4028

Confidential

(Translation)

MINUTES*

OF THE 243rd MEETING OF THE COMMITTEE OF GOVERNORS
OF THE CENTRAL BANKS OF THE MEMBER STATES
OF THE EUROPEAN ECONOMIC COMMUNITY
HELD IN BASLE ON TUESDAY, 13th MARCH 1990 AT 10.00 a.m.

Those present at the meeting were: the President of the Deutsche Bundesbank and Chairman of the Committee, Mr. Pöhl, accompanied by Mr. Tietmeyer and Mr. Rieke; the Governor of the Banque Nationale de Belgique, Mr. Verplaetse, accompanied by Mr. Rey and Mr. Michielsen; the Governor of Danmarks Nationalbank, Mr. Hoffmeyer, accompanied by Mr. Mikkelsen; the Governor of the Bank of Greece, Mr. Chalikias, accompanied by Mr. Karamouzis and Mr. Brissimis; 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. Lagayette and Mr. Cappanera; the Governor of the Central Bank of Ireland, Mr. Doyle, accompanied by Mr. O'Grady Walshe; 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 and Mr. Boot; the Governor of the Banco de Portugal, Mr. Tavares Moreira, accompanied by Mr. Amorim and Mr. Carvalho; 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. Pons; the Director General of the Luxembourg Monetary Institute, Mr. Jaans; the Chairman of the Monetary Committee, Mr. Sarcinelli, accompanied by 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, and Mr. Scheller also attended; Mr. Spinnler and Mr. Dagassan, of the BIS, were invited to attend for the discussion of item VII of the agenda.

---

* Final text approved at the meeting on 15th May 1990, which incorporates some drafting changes.

I. Approval of the minutes of the 242nd meeting

The Committee approved the minutes of the 242nd meeting on the understanding that the editorial amendments suggested would be incorporated in the final text.

II. Preparation for the Inter-governmental Conference

The Chairman opened the meeting by welcoming Mr. Sarcinelli, the Chairman of the Monetary Committee, and thanking him for accepting the invitation to come and talk about the work in which his Committee had been engaged for some time in preparation for the Inter-governmental Conference. The Committee of Governors and the Monetary Committee were very closely related bodies: today, for instance, three Chairmen of the Monetary Committee (two former chairmen and the present incumbent) were together in the room.

The Chairman proposed that President Delors should first be asked to say something about the Commission's intentions concerning Economic and Monetary Union (EMU) and then Mr. Sarcinelli might talk about the Monetary Committee's work.

Mr. Delors began by saying that, at the luncheon of the Council of Finance Ministers yesterday (Monday) in Brussels, most of the time had been taken up with a statement by Mr. Waigel on the economic and monetary consequences of re-unification of the two Germanies. The ECOFIN Council's next informal meeting, at the end of March, should be devoted to the preparation of the Inter-governmental Conference on EMU and a further discussion of economic and monetary union between the two Germanies. The Commission had prepared a paper on EMU which it was expected to adopt that afternoon, but the following outline could be presented to the Governors.

The Commission paper endeavoured first of all to analyse the costs and benefits of EMU on the following basis. What additional contribution would EMU make to the large internal market that was to be achieved in 1993? What would be the links between a better functioning of that market and EMU? In addition, as the Euroean Council had requested, the Commission had studied the other possible forms of EMU and, in that connection, had taken into consideration various academic papers, namely the United Kingdom's proposal, which could be described as monetary union with competing monetary policies and competition between currencies, and the idea of monetary union without economic union, which had been supported by a majority of the "Giscard-Schmidt Committee".

The Commission had ruled out these different approaches and, in its view, the Committee of Experts' report remained the basis for further work; it had not been able to take into account an interesting paper prepared recently on the initiative of Sir Michael Butler, in close collaboration with City businessmen. This paper upheld the idea of the market and competition against what it saw as the centralisation of the system proposed by the Committee of Experts; it assigned a greater role to the ecu: currencies would be determined in relation to the ecu, which would be managed by a European monetary fund.

Within the Commission, the monetary aspects were unlikely to be the subject of major debate. The principle of the establishment of a common institution with a federal structure, independent and with the objectives referred to in the Committee of Experts' report, would be adopted by the Commission. On the economic side, however, some questions were being raised. Firstly, some within the Commission were unsure whether the economic component was really solid enough compared with the monetary component or whether, with an institution whose object was to conduct a common monetary policy, co-ordination of economic policies would be sufficient. The European Council had spoken of parallelism between economic and monetary union. This approach was related to a more political vision of the Community's future; Chancellor Kohl had said, for instance, that EMU could not be achieved unless progress was made within the political institutions. This was similar to the idea of political and democratic control raised by the Committee of Experts in its report. A second area of discussion concerned binding rules for budgetary policy. This point had been challenged at the European Council meeting in Madrid in June 1989, and since then by certain governments. The prevailing Commission view might be less demanding than that of the Committee of Experts: it would advocate very simple binding rules, such as no financing through money creation and no "bail-outs", but would be satisfied with binding procedures which would be activated in the event of slippage. Such an approach rested in particular on the importance attached to the level of saving in relation to the budget and the financing of private or public investment. A third subject, on which views diverged considerably, related to economic and social cohesion. Behind this term lay one of the most important political decisions taken in February 1988, which reflected the desire to help backward regions or those that were transforming their industry to seize all the opportunities offered by the internal market. This had resulted, in financial terms, in a doubling, between 1987 and 1993, of the resources devoted to the structural funds. The question that arose was not whether these structural policies would be pursued, for they would be continued, but whether or not EMU would exacerbate the disparities within the Community. The President of the Commission thought that EMU would be beneficial in that respect.

Mr. Sarcinelli thanked the Governors for the invitation to attend their meeting which, more by chance than by design, coincided with the eleventh anniversary of the EMS. The system had performed well over the past few years, and this augured well for co-operation between the two Committees in the interest of the EEC.

It was important to dwell briefly upon the main lines of the Monetary Committee's work, leaving other points of common interest to the ensuing exchange of views.

It was no secret that the Monetary Committee had been directed to discuss and then report on how to contribute to the process of preparing for the Inter-governmental Conference. It had started from the premise that it would be not only over-ambitious but also tactically ill-advised to try to cover with its suggestions all the relevant issues at the same time. The report to be submitted to the informal ECOFIN Council meeting in March was therefore only one, although the most important so far, of a number of Committee papers on this subject.

At the present stage the Committee's aim was firstly that its deliberations and suggestions, which reflected a high degree of consensus, should help the Finance Ministers to determine the political orientations as well as the technical substance of the whole process leading to EMU. If this were not the case, the Foreign Affairs Ministers would take these decisions, as they too had a mandate to prepare the groundwork for the Inter-governmental Conference.

With regard to the main political orientations which would be presented in the Committee's forthcoming report to the Ministers, Mr. Sarcinelli was pleased to say that a high degree of consensus had emerged so far, but, since this document had not yet been finalised, it was necessary to bear in mind the old Latin saying "in cauda venenum".

As on earlier occasions, a large number of suggestions contained in the Committee's forthcoming report would relate to budgetary policy. Indeed, a solid budgetary stance was a prerequisite for a good policy mix, which in turn was essential for the establishment of a healthy economic union. The Committee's main concern had been to offer a strong framework for budgetary discipline. It would be proposed that certain basic principles should be incorporated in the Treaty of Rome which would constitute the core of the union's budgetary discipline. The sound budgetary policy that was being recommended would help the central banks to steer towards a good monetary policy.

Following the mandate from the Council, the Committee had also discussed at length the organisation and functions of the future European System of Central Banks (ESCB). Work in that area had drawn heavily on the Delors Report and thus on the Governors' contributions. The Committee would be proposing to the Ministers that this system should have price stability as its primary objective and, subject to this, support the general economic policy of the union. There was also broad agreement that in the formulation and implementation of monetary policy the ESCB should act independently of the political authorities. The Committee would fully support that principle as far as domestic monetary policies were concerned. However, it would probably come as no surprise to the Governors to hear that the delimitation of competences was particularly difficult in the area of external monetary policy; on this point opinions still differed, but it was hoped that next week's discussions would help to narrow the divide.

With regard to future work, barring any new mandate from the Ministers, it was clear that certain aspects of economic union required thorough examination. Moreover, in the report now being prepared it was already stressed that the problem of establishing Economic and Monetary Union should be addressed in a comprehensive and operational way. It was also likely that the Committee would have to examine the institutional aspects in some depth once the Commission had presented its report in April. In conclusion, the Monetary Committee was particularly heedful of the political challenges presented by the preparatory phase of the Inter-governmental Conference; judging from the progress it had made so far, one could be fairly confident that the key options suggested by the Committee would enable the Conference to start on time and help it to work successfully.

The Chairman thanked Mr. Sarcinelli for his statement and welcomed the fact that the Monetary Committee had already been able to reach agreement on a number of points.

Mr. de Larosière expressed his concern regarding an approach to budgetary questions consisting only of the following three elements: no "bail-out", no direct financing of deficits by the central banks or the ESCB, and "procedures" in the event of slippage. These elements did not seem adequate. For instance, direct central bank financing of public sector deficits was not necessary, as governments could meet their financing requirements via the banking system. Binding rules were therefore required, otherwise fiscal laxity could be injected into the monetary system. If there were substantial, repeated budgetary slippages, the common monetary policy would have to be tightened increasingly and would thus bear the full burden of adjustment. This was the situation observed in countries with a large public sector deficit and a low level of saving, where interest rates had to be raised to very high levels. The Ministers should, therefore, be told that the Governors considered it necessary to go beyond statements of intent or of principles and to have a binding system based on a collective appraisal within the Community of any budgetary situation that seemed unsustainable and could constitute a dangerous slippage. Such a system could not be based on a crude rule expressing the budget deficit in terms of GDP, for example; a joint analysis had to be undertaken on a case-by-case basis in order to determine whether a slippage was intolerable in the light of the country's situation and in particular its level of saving.

The Chairman observed that the Governors were certainly in agreement with Mr. de Larosière's views: the conflict between fiscal and monetary policy was a very important problem.

Mr. Sarcinelli said that the Monetary Committee was in full agreement with Mr. de Larosière's views on the need for effective budgetary discipline. To lay down a rule for public sector deficits in terms of a percentage of GNP, for example, would indeed be a crude approach. Deficits had to be examined in the light of a number of factors, in particular the flow of savings. Furthermore, whether or not a deficit was excessive should be determined not by the national authorities concerned but collectively, as part of a Community exercise.

Mr. Delors agreed that financing through the banks, or even through the markets, could be just as destabilising as central bank financing and that it would therefore be necessary to examine closely what the Monetary Committee would be proposing as a binding procedure. It had to be emphasised that Stage One of EMU was generally underestimated, not in terms of its implications but in terms of its difficulty. During that stage responsibility for monetary affairs would have to pass increasingly to the Committee of Governors, whose influence in giving its opinion and making proposals on monetary policy would become significant. Furthermore, the multilateral surveillance exercise which governments would have to undertake at least twice a year would no longer be purely academic as in the past. The first two exercises that had taken place since July 1989 had already shown slight progress - certain matters that had previously been taboo had been debated - but multilateral surveillance would be successful only if it became transparent, i.e. if every government knew that its policy could be criticised by the Council of Ministers and that the latter's conclusion would be made public. This transition from an academic to an operational exercise, from secrecy to transparency, was a policy leap that perhaps not all countries were prepared to accept or support; this therefore had to be taken into account and the legitimate fears expressed by Mr. de Larosière answered.

Mr. Duisenberg noted that the view of the Dutch authorities, both the Government and the central bank, differed from that of the UK authorities concerning binding rules for the budget; in fact they shared Mr. de Larosière's view and were therefore opposed to over-simple rules, such as setting a percentage of GDP for public sector deficits, but favoured more refined binding rules, calling for example specifically for balance on current budget items or long-term borrowing solely to cover investment. It also had to be stressed that it was inconceivable that the ESCB should apply an internal monetary policy independently (which was unanimously accepted within the Monetary Committee) unless it was also independent in respect of "external monetary policy". Another very important matter was banking supervision, on which the prevailing opinion within the Monetary Committee was that this should be left to the national authorities. Such a position was not acceptable. In eight Member States the central banks were responsible in this field, and the possibility of the ESCB having responsibilities in at least some areas of banking supervision must therefore be left open. Banks were crossing borders, establishing conglomerates and intra-European agreements and it was necessary to consider how supervision could be organised in such an environment. The sub-committee chaired by Mr. Quinn could study these questions, and the Governors and Finance Ministers should keep them on their agenda and examine what could be done in future. The informal meeting in Ireland must not conclude that the European System of Central Banks was not competent in the area of banking supervision.

Mr. Leigh-Pemberton fully shared Mr. Duisenberg's view on banking supervision. The principle of subsidiarity meant that the central banks were responsible for supervising banking activities on their national territory but this was no longer adequate for the supervision of banks operating transnationally, with rules that varied from one country to another. It was only natural for a Governor to take the view that the ESCB should be responsible for external monetary policy but there was a difficulty with the interface between the exchange rate of a common EEC currency and that of other currencies, such as the dollar. These questions could not be excluded from international political forums, such as the G-7, and a compromise would therefore have to be found between the Finance Ministers' role globally and responsibility for monetary policy.

With regard to budgetary policies, it was clear that a substantial deficit, expressed as a percentage of GDP, in small EEC countries would be a less serious constraint on the Community as a whole than a modest deficit in large countries. A kind of regional transfer could therefore be considered, whereby certain smaller countries could have larger public sector deficits in order to sustain their own development, while the larger countries would be required to exercise discipline. Such a differentiated approach to public sector deficits might be appropriate for economic and social cohesion but it would run counter to the budgetary discipline advocated by many.

Mr. Sarcinelli said that the Monetary Committee had discussed the problem of banking supervision and that it recognised that, with the globalisation of markets and the growing responsibility of the central banks, it would be inappropriate to establish too clear a separation of responsibilities. A consensus had emerged based on the following principle: responsibility for banking supervision would remain with the national authorities but the ESCB should judge whether the banking system was sound enough and able to ensure an effective monetary policy. In other words, what was needed was a decentralised banking system, competitive, sound and efficient. The central banks had to have a right to monitor banking supervision and, if the Governors were in favour of growing centralisation in this area, the Monetary Committee could certainly support that view.

With regard to external monetary policy, the exchange rate regime was the responsibility of the political authorities, while its implementation, including intervention, was that of the monetary authorities and therefore in future the ESCB. However, the problem was whether the policies, as they had been defined and would be implemented, would be perfectly harmonised. According to the "Delors Report", responsibility for the balance of payments for the Community as a whole would lie with the political authorities but there was also the responsibility for the day-to-day decisions connected with the balance-of-payments and exchange rates. The Monetary Committee intended to propose that it should provide the forum in which balance-of-payments and exchange rate policies were co-ordinated among central banks and Treasuries.

The Monetary Committee had certain misgivings about the idea referred to by Mr. Leigh-Pemberton of regional transfers via the budgets and saw in this a moral hazard. The problem was directly related to Mr. Delors' remark on the impact of EMU on economic and social cohesion. The Monetary Committee had not yet discussed this question in any detail but it was inclined to think that, for instance, Community loans for balance-of-payments purposes should be abolished, or at least modified, as abolishing them would risk sending a negative signal with regard to solidarity and cohesion.

Mr. Hoffmeyer agreed with Mr. de Larosière's views on budgetary discipline. The problems encountered within the Committee of Experts had not changed much: politicians were prepared to enter into monetary union but wished to retain responsibility for budgetary matters and were unwilling to make any further commitments. But the commitments had in fact to be much firmer and more binding than had been envisaged so far.

Mr. Ciampi supported Mr. de Larosière's views on budgetary discipline and stressed that the Committee of Experts had always worked in terms of Economic and Monetary Union, given that monetary union implied co-ordination of budgetary policies. In that context, to say that monetary financing of deficits had to be avoided was not enough; genuine co-ordination and joint evaluation of budgetary policies was necessary. With regard to banking supervision, at present there was co-ordination among the national authorities. This would be increasingly necessary and would have to become closer and closer, given the development of banking structures and the rapid disappearance of borders. On the subject of exchange rate policy, the Monetary Committee considered that intervention would be the result, at least in terms of overall strategy, of the general monetary policy, but it should not be forgotten that price stability would always have to take priority. In reference to the monetary policy of the Community, Mr. Ciampi mentioned his own proposal, published in an annex to the Delors Report. The proposal offers a possible solution, for discussion, to the problem of conducting a common monetary policy for the entire Community during the transition period when all the different national currencies will continue to coexist.

Mr. Delors noted that, as far as banking supervision was concerned, the Commission had an open mind and was awaiting the opinion of the Committee of Governors; he recalled that, according to the Committee of Experts' report, the European System of Central Banks would participate in the co-ordination of national policies but would not have a monopoly of those policies. According to current Community practice, common rules, linked to the emergence of the common financial space, had to take the form of guidelines, which had to be translated into national laws. The Commission was also interested in the Governors' view on the application of the principle of subsidiarity within the ESCB in relation to two points: firstly, with regard to banking supervision, where, despite national diversity, the ESCB might undertake a certain degree of co-ordination and even make recommendations; secondly, with regard to the regulation of money and capital markets, where the national central banks could retain a role and certain secondary monetary policy instruments in order to take account of the specific characteristics of financial centres and countries.

On the economic side, the Commission would emphasise the importance, at Community level, of competition policy, supervision of state aids, structural policies and close monitoring of the development of production costs, and therefore wages.

Mr. Rubio felt that external monetary policy was a very important question. Without ignoring the political dimension, account had to be taken of the operation of the economic system. There was clearly a link between the determination of the exchange rate and monetary policy. Different judgements in regard to this problem might emerge in the future, but it was important to explain to the Finance Ministers the real situation, which could not be changed for the time being, and to present clearly the differences of opinion that existed in this field.

Mr. Jaans wondered whether the establishment of procedures to deal with budgetary slippages would be sufficient for the realisation of EMU. A balance would have to be struck, for it was highly likely that the looser the budgetary discipline, the more Stage One would, or would have to, be extended. This would not be a disaster perhaps, but one had to be aware of it, just as it had to be realised that, more generally, the problem of the transition within EMU from one stage to another - a problem which had not been dealt with in the "Delors Report" - would be the most difficult one. The drafting of a charter for the ESCB should not raise any major difficulties; it would, however, be no easy matter to decide when and on the basis of what criteria the ESCB would be created.

Mr. Verplaetse concurred with Mr. de Larosière's remarks on budgetary discipline, which also coincided with those of Mr. Duisenberg with regard to the idea that various factors should be taken into account rather than a single rule set for public sector deficits in terms of a percentage of GDP. Monetary policy was part of economic policy, in respect of which ultimate responsibility for the major decisions rested with governments. The central banks did, however, have a specific responsibility for overall balance-of-payments policy, given their activities in the field of capital movements, intervention and interest rates. It would therefore be difficult to accept that balance-of-payments policy should be the responsibility of the Finance Ministers.

Mr. Chalikias fully shared Mr. de Larosière's view on budgetary discipline. Experience had shown that it was not enough to state that monetary financing of public sector deficits was ruled out, particularly in countries where the capital markets were not very highly developed. The political authorities had to make the necessary budgetary adjustments and, to that end, it was necessary to have binding rules and not rely on market constraints.

Mr. Tavares Moreira also favoured genuine budgetary discipline, which would ensure economic convergence; he wondered how the "no bail-out" rule could be established. The principle of subsidiarity should be applied to banking supervision and co-operation between the national authorities should be improved. It would not, however, be desirable to give responsibilities in this area to the ESCB too quickly.

Mr. Doyle was also in favour of genuine budgetary discipline and feared that progress in the monetary field might be expected to compensate for the lack of progress in other areas. It was regrettable to hear that the idea of monetary union alone was being raised or discussed, when the European Council had stated on a number of occasions that the aim was to achieve Economic and Monetary Union. He added that the long experience of monetary union between Ireland and the United Kingdom did not argue in favour of such an approach, which, in any event, would not lead to the type of Community aimed for.

Ireland was of course in favour of transfers of resources, but extreme caution was called for with regard to transfers in the form of aid for budget deficits. It was true that for the Community as a whole the size of a public sector deficit might be unimportant if the country in question was small. This was not the problem, however. Persistent deficits in a particular country, whatever the size of that country, led to budgetary laxity and ultimately an inefficient utilisation of resources. Aid for the poorest countries to strengthen economic cohesion was necessary, but it should be provided in a Community context, or it might be ineffective and even dangerous. With that in mind, the structural funds should be developed and they could also cover areas other than infrastructure. Such an approach was far preferable to aid for financing the general budget, which gave rise to major reservations and which, to be acceptable, would necessitate other constraints and rules.

Mr. Leigh-Pemberton pointed out that he was not advocating a system of aid for the general budget; it was simply an idea that had not yet been raised and to which thought could be given in the future.

Mr. Duisenberg felt that the co-ordination of overall balance-of-payments policies lay within the competence of the political authorities, which included the conclusion of agreements on exchange rates, whether fixed or floating. Exchange rates were too important to be left to the central banks alone. However, once an exchange rate system had been defined its implementation and the corresponding intervention policies were part of monetary policy, for which the central banks were responsible. In the same way, realignments lay within the competence of the political authorities, acting in consultation with the central banks.

The Chairman made a few remarks in his dual capacity as President of the Deutsche Bundesbank and Chairman of the Committee. In his latter capacity, he said that he could give a brief outline of the Governors' views at the informal ECOFIN Council meeting. One point was very clear, namely the general agreement on the budgetary discipline aspect raised by Mr. de Larosière and a number of members. On the question of banking supervision, there also seemed to be a consensus in favour of the idea that the central banks, the Committee of Governors and subsequently the European System of Central Banks had a certain role to play. It still was not very clear what that role would be, and, until the Sub-Committee chaired by Mr. Quinn had defined it in greater detail, the observations conveyed to the Ministers would be limited. The most difficult point was external monetary policy and exchange rate policy. The difficulty related more to the fact that exchange rate policy might quite often come into conflict with monetary policy than to the division of responsibilities between Finance Ministers and Governors. In that respect, one distinction was clear: within the EMS, the Ministers were responsible for the exchange rate regime and realignments, and the central banks for day-to-day management on the basis of the Agreement of 13th March 1979 and supplementary accords such as the Basle/Nyborg Agreement. Such an arrangement could be incorporated in the Treaty and it was obvious that the greater the convergence, the fewer the realignments.

The second aspect of external monetary policy concerned the exchange rate relationship between the ecu and the dollar and the policy in this respect, which presented a real problem. The central banks had to fulfil commitments entered into within the framework of the G-5 or G-7 and conflicts could arise. It was therefore important to emphasise clearly that the priority was not the exchange rate vis-à-vis third currencies but price stability within the EMS and the Community. The room for manoeuvre in exchange rate policy, for which the Ministers were responsible, was consequently circumscribed by the overriding objective of price stability. The Ministers tended, as experience had shown, to give priority to exchange rate targets, for instance under the Louvre Accords, and this had led to conflicts; the Governors should therefore reaffirm the principle that, within the EMS and the Community, priority was to be given to price stability and not to the stabilisation of exchange rates, essentially vis-à-vis the dollar.

The Chairman concluded by saying that he would prepare a brief statement for the informal ECOFIN Council meeting in Ireland and that he planned to distribute a text to the Governors before that meeting.

In response to a remark by Mr. de Larosière on the possibility of setting up a small working party to comply with Mr. Delors' wish to know more about the central banks' views on banking supervision, the Chairman said that the Sub-Committee chaired by Mr. Quinn was the appropriate body.

III. 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

V. Examination of Report No. 37 prepared by the Group of Experts chaired by Mr. Raymond on current monetary policies in EEC member countries

The Chairman proposed that items III and V be dealt with together and that the reports by Mr. Dalgaard, Mr. Raymond and Mr. Rey therefore be heard in turn.

Mr. Dalgaard said that the "Monitoring Group" had focused on the problems relating to the Deutsche Mark at its meeting on Monday morning and had also discussed the problems affecting the other EEC currencies and third currencies, the US dollar and Japanese yen, in its telephone concertation last Friday.

Statement by Mr. Raymond

A detailed analysis of the economic and monetary situation in the EEC had been presented in Report No. 36 last November. In March the Group of Experts updated this information on the basis of data for the previous year and took note of the objectives adopted by the central banks. Report No. 37 should be less substantial than the preceding one, but it was appearing at a time when both the internal economic situation and the position in eastern Europe were raising particular questions.

In 1989 growth had remained strong. It was not much lower in the EEC on average than in the previous year and was one percentage point higher than initially forecast. Rising above the OECD average for the first time in many years, Europe had been one of the engines of world growth.

Inflation, however, had been 1.6 percentage points higher on average than in 1988. This deterioration had been due largely to external factors and confined to the first half of the year. On average inflation was expected to slow down in 1990, but by too little. The risk of inflation - i.e. that it might prove intractable in high-inflation countries and might take off again in low-inflation countries - was attributable to numerous factors, some external to the EEC, others internal: a possible rebound of the dollar and the yen, firm oil prices, excessive pressure on production capacities and wage negotiations. Domestic demand was proving difficult to control in EEC countries with overheating economies, and this might be compounded by additional demand from eastern Europe.

These risks should not be dramatised, but neither should they be ignored. Monetary policies in particular should not be relaxed in 1990. Account had been taken of that need in setting the intermediate objectives for 1990, which were generally in line with those that had been adopted for 1989. The 1989 targets had originally been considered to be rather restrictive, and had indeed proved to be so, especially as growth had been more rapid than forecast.

At the same time, taking the 1989 targets - which had by and large been met - over into 1990 might be judged disappointing for the following reasons. The experts had noted from the outset that the 1989 targets would be unlikely to lead to greater convergence, which in fact had not improved in 1989. For 1990 the Group had recommended more ambitious targets for countries requiring macro-economic adjustment, if only for the galvanising effect such an announcement would have, and even if the need not to push up the exchange rate stood in the way of an increase in or a more marked differentiation of interest rates. Continuing with the same targets was more likely to prolong the current divergences, whose cumulative effect might in the long term threaten the credibility of the parity grid.

The explanations given by the central banks of the countries in need of macro-economic adjustment did, however, hold out hope of closer price convergence, with a more marked slowdown in the rate of inflation where it was highest.

With regard to current payments balances, prospects were less favourable, except in the United Kingdom, where the current-account deficit was expected to narrow by 1.5 percentage points of GNP to 2.5%. In Spain the deficit was likely to be higher in 1990 than in 1989, despite an improvement during the year in monthly import and export flows. Greece's deficit could be expected to persist, as could Germany's surplus, subject to the uncertainties relating to the closer ties with the GDR.

Fiscal policies were neither more convergent among themselves nor likely in many cases to help monetary policies to increase the convergence of inflation rates and current-account balances.

A reform of public finances was under way in Ireland, Spain and the Netherlands, while there was no sign yet of this happening in Italy. Following an improvement in 1989, the situation was expected to worsen in

Portugal in 1990. It had greatly deteriorated in 1989 in Greece, where the future was still uncertain. Desirable though the widening of the deficit in the Federal Republic of Germany was for boosting domestic demand and adjusting current payments, it was less so if account was taken of the impact of possible strong demand in the GDR on productive resources in the Federal Republic.

The experts had been unable to assess the precise effect of the events occurring in eastern Europe. If the current process of political and economic liberalisation continued, a strong demand for capital and consumer goods was likely to emerge. Pressure could be expected to be concentrated on the Federal Republic because of the specific implications of German reunification.

A new problem of macro-economic control might then arise in the Federal Republic, where the capacity utilisation rate was too high, owing to the combined effect of three sources of demand:

- the other EEC countries, where demand had sustained exports in 1989 and was not yet easing;
- the domestic market, where demand had been stimulated by the final phase of the tax reforms;
- the GDR.

What was needed, therefore, was for the EEC countries with overheating economies to better control their absorption, especially of German products. Otherwise it would be desirable for the public finances in the Federal Republic to be less expansionary than initially projected, so as to ease the burden on monetary policy in that country.

Finally, the financial and foreign exchange markets deserved close attention.

The foreign exchange markets, made intrinsically fragile by the exogenous movements of the yen and the dollar and by intra-European divergences, might feel the effects of the events in eastern Europe, which could bring about both an initial weakening of the Deutsche Mark, owing to the transitional difficulties, and a subsequent strengthening of that currency, which could be serving an enlarged geographical area with high productivity gains.

Long-term interest rates had risen, rectifying the yield curve. Their sensitivity would have to be taken into consideration if short-term rates had to be raised again. It was unclear whether the recent increase in long-term rates reflected pessimistic inflationary expectations on the part of market participants who felt that short-term rates would not be eased in the near future or whether it simply reflected the shifting of the equilibrium price between a growing demand for capital, owing to new requirements in eastern Europe, and a stagnating supply of savings. In the former case a tightening of monetary policies might reassure the markets. In the latter it might depress share prices.

This fluid situation provided a particularly appropriate test-bed for closer co-ordination of monetary policies in the spirit of Stage One of EMU.

Statement by Mr. Rey

The following points had emerged from the thorough discussion which the Alternates had had on the reports by Mr. Dalgaard and Mr. Raymond.

There was a strong interest in a close monitoring of the economic and monetary consequences of German unification, although it had been pointed out that other developments, such as the recent behaviour of the Japanese yen, also deserved particular attention.

1. Concerning the German situation, it had been noticed that markets had reacted, and perhaps over-reacted, to the inevitable uncertainties surrounding the size of the prospective budgetary transfers to the GDR and the manner in which they would be financed. It was therefore desirable to avoid any move or statement which might fuel the most pessimistic expectations or cast doubt on the ability of the German authorities to deal in an effective anti-inflationary way with the new situation. While it was certainly too early at this stage to give quantitative estimates of financial needs and transfers, it had been felt by several Alternates that an efficient way to reassure and calm the markets would be precisely to provide a reliable quantitative framework of estimates as soon as feasible.

2. Despite these uncertainties it was obvious that the additional demand coming from the GDR and other eastern European countries would come about at a time when demand was already very strong, both in the Federal Republic and in many other European countries. Cautious monetary policies were therefore called for, given the present risks of accelerating inflation. Some Alternates had pointed out, however, that an offsetting factor had recently appeared in the form of a substantial rise in long-term interest rates, so that a case could be made for avoiding premature further increases

in short-term rates. Should the need arise, more forceful interventions could be carried out to avoid any undesirable depreciation of the Deutsche Mark.

3. A non-inflationary accommodation of the additional demand deriving from eastern Europe was not a purely German problem but required a higher degree of policy convergence in the Community. For its part the Bundesbank had spared no effort to draw the attention of the Federal Government to the limited budgetary room for manoeuvre currently available. It was necessary, however, for other countries to help in reducing the German external surplus by a tightening of domestic demand, particularly in deficit countries. It was a matter of overall policy stance, but also a matter of shifting the policy mix towards less fiscal laxity in a number of countries. It had, indeed, been felt that the importance of this last point, which had been stressed once more in the latest "Raymond" report, might usefully be brought to the attention of the Ministers at the forthcoming informal ECOFIN meeting.

4. A number of more specific situations deserved special attention.

In Italy, notwithstanding the lira's position at the top of the narrow band, high interest rates were considered indispensable given the scale of budget financing. In Greece the situation could become unsustainable in the absence of an improvement in fiscal policy conditions.

5. According to the UK Alternate the significant weakening of the pound sterling was related to political difficulties. The inflation rate was proving to be resilient and was unlikely to come down over the coming months, or could even rise owing to the effect of some tax decision.

6. The main concern outside the Community was currently the weakening of the Japanese yen. It was difficult to say at this stage if the weakness was due to reversible, short-term factors, predominantly of a political nature, or reflected fundamental changes in the Japanese balance of payments which would exclude an early reversal. Some Alternates had expressed doubt about the usefulness of Japanese yen interventions; others had felt that such interventions at least showed the desire of the Japanese authorities to strengthen their currency. The "Dalgaard Group" might perhaps undertake an in-depth analysis of the stabilisation prospects for the Japanese yen.

Discussion by the Committee

The Chairman opened the discussion with a statement on the various aspects of the situation in the GDR and German economic and monetary unification.

Mr. Leigh-Pemberton confirmed that the fall in the pound sterling was linked with the fact that the markets felt that the Government was being confronted with more and more difficulties. Inflationary pressures were considerable and would probably intensify under the influence of the newly introduced community charge and the increase in mortgage interest rates and electricity and public transport charges. The authorities were reluctant to raise interest rates further since, in addition to its unpopularity, such a measure might have counter-productive effects on the pound in the absence of better news about the UK economy. While the new budget, to be presented on 20th March, should mark a tightening, the surplus was likely to be smaller owing mainly to the slowdown in economic activity and the consequent decline in revenue.

Mr. Chalikias pointed out that in Greece monetary policy had come under strong pressure in 1989 mainly because of the large and growing government borrowing requirement, which had reached a record of more than 19% of GDP. The monetary targets set by the Bank of Greece for 1990 aimed at preventing an acceleration in inflation. Inflationary pressures were such that a reduction in the rate of price increase in 1990 did not appear feasible; moreover, underlying inflation was higher than reflected in the consumer price index. The Bank of Greece had intervened very actively on the interbank market to soak up liquidity and maintain tight conditions on the money market; it would continue to apply a restrictive monetary policy and envisaged taking supplementary measures that could be expected to lead to a further rise in interest rates. However, the effectiveness of that policy would depend to a very large extent on the adoption of a credible fiscal consolidation programme which could be implemented after the April elections. It should be noted that the public sector deficit had widened in the first two months of the year; its current level was not sustainable, and not only was it undermining the effectiveness of monetary policy, it was also contributing to the worsening of the balance of payments and to the persistent pressures on the drachma which had obliged the Bank of Greece to carry out large-scale intervention.

Mr. Rubio referred to Mr. Raymond's remarks on convergence and noted that progress had been made in this respect in Spain. Even though the monetary targets for 1990 were the same as for 1989, monetary growth had declined sharply, falling from 13-14% to its current level of 5%. Moreover, the policy mix had improved: the budget deficit was expected to reach 1.7% of GDP in 1990, against over 2% last year, and in parallel with this reduction a moderation of public expenditure was to be observed.

Mr. Tavares Moreira said that important changes would very shortly be made to monetary policy in Portugal. In particular, the system of administrative credit control that had been in force since 1978 had been abolished; it had lost much of its effectiveness and was to be replaced by a system of indirect control based on more active intervention by the Banco de Portugal on the interbank market. These changes would in some way complement those already introduced in 1988 for the system of reserve requirements.

Mr. Tavares Moreira added that in a few days he would be distributing a note describing the details of this reform.

The Chairman said that the report prepared by the "Raymond Group" was excellent and that, had it been possible, more time should have been devoted to it. A number of questions arose which deserved discussion at a later meeting. For example, the increase in interest rates might be considered welcome insofar as it would have a moderating effect on demand. Signs of overheating existed in a number of countries, and if additional demand came from eastern European countries inflationary pressures could become serious. The surprising and marked increase in market interest rates which had followed the announcement of German monetary unification was therefore positive in this respect; it should also contribute to a stabilisation of the Deutsche Mark vis-à-vis the US dollar, which was important, as a weakening of the German currency leading to a weakening of the other EMS currencies would only aggravate inflationary pressures.

IV. Adoption of the Committee's report to the EEC Ministers of Finance of developments on the foreign exchange markets of the nineteen countries participating in the concertation procedure during February and the first few days of March 1990

The Chairman took note of the Committee's adoption of the "concertation report", which would be sent to the EEC Ministers of Finance in the usual way.

VI. Continuation of the discussion on issues raised by a possible association of third countries with the EMS

Mr. Rey stated that he had given the Governors a note during the meeting summarising the progress made on this matter; he would therefore confine himself to the following remarks.

At the February meeting two distinct views had emerged among the Alternates: one, in favour, was based in particular on the desirability of extending the concept of fixed exchange rates, and hence the zone of monetary stability, beyond the Community; the second, which was more guarded, stressed that the EMS could not be dissociated from the process of Economic and Monetary Union and that association would therefore be viable only for those countries that were prepared to commit themselves to the Community's final goals. During the Alternates' discussion it became apparent that these two views could perhaps be reconciled if the minimum selection criteria already agreed (i.e. a sound economy, the willingness to follow stability-oriented policies and freedom of capital movements) were to be supplemented by the following additional criterion, namely that only countries which had clearly expressed their desire to become members of the Community and had not been dissuaded from so doing, or countries which had already embarked upon the process of acceding to the EEC, would be considered for association. In addition, these countries should confirm their willingness to accept the Community's philosophy of EMU. With regard to institutional arrangements, there seemed to be no major obstacle to participation by associate countries in the various procedures established within the EMS.

Mr. Delors expressed serious misgivings at the idea that associate status could be given to countries which had expressed the desire to join the Community: a purely monetary decision should not delude certain countries into thinking that, since their currency had been accepted for association with the EMS, they would be entitled to join the Community after 1992. The Community had a number of explicit or potential membership applications before it; one country was particularly insistent, and its acceptance as an associate would trigger a process which the Council of Ministers had not intended. The Commission therefore had to enter reservations regarding the additional criterion referred to by the Alternates. Besides, it would be possible to devise a status which, while falling short of full association, would enable the countries concerned to link their currencies to the EMS monetary zone and follow the development of the EMS. Such a formula should not be referred to as "association", as it would be more flexible, looser and less binding. The Commission was prepared to draw up a note giving further details of such a formula.

Mr. de Larosière thought that the question of association should be examined more thoroughly. Mr. Rey's line of thinking was interesting but failed to take account of the problems referred to by Mr. Delors. It was tantamount to saying, on the one hand, that a country could not benefit fully from association with the exchange rate mechanism unless it was truly subject to the intensive convergence and co-ordination procedures existing within the EMS and, on the other hand, that if a country submitted to these procedures and had lodged its application for membership of the Community, it would be accepted as an associate with the EMS until such time as it became a member. There was a risk that such an approach might confront the political authorities of the EEC with a kind of fait accompli. It would therefore be desirable to seek a third formula whereby the country in question would adopt a kind of relative position vis-à-vis the exchange rate mechanism - which would provide a useful indication for the markets - but without being actively involved in it. The Governors could come back to this matter when they had received the note proposed by Mr. Delors.

The Chairman acknowledged that association had implications which extended far beyond the monetary, exchange rate or technical aspects. If only these factors were considered, it would certainly be desirable for more countries to anchor themselves to the EMS and to align their monetary policies with those of the Member States, but the Governors could not decide this matter alone, in view of the political implications.

The Chairman pointed out that he would perhaps be called upon to present the Governors' views on association at the informal ECOFIN Council meeting to be held on 31st March.

Mr. Rey observed that the candidates for association with the EMS would probably hardly be interested in a flexible "shadowing" formula.

Mr. Verplaetse felt that account should be taken of the work done by the Alternates. The third formula referred to by Mr. Delors could not be limited to a de facto situation but should be structured and involve a certain formal status, otherwise it would not be of interest to any country. Provided that there were stringent conditions, association should enrich the Community.

In response to a question from Mr. Duisenberg on the situation regarding Austria's application to join the Community and the opening of negotiations, Mr. Delors stated that Austria had lodged a formal application, which had been studied by the Commission at the Council's request. If the reply to Austria's application was favourable, negotiations would commence after 1992. There were currently considerable difficulties with Poland and Hungary, which had been exacerbated by the fact that these two countries thought, wrongly, that the Commission was giving the GDR special treatment.

VII. Examination of Report No. 69 prepared by the group of experts chaired by Mr. Dalgaard on proposals concerning a liquidity facility for the private ecu clearing

Mr. Dalgaard briefly presented Report No. 69 prepared by the group of experts on the proposals made by the Bank of England and the Banque de France concerning the establishment of a liquidity facility for the private ecu clearing.

A. Statement by Mr. Rey

On the whole, the Alternates shared the opinion of the group of experts that the implementation of a liquidity facility would enhance the functioning of the present ecu clearing system and be a possible means of reducing the associated systemic risk. It had been agreed that the facilities currently being proposed by the Bank of England and the Banque de France would not impinge on the guidelines drawn up in March 1983, except for any proposed involvement of central banks. Furthermore, it had been recognised that they would have no impact on the monetary policies of the Member States of the Community. Finally, it had been noted that the BIS would be prepared to devise an equivalent scheme similar to those proposed by the Bank of England and the Banque de France.

The German Alternate, while expressing some reservations about the underlying need for such a liquidity facility, had made it clear that he could accept the establishment of a liquidity facility provided there was a centralised solution operated by the BIS. He was not in favour of national systems operating in parallel with the BIS facility. Furthermore, the terms and conditions should be such as to make it unattractive to the clearing banks, which would underline the fact that the facility should be used only in an emergency. He also questioned the need to provide collateral solely in ecus.

Both the French and British Alternates were in favour of implementing a facility within a very short time-scale. They both felt that central bank systems could operate alongside that of the BIS. The Banque de France Alternate saw no need for a single centralised scheme. The British Alternate had, however, stated that the Bank of England would consider withdrawing its proposal should the majority of Governors prefer a single scheme, namely that of the BIS, and should that scheme meet the requirements of the commercial banks.

In conclusion, the Alternates had agreed that it should be suggested to the Governors that they invite the BIS to prepare a proposal for a liquidity facility for the private ecu clearing system along the lines of the proposals put forward by the Bank of England and the Banque de France. The BIS could discuss its proposal with the members of the ecu clearing system so as to be able to submit to the Committee of Governors, for the April meeting, a scheme which would be both operational and ready to implement. The Governors could then decide whether they accepted the BIS scheme and whether it would be implemented as the only system or alongside other facilities offered by central banks. In the meantime, it was hoped that neither the Bank of England nor the Banque de France would implement their systems.

B. Discussion by the Committee

Mr. de Larosière stated that he was dissatisfied with progress on this matter over the past month. In February he had understood that the two schemes proposed would be able to start just after the March meeting. Now, however, an attempt was being made to bury the two schemes in bureaucracy and replace them by a centralised BIS system, which called for the greatest reservations.

It was unwise, from an institutional point of view, to merge the day-to-day operation of the clearing, which was undertaken by the BIS, and the covering of day-to-day liquidity requirements on a collateralised basis. Furthermore, there were technical arguments in favour of the national central banks providing this kind of service. The French commercial banks held accounts in ecus with the Banque de France for various reasons unrelated to the existence of a liquidity facility for the clearing system. They were not, however, particularly interested in having deposits with the BIS and in fact did not have such deposits. It therefore appeared inconceivable, except for obscure bureaucratic reasons, that the Banque de France should be obliged to tell the French banks that it could not provide this liquidity support. The principle of subsidiarity could also be invoked in favour of a number of national systems and against a single centralised system.

Mr. de Larosière agreed not to implement the French system for the time being, but emphasised that:

- it could be applied without any special decision, for the ecu accounts existed with the Banque de France and BIS intervention for an overnight facility did not require formal consultation of its Board of Directors;
- the Banque de France would not be bound by any conclusion the experts might arrive at on the possibility of a centralised system and would introduce its facility if it met the requirements of French banks.

The following alternative solution should be examined. The BIS would be asked to monitor the different national systems, i.e. those of the Bank of England and the Banque de France and those of other central banks, such as the Banca d'Italia and the Banque Nationale de Belgique, if they wished to put forward their own schemes. The BIS could monitor the facilities managed by the central banks and would report to the Committee of Governors on the way in which those facilities operated and the impact the admission of a growing number of banks to the clearing system could have on the different national systems. In time, it might be examined whether the BIS should perhaps do more than simply monitor the systems. At the same time it was necessary not to lose too much time on this matter and not to centralise excessively.

Mr. Duisenberg disagreed with Mr. de Larosière; he felt that the provision of overnight liquidity was an integral part of the agreement concluded whereby the clearing was operated by the BIS. Given that there was no urgency, it was not absolutely necessary to decide today; an effort should, however, be made to reach agreement, there having appeared to be a consensus, with one Governor dissenting, in favour of the BIS.

Mr. de Larosière said that he would like the solution of monitoring by the BIS to be studied and presented for April.

Mr. Jaans raised the question of competition between the central banks offering a liquidity facility and pointed out that the general consensus was that the conditions governing the facilities should be such as to discourage the clearing banks from using them and, on the contrary, to encourage them to settle their liquidity problems among themselves.

Mr. Rey confirmed that in the Alternates' view the terms and conditions governing the facilities should be defined in such a way that the banks would use them only very rarely, in fact solely in the event of a very pressing need.

The Chairman concluded the discussion by stating that this matter of the liquidity facility was an important one and that the Governors would decide in April.

VIII. Other matters falling within the competence of the Committee

There were no other matters.

IX. Date and place of the next meeting

The Committee's next meeting would be held in Basle on Tuesday, 10th April 1990 at 9.30 a.m.