiers in 1993.

I. Approval of the minutes of the 232nd meeting.

The Committee approved the minutes of the 232nd 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

In December and January the dollar had been relatively strong, but in February and early March its performance had been more mixed. Apparently, the market no longer believed that the US currency would remain permanently on an upward path, and it had consequently stabilised at around DM 1.85. This could be explained by a number of factors:

- disappointment regarding the new US Administration, and in particular the abandonment of all hope of a swift reduction of the budget deficit;
- increasing doubts, despite the 1/2 point rise in the discount rate, about the Fed's will or ability to tighten monetary policy sufficiently;
- growing fears concerning inflation;
- a general loss of confidence in high-yield currencies, including the dollar, owing to a greater awareness of exchange rate risk.

Interest rate differentials had played a very important role in determining exchange rate levels. In December-February interest rates had risen more rapidly in Germany than in the United States and this trend had been expected to continue. This had led to a decline in the dollar in February. The decision by the Deutsche Bundesbank in early March not to raise official rates had come as a surprise to the market, which had expected a rise in view of the relative firmness of the dollar, the increase in prices in Germany and the rise in repo rates. Most of the European central banks had welcomed the Bundesbank's decision, which had enabled them to avoid further rate increases. There were several reasons for that decision. The increase in prices in Germany had been due essentially to the rise in official prices and taxes and so did not call for a further tightening of monetary policy. The fundamentals continued to be favourable and capital exports should gradually decline since it could be expected that the effect of the withholding tax in Germany would be judged more calmly and real interest rates were rising. External considerations had also played a role. Many trading partners were at present trying to dampen domestic demand by tightening monetary policy, which should reduce demand for German exports. These various factors should combine to strengthen the Deutsche Mark in the long run.

German policy might, however, be reappraised if the rise in prices led the trade unions to make wage claims that risked triggering cost-push inflation and if the country's trading partners did not manage to reduce their imports from Germany and so achieve the necessary balance-of-payments adjustment. This could happen if high interest rates in those countries caused their currencies to strengthen, hindering the required reduction in imports.

On its tenth anniversary the situation within the EMS was good; there were no expectations of a realignment in the near future and no tensions among member currencies. This had been the case for some time now, despite, more recently, a sharp contraction of interest rate differentials. Differentials were narrower between the Deutsche Mark and virtually all the other currncies participating in the exchange rate mechanism, most notably the Danish krone with a decline from 4 percentage points a year ago to 1 1/2 points at present.

This development was the result of a fall in interest rates in Denmark and a rise in Germany and elsewhere; it reflected differences in economic situations; Denmark was now in its third year of virtually zero growth, while most other European countries had experienced sustained growth. The very wide interest rate differential which had existed a year ago had been clearly excessive from the point of view of the exchange markets; it had induced much larger private capital imports than had been necessary to finance the current-account deficit, despite the Danish krone's relatively strong position in the EMS. As the interest rate differential had narrowed the krone had weakened within the EMS and in February it had stood very close to its lower intervention point. However, the market had remained calm throughout this period. The central bank had intervened only on a few occasions on a very modest scale. This calm had only been possible because of overall market confidence that there would be no realignment in the short term. The experts had thought that the Danish krone's proximity to its intervention point might give rise to problems for the whole of the EMS as it might trigger undesirable reactions on the market. There had been such experience in the past, but it had not been repeated this time, either in Denmark or in the other EMS countries.

The Italian lira had recently been more volatile then the other currencies; it had appreciated by 2 1/2% between September 1988 and mid-February 1989, largely owing to wide interest rate differentials. Its upward trend had come to rather an abrupt halt around mid-February in the wake of commercial demand for foreign exchange and the introduction of a reserve requirement on Italian banks' foreign currency borrowing. It had then weakened by 1 1/2% in the space of two weeks, only to recover again following the 1 point increase in the discount rate in early March. The discount rate had been raised on domestic grounds. The fundamentals had deteriorated recently: the trade deficit and inflation were rising and banks' domestic lending was growing rapidly. The Government was trying to tighten fiscal policy but this was difficult and took time. In the meanwhile the Banca d'Italia had had to tighten its monetary policy.

The French franc had performed well despite a continued fall in interest rate differentials. It had weakened a little up to the end of February but had since firmed notably, primarily because of the positive development of the fundamentals. Recent foreign trade and price figures had been good. The decision to abolish the remaining foreign exchange controls on the corporate sector, including banks, had tended to further strengthen confidence in the French franc.

The "Monitoring Group" believed that the positive situation within the EMS was attributable to increasing convergence as well as to the fact that the central banks were making more flexible use of the instruments available, principally the exchange rate and interest rates depending on the circumstances, which had made it possible to limit intervention.

The UK economy still showed no clear signs of cooling off. Interest rates had remained high but stable, leading to a narrowing of differentials which had been one reason for the weakening of sterling in late February and early March. As the authorities did not wish the currency to fall too far, the Bank of England had intervened quite heavily for a few days when its rate vis-à-vis the Deutsche Mark had dropped to 3.165. It had subsequently stabilised, with the market awaiting the presentation of the budget on 14th March.

The peseta had been rather more stable. Domestic demand in Spain was still buoyant but measures had been taken in early February to limit capital inflows and the financial markets had stabilised somewhat. The exchange rate had changed little, interest rates had risen but more or less in step with those elsewhere and there had been little intervention.

B. <u>Statement by Mr. Papademos</u>

The Alternates had concentrated their discussion on three issues: the relative stability of the foreign exchange markets in recent weeks, interest rate policy in the Federal Republic of Germany, and the causes and implications of the current-account imbalances in the Community.

The dollar had fluctuated against the Deutsche Mark and other European currencies within a relatively narrow range in recent weeks; it had been influenced by changes in interest rate differentials and market perceptions of the stance of macro-economic policies over the coming months. Some Alternates viewed the present level of the DM/dollar rate as satisfactory; others considered that it was still high and did not contribute to the adjustment process. It was felt, however, that the current level was acceptable in that domestic conditions did not appear to justify a further rise in German and other European interest rates and interventions could not have significant effects in the present circumstances.

The Alternates had expressed satisfaction with the stability of the EMS in the past month despite the narrowing of interest rate differentials between the Deutsche Mark and a number of other participant currencies. The Bundesbank's decision not to allow a further rise in interest rates had been welcomed by the Alternates. By not raising the lombard rate, contrary to market expectations, and by announcing a lower fixed rate for repurchase agreements, the Bundesbank had sent a clear signal to the markets. These decisions had been justified because monetary policy had already been tightened considerably, with short-term interest rates almost twice as high as a year ago. The acceleration of inflation in January had been viewed as an aberration, due to the introduction of excise taxes, and had been taken into consideration when interest rates had been set earlier. Moreover, because the German economy was export driven, a rise in interest rates could not contribute much to slowing down aggregate demand; this could be achieved only through a reduction in imports by Germany's trading partners. It had been noted, however, that tight labour market conditions in certain sectors and high capacity utilisation might exert upward pressure on wages at the end of the year.

Despite a fall in interest rate differentials, the French franc had performed well, influenced by improved fundamentals, for example the lower inflation differential with Germany and the lifting of foreign exchange controls. The French experience was a further demonstration that measures to liberalise capital movements accompanied by appropriate macro-economic policies could result in a strengthening of the currency. In addition, long-term interest rates in France were lower today than they had been a year ago, which reflected the success and credibility of anti-inflation policies.

In Denmark, the authorities had not allowed domestic interest rates to rise because of continued weak economic growth and because the reduced interest rate differentials were not viewed as inconsistent with balance-of-payments equilibrium. Other policies had been employed to correct imbalances. As a result of the narrower interest rate differentials the Danish krone had remained close to its lower intervention point without, however, being subjected to excessive pressure requiring interventions.

In the view of one Alternate the recent relative stability of the EMS might prove to be deceptive. Balance-of-payments disequilibria and divergences in inflation performances seemed likely to worsen and this could cause problems, especially if interest rate differentials could not be employed to bring about equilibrium.

The Alternates had discussed some of the causes and implications of the current-account disequilibria in the Community. It had been pointed out that capital flows induced by high interest rate policies pursued by countries with overheated economies could cause and sustain current-account deficits. The appreciation of the currency and the modest short-term impact of high interest rates on economic activity could produce such an outcome. It had been argued that current-account disequilibria would not matter when financial integration was complete and the Community had a common currency. Other Alternates had disagreed with this view and had stressed that even if current-account deficits were easily financed by the market they did have employment and output effects and if they persisted they would also have financial implications. Moreover, financial integration did not imply that current-account imbalances were unimportant as long as inflation differentials existed and exchange rates were not fixed.

Finally, the Alternates had endorsed a proposal by the Group of Experts to proceed with the testing of the use of the concertation tele-communication system for data transmission.

C. Discussion by the Committee

Mr. Ciampi had a few comments to make on the situation in Italy and in particular on the reasons for the discount rate increase, the principal ones having already been mentioned by Mr. Dalgaard. Domestic demand in Italy was strong and the economy was in a cycle of very vigorous expansion. Since 1984 the annual rate of growth had exceeded 3% and in 1988 it had reached 4%. Last year domestic demand had been particularly strong, in both the investment and the consumer sectors. The rate of capacity utilisation had been very high, order books were well stocked and bank lending had risen by almost 20% in a year. The public sector deficit was still large and its impact pro-cyclical, hence the need for measures, firstly, to bring the deficit within limits structurally consistent with a reasonably managed economy and, secondly, to dampen domestic demand, which was plainly overheated. The Government had taken a number of initiatives in late 1988 but these were insufficient to offset the deterioration in the public finances. More would have to be done; in particular expenditure must be curbed, which would hit sensitive sectors such as pensioners, health and transfers to local authorities. Public sector wage demands must therefore be resisted. The will and the acknowledged need to act had not yet been translated into concrete measures, and in the meantime there had been disturbing signs of a deterioration. Inflation, which had stabilised in 1988 at an annual rate of 4.5-5%, had accelerated and in February had been running at an annual rate of 6.3% on a consumer price basis. The trade balance had also worsened, not so much because exports had slackened, but because of a sharp increase in imports, confirming the buoyancy of domestic demand. Against this background, pending fiscal measures, the Banca d'Italia had proposed monetary measures. Firstly, a reserve requirement had been set against non-resident deposits with Italian banks, primarily so as to end the asymmetry in the treatment of fund-raising at home and abroad. The system of Treasury bill auctions had been reformed with the abolition of the floor price. The new system had first been used for 3-month bills and had been extended to 6 and 12-month paper. Italy had not joined in the round of interest rate increases in January as differentials with the other currencies were large and the lira firm. In early March, however, the discount rate had been raised for the essentially domestic reasons already mentioned. The objective was not to strengthen the lira, though obviously a strong currency could only support a policy of disinflation.

Mr. Pöhl wished to come back briefly to the Commission's communication to the Council entitled "The EMS ten years on". After glancing through the text he was astonished at its content, its style and its tone; he was also rather taken aback by the statement made by the Chairman of the Committee. The EMS was based on an agreement between the central banks and the Commission had no competence in its management; it was therefore surprising that it should present a communication to the Ministers marking the first ten years of the system's existence without first consulting the Governors and asking their opinion. What was more, certain passages of the communication, for example those on the role of the ECU or the institutional aspects, were one-sided and raised serious objections, while the role of convergence, by contrast, was given too little prominence.

Mr. Delors expressed surprise at this criticism, since in its communication the Commission made no proposal and had no intention of interfering in the management of a mechanism which lay within the sole competence of the central bank Governors. The text was modest and restrained and it was inconceivable that the Commission should not be able to comment on experience with the EMS, express satisfaction at its success and compliment the central banks on the role they had played. Contrary to what had happened in 1984, since then the Commission had always refrained from making proposals regarding the EMS and interfering in matters which were the sole responsibility of the Governors. The President of the Commission had himself always been very discreet and he therefore could not accept a criticism which seemed unjustified.

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 February and the first few days of March 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. 34 prepared by the Group of Experts chaired by Mr. Raymond on current monetary policies in EEC member countries.

A. Statement by Mr. Raymond

In the previous report, last November, the experts had presented an in-depth examination of the economic and monetary situation in the Community and of ways of promoting convergence among member countries. The Governors had wished to have this "stock-taking" before formulating monetary policy for the year ahead.

The present report took note of the policies set and, in conclusion, tried to assess the compatibility of national objectives. The experts had of course also reported on the new measures adopted since November 1988.

Compared with their November report, the experts had revised their projections for growth and inflation upwards, both for the current period and for 1989 as a whole. They had confirmed that the international balance-of-payments adjustment process was marking time.

Within the Community, as elsewhere, inflation rates were accelerating somewhat. The acceleration was apparent even in those countries where inflation had been lowest, from which, on the basis of figures available in mid-February, the Group had concluded that convergence was improving somewhat. It was possible that with the more pessimistic data reported in the last few days by those countries outside the exchange rate mechanism this conclusion would have to be revised. All in all, however, the experts had felt that underlying inflation expressed in terms of unit production costs should be kept relatively well in check in 1989 and 1990 as a whole.

Divergences in current-account performances continued to widen within the Community. The German surplus was still very large. Growing and in some cases already high deficits existed outside the area of the narrow fluctuation band, either as a result of overheating or because of a deterioration in the public finances in countries where they were in any case already relatively unfavourable.

The report noted a tightening of monetary policy in a number of Community countries since November, partly for domestic reasons (such as a resurgence of inflationary pressures or strong growth of the monetary and credit aggregates) and partly influenced by exchange rate considerations. Among the countries participating in the exchange rate mechanism only Denmark, Ireland and - until early March - Italy had not raised interest rates.

On average, short-term interest rates had risen by approximately 1.5 percentage points in nominal terms between October and February. The increase in long-term rates had been less, pointing to relative confidence on the part of the markets in the central banks' responses. Adjusted for inflation, long-term interest rates had not on the whole changed very significantly since last October (except in the Netherlands and Spain, where they had firmed): the weighted average for the Community had remained close to 4%, the lowest level for eight years.

The experts had examined the monetary policies announced for 1989. Quantitative objectives had been set in Germany, France, Italy, Spain, Portugal and Greece. In the first three countries - Germany, France and Italy - the current objectives differed little from those set for 1988. In the other three they reflected the authorities' desire to tighten their policy stance.

In the United Kingdom the monetary strategy would be set in mid-March, just before the beginning of the next financial year on 1st April.

Belgium, Denmark, Ireland and the Netherlands had stressed that they continued to give priority to the objective of exchange rate stability within the EMS.

The Group had concluded that the monetary policies announced for 1989 everywhere aimed at containing developing inflationary pressures, but that they would contribute only modestly - if at all - to reducing inflation differentials between member countries and, as far as could be seen, would not promote the adjustment of current-account disequilibria.

As the Group had already noted on several occasions in earlier reports, a more marked differentiation in the policies pursued would obviously be desirable, and at present this applied above all to interest rate policies.

However, as Report No. 33 had made clear, there were a number of obstacles to such a strategy:

- those countries in current-account surplus and with the lowest inflation rates saw no scope at present for pursuing a more expansionary policy in view of the recent increase in inflationary pressures, so that the whole burden of effort would rest with the others;
- precisely in those countries where current balances and inflation would warrant even more restrictive action, various factors placed a limit on the scope, or the willingness, to raise interest rates further, either social factors (high unemployment), budgetary factors

(the burden of interest on the public debt) or exchange rate factors, i.e. capital inflows attracted by a high yield.

The report reaffirmed the desirability of adjusting the policy mix so as to avoid placing the full burden of correcting the disequilibria, particularly in current balances, on monetary policy.

As Report No. 34 was essentially an updating of the November report it had been compiled in a single meeting of the Group, and the in-depth discussion of means of increasing convergence had not been reopened. On the whole, the various groups of countries, those in surplus, those in deficit, those with high inflation and those with low inflation, felt that they had very little room for manoeuvre, and they had continued to defend the positions described to the Governors in Chapter III of last November's Report No. 33, to which reference could be made.

B. Statement by Mr. Papademos

The Alternates had thanked Mr. Raymond and the Group of Experts for their excellent report. It was the first report in the new series of such analyses requested by the Governors last November and as such it was the forerunner in the process of a more systematic and fundamental analysis of monetary policies in the Community.

It had been agreed by the Alternates that the report highlighted the principal factors, outlined below, affecting monetary policy at this juncture.

The danger of the upward inflationary trend should not be underestimated. Most of the latest data suggested that demand pressures continued to be strong and in some countries inflation might exceed even the revised forecasts of Report No. 34. This was worrying and becoming more visible to the market. If inflationary pressures were not contained at an early stage, it could ultimately prove very costly to re-establish price stability. The question had been raised whether monetary policies might have to be tightened further to contain this inflationary tendency. So far, there appeared to be no need for a further general tightening of monetary policies, although the circumstances were not the same in each country.

The present degree of differentiation of monetary policies between the EEC countries was not, by itself, capable of reducing external imbalances. The Alternates considered that such imbalances would not be sustainable in the longer run. An attempt to correct them by relying on monetary policy measures alone might not be sufficient. Monetary policies might have to face conflicting domestic and external considerations since a rise in interest rates induced capital inflows which led either to exchange rate appreciation or to a loss of control of the monetary aggregates. In some countries, the possibility of implementing tighter monetary policies was confined by other constraints, and there was a clear need for a better policy mix. In addition, it had been observed that the effectiveness of interest rate policies was not uniform throughout all EEC countries.

The Spanish Alternate had pointed out that recent evidence on the Spanish economy was not very encouraging. Monetary growth continued to overshoot the target range for the year despite the loss of foreign exchange reserves. Preliminary estimates for the first two months of the year showed rising inflation and a continuing worsening of the trade deficit. Complications with the constitutionality of certain aspects of the existing income tax laws along with the current political confrontation between the trade unions and the Government added to the problems. Pressure for wage increases was substantial and unit labour costs were likely to increase in 1989.

Some Alternates had noted that in some countries there appeared to be a close relationship between the emergence of inflationary pressures and the strong expansion of monetary aggregates in previous years. Although initially linked to a shift in money demand partly associated with financial innovations, the rapid monetary growth had contributed to the inflationary pressures being experienced now.

More generally, two points had been stressed:

- the present emphasis on exchange rate stability should not overshadow the need to make progress in the area of convergence; and
- the problem of convergence, especially the elimination of external disequilibria, was not likely to be resolved unless the policy mix was changed.

The Chairman added a few comments on the situation in Greece. The growth of the broad monetary aggregate had slackened slightly in 1988 from 1987 but had considerably exceeded the target. This overshooting had mainly been due to the budgetary difficulties; the public sector borrowing requirement had risen by 3% of GDP to some 16%. Monetary policy had been fairly restrictive to judge by real interest rates, which had risen and which in the summer of 1988 had stood at almost 10%. A greater proportion of the government borrowing requirement had been covered by the non-bank sector. Fiscal policy for 1989 provided for a deficit about the same in terms of GDP as in 1988, which meant that monetary policy would again have to bear most of the burden of adjustment. It would therefore be necessary to pursue a policy of high real interest rates, which, obviously, would add to an already heavy public debt service burden.

V. Other matters falling within the competence of the Committee.

There was no other business.

VI. Date and place of the next meeting.

The next meeting would be held in Basle on Tuesday, 11th April 1989 at 9.30 a.m.

Annex

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

14th March 1989

Confidential

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

FEBRUARY 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 February and the first few days of March 1989.

I. EXCHANGE RATE DEVELOPMENTS

The main features of the foreign exchange markets in February 1989 were:

- a weakening of the US dollar against all currencies except the pound sterling and the Canadian dollar;
- a strengthening of the Deutsche Mark vis-à-vis all other currencies in response to rising German interest rates and a general weakening trend for high yielding currencies;
- a continued absence of tensions in the EMS.

The US dollar shed some of the strength it had displayed at the end of January and early February, as optimism about the new administration and investment prospects in the United States began to fade. Concerns increased about the magnitude of the inflation problem in the United States with economic data revealing continued and surprising strength. At the same

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

time, expectations grew that monetary conditions abroad would be tightened. The mid-month report of a slight improvement in the US trade deficit in December offered little encouragement and the increase in the discount rate by 0.5 percentage point to 7.0% also had little effect. As dealers adopted a more cautious attitude, the dollar declined to close on balance 2% lower against the Deutsche Mark and 1.6% lower against the yen.

There were still no tensions within the EMS. The major changes were a fall of the Italian lira in the second half of the month and a further weakening of the Danish krone to a position close to the lower limit.

The Deutsche Mark firmed markedly vis-à-vis all currencies officially quoted in Frankfurt. Its weighted index vis-à-vis fourteen major industrial countries (1972=100) rose from 167.5 on 31st January to 169.1 on 28th February. Probable contributory factors were that greater account was taken of the fundamentals and that interest rates in the Federal Republic rose sharply.

The French franc remained stable for most of the period under review. The rise in domestic interest rates contributed to this, as did the publication of encouraging statistics for January (narrowing of the trade deficit to Fr.fr. 2.8 from 4.8 billion in December and a rate of retail price increase of 0.4%, or only 3.3% on an annual basis).

Against the background of a general rise in interest rates on the major currencies the Banque Nationale de Belgique also found it necessary to raise the rate on short-term Treasury certificates several times and to intervene moderately to support the Belgian franc.

The Dutch guilder strengthened somewhat vis-à-vis most EMS currencies, and remained in the upper part of the intervention band. On balance the exchange rate with the Deutsche Mark was almost unchanged, notwithstanding a decrease in the interest rate differential.

The Danish krone remained the weakest currency in the EMS band. The interest rate differential vis-à-vis the international markets narrowed further as interest rates in Denmark rose less than in most other countries.

The Irish pound weakened slightly but remained well within the upper half of the EMS band. Net outflows of currency over the month resulted in net sales of foreign currency by the Central Bank of Ireland.

Capital inflows led to a further appreciation of the Italian lira in the EMS during the first half of the month. Following the announcement of the extension to foreign currency borrowing of the 25% compulsory reserve requirement on banks' liabilities, the lira began to weaken in the third week of February also as a result of narrower interest rate differentials and of a strengthening of the Deutsche Mark. The Banca d'Italia conducted smoothing interventions throughout the month on both sides of the market but ended up as a net buyer of Deutsche Mark.

Sterling suffered bouts of professional selling amid fears of a narrowing in its favourable interest rate differential. Persistent downward pressure was encountered during the latter part of the month, on concerns about the UK trade figures for January (released on 1st March) which contributed to the nervous atmosphere. Sterling's trade-weighted index fell by 2.4% to 95.8 (1985=100).

The Greek drachma came under some pressure during the month. It depreciated vis-à-vis the ECU by 0.7% while against the US dollar it appreciated by 0.7%. In effective terms it depreciated by 0.6%.

The Spanish peseta lost some ground in the wake of the exchange control measures introduced on 1st February and in spite of a further 1 percentage point rise in the intervention rate for overnight funds to 13.4% on 3rd February and a 0.5 percentage point rise in the three-month repurchase agreement rate to 13% on 6th February by the Banco de España. It ended 0.7% lower with respect to the ECU and 0.7% higher with respect to the US dollar.

In effective terms the depreciation of the Portuguese escudo was 0.25%, in line with the foreign exchange policy defined by the authorities. Against the US dollar the escudo increased by 0.8%.

The Swiss franc stabilised at a low level. Despite a slight decline against the EMS currencies it showed an increase in value of 0.4% on an export-weighted basis. This rise is attributable to the tendency of some of the other currencies to weaken. Vis-à-vis the US dollar the Swiss franc strengthened to the extent of roughly 2%. The interest rate increase in the domestic money market continued at only a slower pace; consequently the interest rate differential in favour of other currencies broadened.

The Austrian schilling strengthened by 1.9% vis-à-vis the US dollar, with a monthly spread of 3.7%. Against the Deutsche Mark it fluctuated by only 0.06%.

Continued stability of the Norwegian krone in the first few weeks of February gave room for a further 0.5 percentage point reduction in Norges Bank's overnight lending rate from 11.5% to 11.0% effective 14th February.

However, towards the end of the month the krone showed a tendency to weaken somewhat and during the month the krone depreciated by 0.5% in effective terms.

The Swedish krona weakened towards the middle of the month due to a narrowing of the interest rate differentials against foreign currencies. The Riksbank withdrew liquidity from the market and interest rates rose over the whole yield curve. The krona stabilised at an index level of about 131.0.

The Finnish markka depreciated slightly in effective terms. Short-term interest rates fluctuated rather widely during the period but on average they were at slightly lower levels than in January.

The Japanese yen appreciated by 1.6% against the US dollar to close at Yen 127.15, reflecting an increased market perception that a curtailment of the US budget deficit was not as imminent as expected. Meanwhile, the yen depreciated by 0.5% against the Deutsche Mark.

The Canadian dollar stood at US$ 0.8344, to show a decline of 1.3% over the month vis-à-vis the US dollar and one of 1.6% in effective terms. At the beginning of the month the Canadian currency reached its highest level for seven years against the US dollar under the influence of net inflows of foreign capital. Towards the end of the month, however, it declined in response to the publication of figures pointing to a deterioration in the trade balance and indications that the current account for the final quarter of 1988 would post a large deficit. The weakness in the second half of the month of a number of other currencies carrying high interest rates also served as a backdrop to the Canadian dollar's decline.

II. INTERVENTIONS

A. Interventions in US dollars

Net sales of US dollars amounted to US$ 3.3 billion, compared with US$ 4.1 billion during the month of January. Of the net sales only US$ 0.8 billion were against Deutsche Mark compared with US$ 4.1 billion in January. The Banco de España, the Bank of Canada and Norges Bank were the major sellers, while Finlands Bank was the largest purchaser.

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$ 1.9 billion compared with US$ 4.2 billion in January 1989. The interventions consisted mainly of purchases of Deutsche Mark, with the Banca d'Italia and the Banco de España being the main buyers.

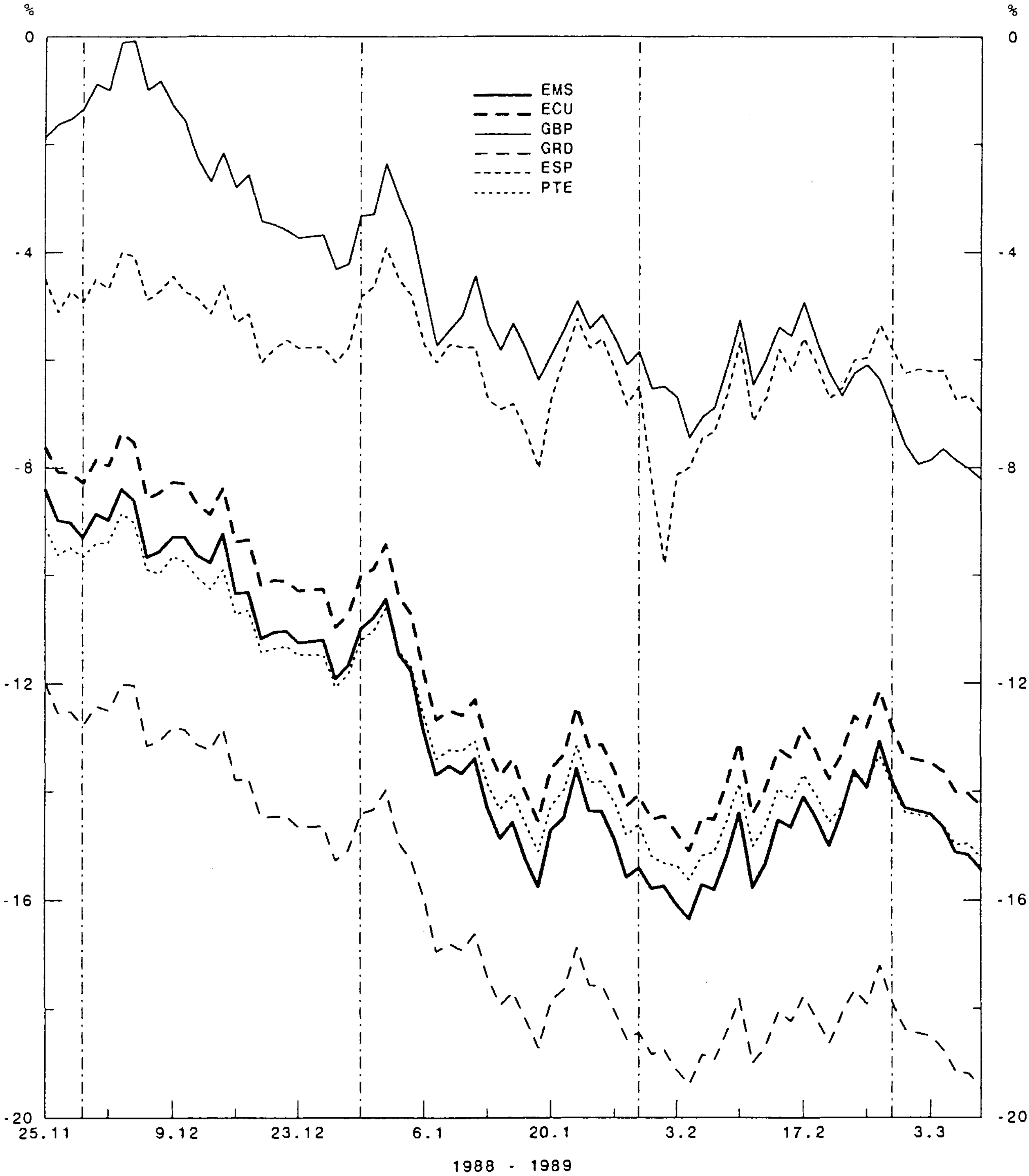
III. DEVELOPMENTS IN THE CURRENT MONTH, UP TO 10TH MARCH

The dollar strengthened in the first days of March due to lower European interest rates. Following the release of the US employment data the US dollar strengthened further.

Sustained intervention underpinned the pound sterling.

Within the EMS, against the background of a fall in German interest rates, the Italian lira and the French franc firmed. The Banca d'Italia raised the discount rate from 12.5% to 13.5% and in France the remaining exchange controls for companies and banks were lifted.

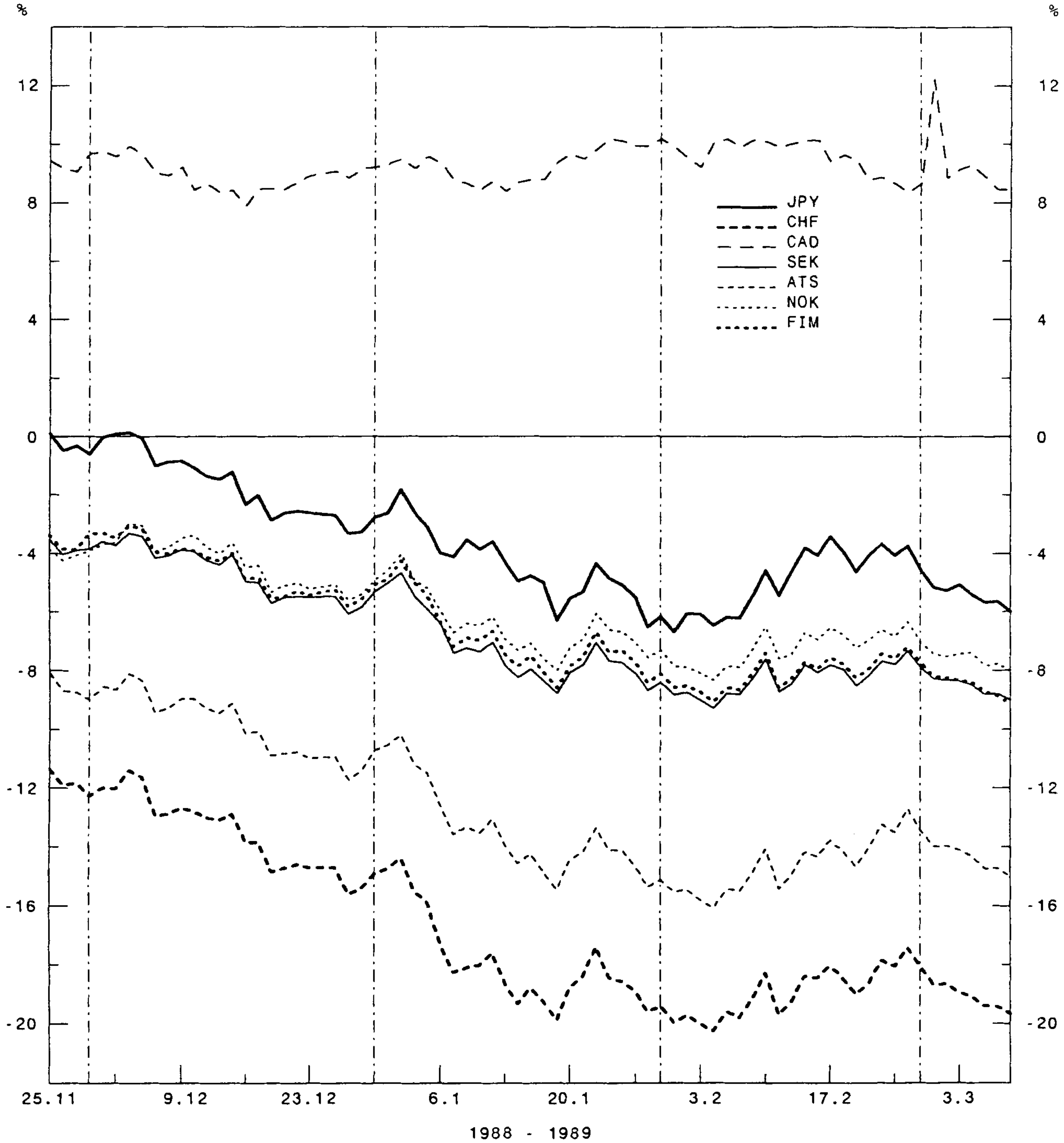
EVOLUTION OF THE ECU, THE MIDDLE RATE OF THE CURRENCIES PARTICIPATING IN THE EXCHANGE RATE MECHANISM OF THE EMS, AND THE CURRENCIES OF THE EEC CENTRAL BANKS WHICH DO NOT PARTICIPATE IN THAT MECHANISM, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* See next page.

10.3.1989

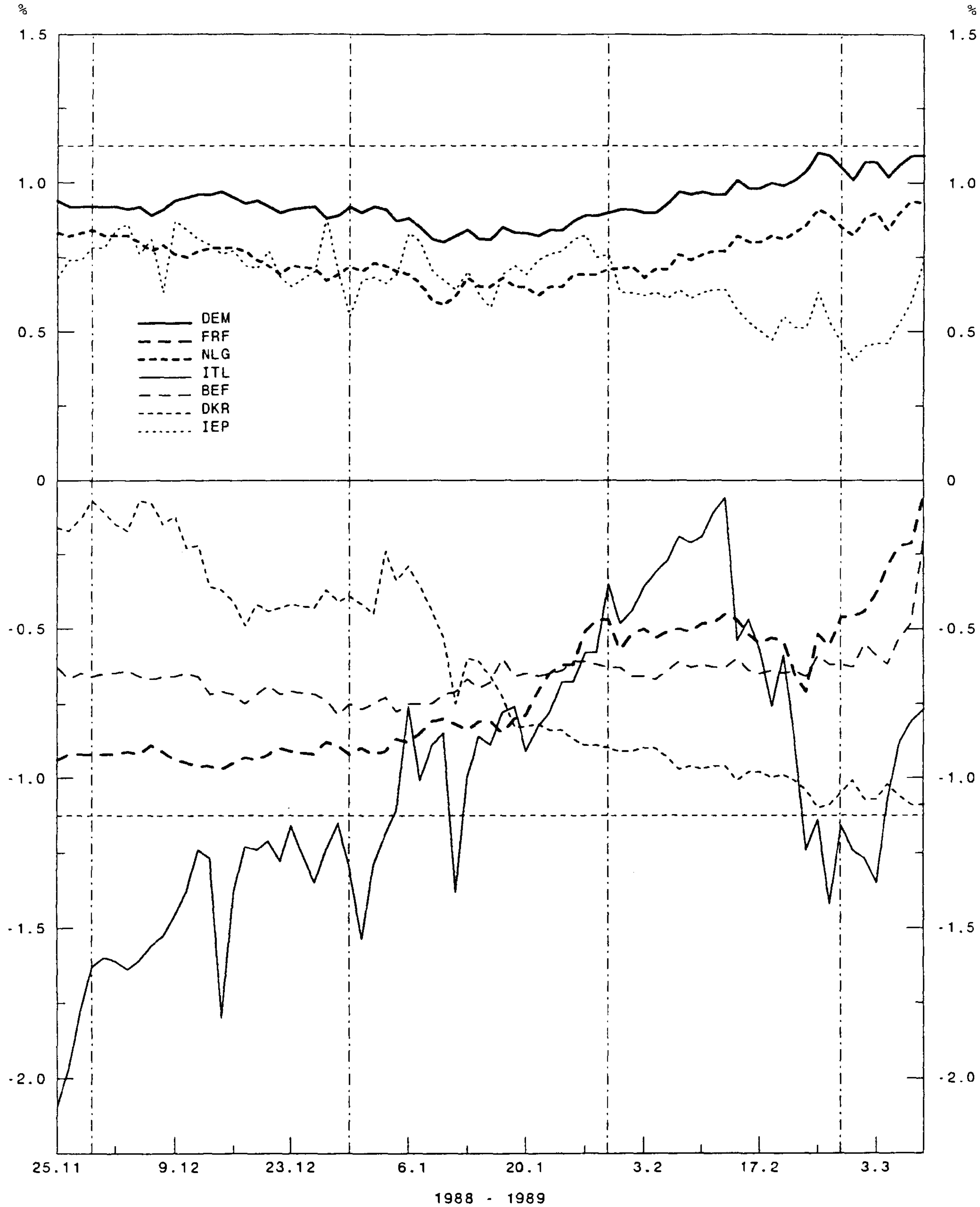
EVOLUTION OF THE CURRENCIES OF THE NON-EEC CENTRAL BANKS PARTICIPATING IN THE CONCERTATION, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* 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%.

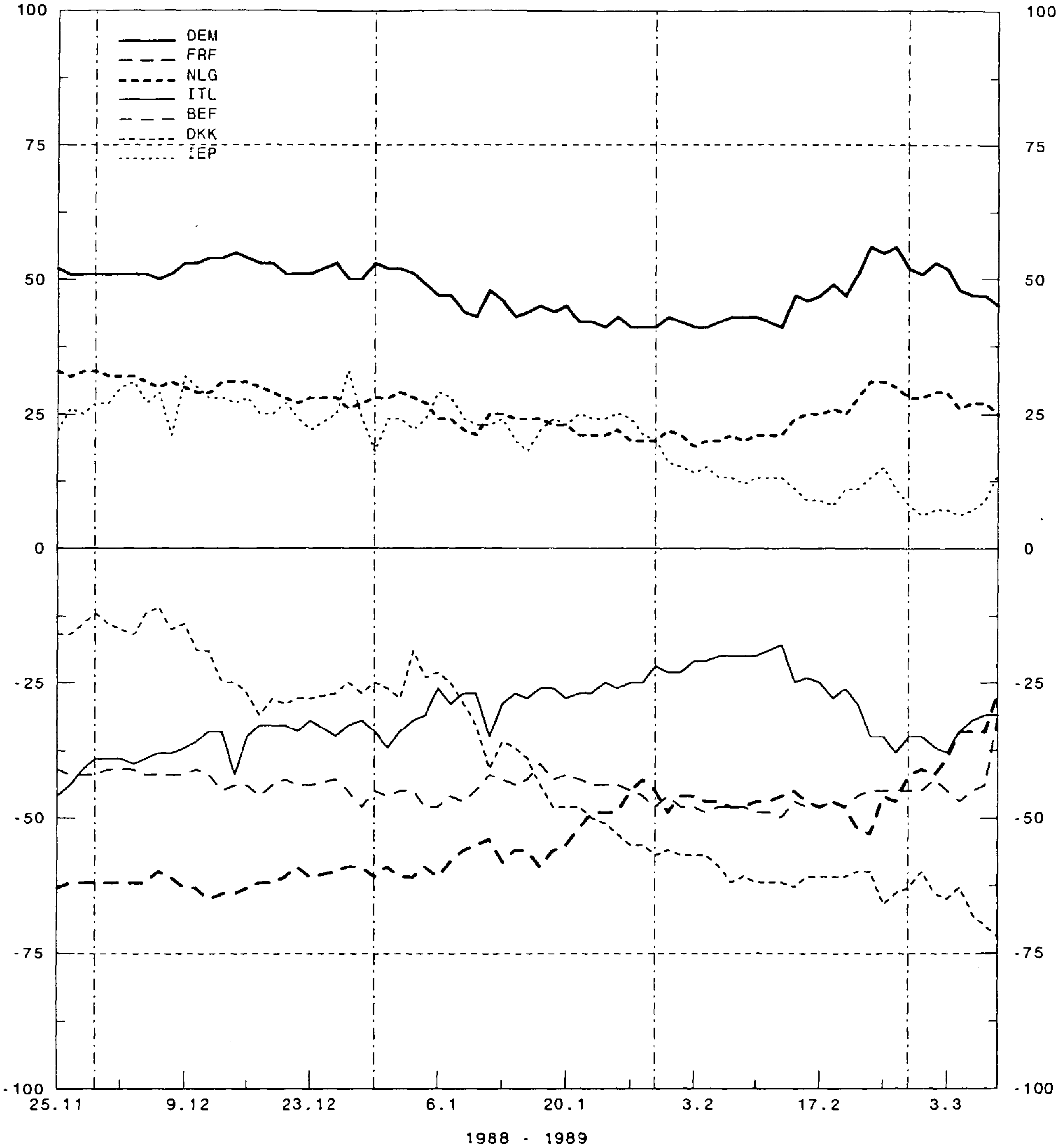
10.3.1989

MOVEMENTS IN THE EMS PARITY GRID



10.3.1989

EVOLUTION OF THE DIVERGENCE INDICATOR*

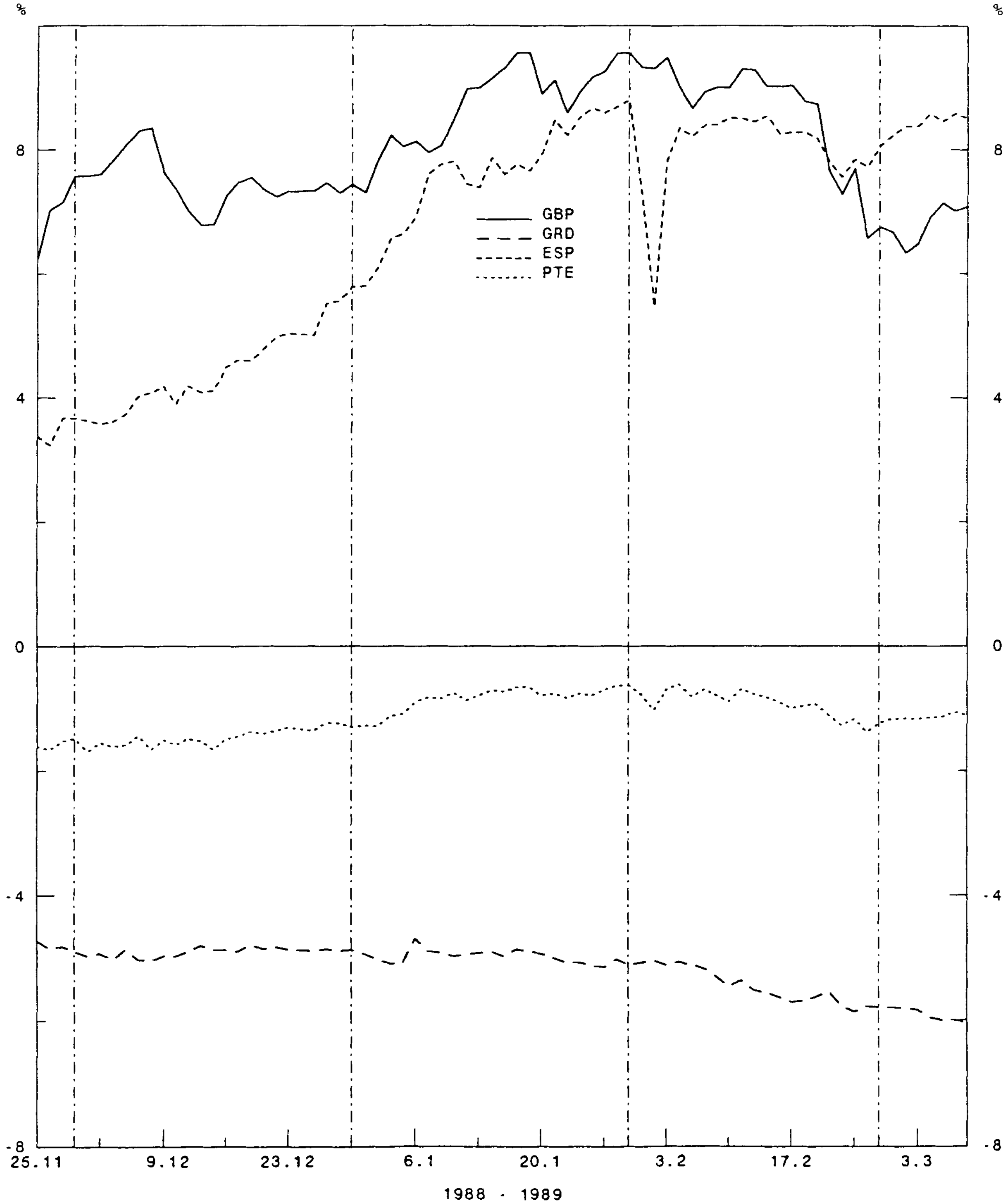


1988 - 1989

* 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.

10.3.1989

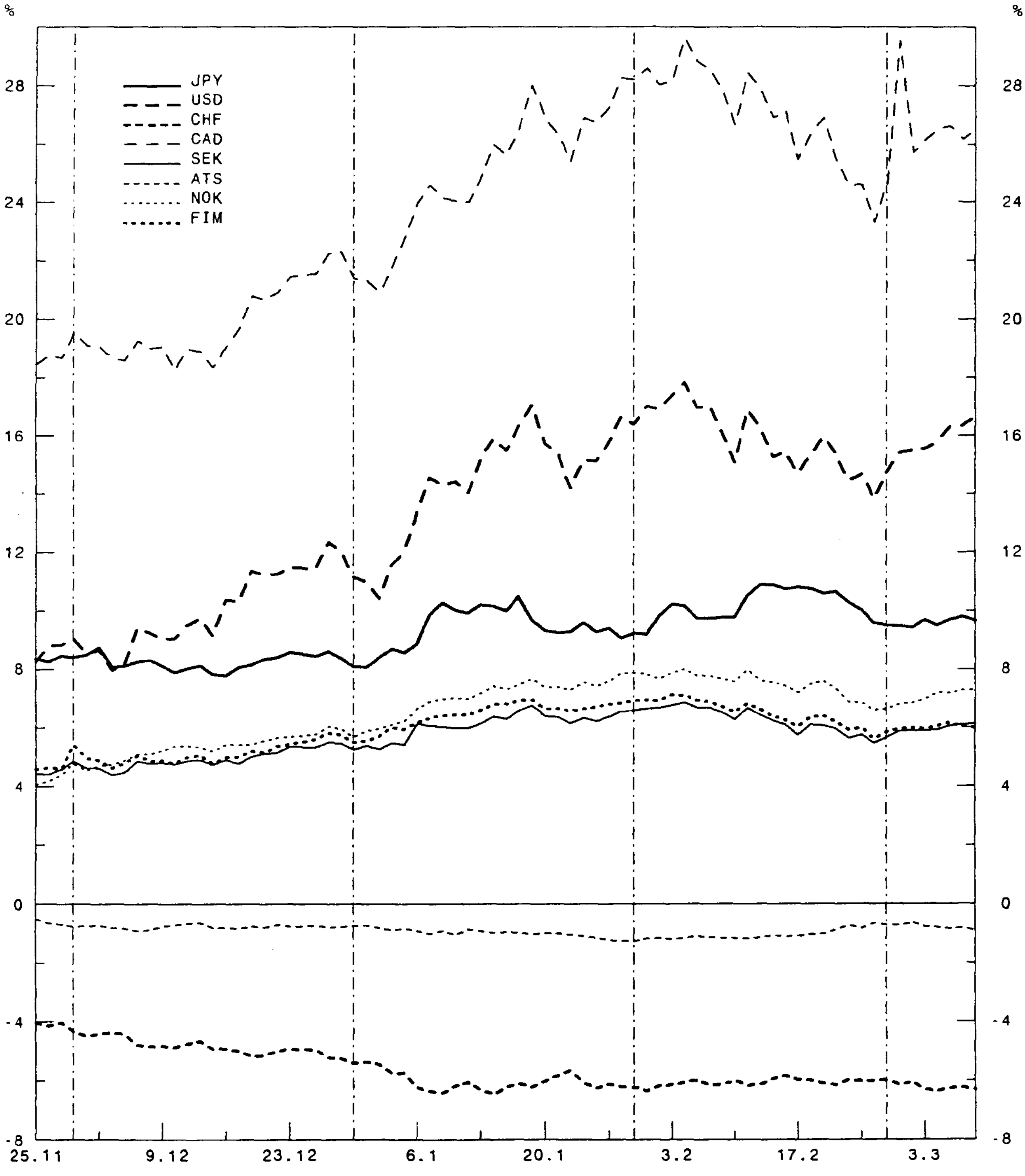
EVOLUTION OF THE POUND STERLING, THE GREEK DRACHMA, THE SPANISH PESETA AND THE PORTUGUESE ESCUDO, ON THE BASIS OF THE MARKET RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE ECU*



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

10.3.1989

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.

10.3.1989