

COMMITTEE OF GOVERNORS OF THE CENTRAL BANKS
OF THE MEMBER STATES
OF THE EUROPEAN ECONOMIC COMMUNITY

SECRETARIAT

Basle, 7th January 1991

Monsieur Jacques de Larosière
Gouverneur de la Banque de France
Boîte Postale 140-01
F-75049 Paris Cedex 01

Dear Mr. Governor,

In response to the remarks and questions raised by the Banque de France with respect to the note on "Policy dilemmas in the exchange rate mechanism in 1991", please find attached some brief comments and data relevant to the points made by the Banque de France staff.

With kind regards,

Yours sincerely,
Günther Ban

Enclosure

Responses to French Comments on the Policy Dilemmas note

Question 1:

Cyclical divergence

Whilst the Banque de France is correct in pointing out that on the basis of Graph 4 that the forecast change in German GNP growth between 1990 and 1991 is similar to other countries, they do not take account of:

- (a) The levels of growth - German growth is above all other ERM members in 1991 (bar Luxembourg) and remains much higher than in the low growth economies (such as the United Kingdom and Denmark), thereby accentuating the cyclical divergence.
- (b) The estimate for German growth in 1991 is regarded as a minimum (the attached updated table from the MPSC Report update said 3% or >), whilst the figure for Italy, for example, is viewed as a maximum (2.7% or <).
- (c) There are signs in some countries (outside Germany) that activity may be cooling more rapidly than earlier expected, suggesting that forecasts contained in the MPSC Report may be on the optimistic side. In contrast, the very strong growth in Germany in the third quarter has led to an upward adjustment to the 1990 forecast (the Economics Ministry are projecting 4.5% compared to 4% in the MPSC Report).

Question 2:

Demand pressures in Germany

External demand for German goods is weakening as the Banque de France suggest. For example in the third quarter of 1990 figures for the volume of orders received by the West German manufacturing sector show the following twelve-month growth rates:

| <u>Domestic Orders</u> | <u>Export orders</u> | <u>Total orders</u> |
|------------------------|----------------------|---------------------|
| 12.5% | -1% | 7.5% |

Internal demand remains very buoyant, as instanced by the domestic orders data shown above. Further evidence comes from retail turnover data which in volume terms were around 11% higher in Q3 1990 than

in Q3 1989 (although this partly reflects the surge following monetary unification in July).

Maintenance of low inflation in Germany has been aided by the relative weakness of import prices as the Banque de France suggest, although the oil price hike in the third quarter diminishes the force of the point somewhat. Latest figures are:

| | <u>Cost of living index (W.Germany)</u> | | <u>Import prices</u> |
|---------------|---|---|--|
| | <u>Total</u> | <u>(excluding fuel and heating oil)</u> | |
| November 1990 | 3.0 | 2.7 | +0.8 (c.f. 12 months to June 1990 -5.4%) |
| December 1990 | 2.7 | | |

National accounts data:

| | <u>GNP deflator</u> | <u>Imports of goods and services (deflator)</u> | <u>Consumer spending deflator</u> |
|---------|---------------------|---|-----------------------------------|
| 1990 Q3 | +3.7% | -1.5% | +2.9 |

Capacity utilisation and investment:

Capacity utilisation remains high in West Germany. The latest IFO Survey puts capacity utilisation in manufacturing at 89.6% (for 1990 Q3). This is similar to the levels of the previous twelve months, and recent figures for utilisation rates are the highest since 1970. The December 1990 IFO Survey states that "In the light of the high order reserves and the basically positive expectations, the production capacities of West German industry appear to be not large enough during the coming twelve months". Investment remains strong. Latest national accounts figures for the growth in the volume of machinery and equipment investment are:

| | <u>% change from previous year</u> | | | |
|--|------------------------------------|-------------|-------------|--------------------------------|
| | <u>1987</u> | <u>1988</u> | <u>1989</u> | <u>1990 (first 3 quarters)</u> |
| | +5.6 | +7.5 | +9.7 | +13.4 |

Question3

Yield curve:

A full analysis of developments in the yield curve and the information contained therein, is very difficult. For example, it would require a detailed examination of international developments (US, Eastern Europe and the Gulf) and any associated changes in risk premia.

Following the sharp rise in German government bond yields in the autumn of 1989 and spring of 1990 (from around 7% to around 9% - see attached chart) - capital market yields have remained around the 9% level subsequently, whilst short-term rates have drifted upwards. The yield curve has consequently flattened. As bond yields have been relatively static, it is hard to argue that the flattening of the curve reflects a decline in inflation expectations over this period - a neutral interpretation might be that the rise in short-term rates has succeeded in avoiding a deterioration in inflation expectations in Germany.

Wages

Latest earnings data for the whole West German economy (Q3 1990) show a twelve month increase of just under 6% (up from just under 4% a year before). In the production sector (including construction), the rise in the year to the third quarter was 6.2% (again from just below 4% a year earlier). The Bundesbank is concerned about wage claims, which Governor Pöhl noted in the last Governor's meeting were reaching 10% in some industries.

Question 4

The figures show steady consolidation of the French fiscal deficit since 1985. The German figures are shown alongside:

Net borrowing requirement of general government on a cash basis (% of GDP)

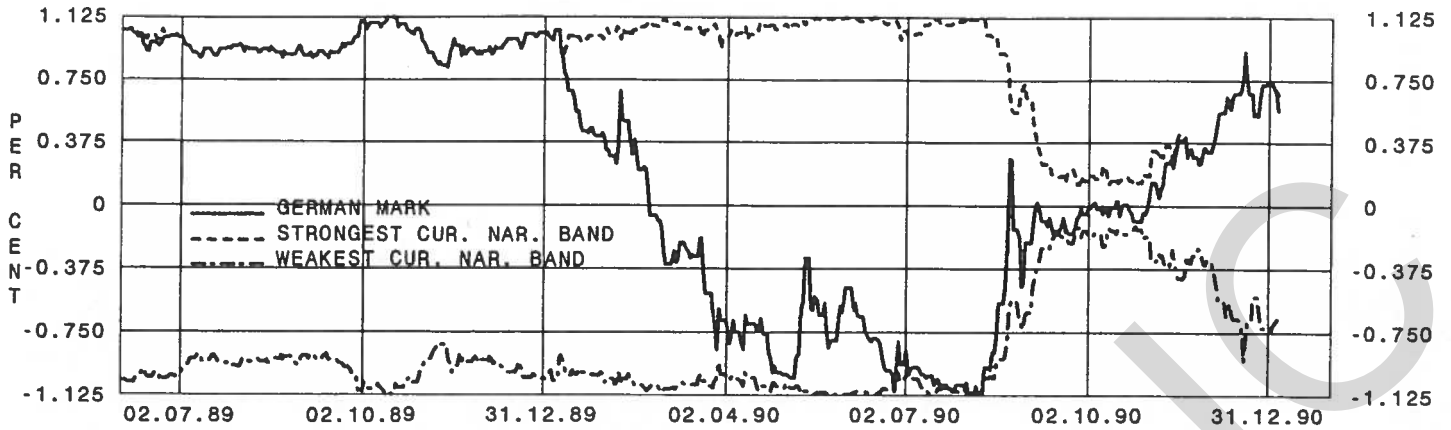
| | France | Germany |
|-----------------|--------|---------|
| 1985 | 2.9 | 2.3 |
| 1986 | 2.7 | 2.1 |
| 1987 | 2.0 | 2.4 |
| 1988 | 1.4 | 2.6 |
| 1989 | 1.4 | 1.2 |
| 1990 (forecast) | 1.5 | 4.0 |
| 1991 (forecast) | 1.5 | 5.0* |

*Assuming a deficit of DM 150 billion.

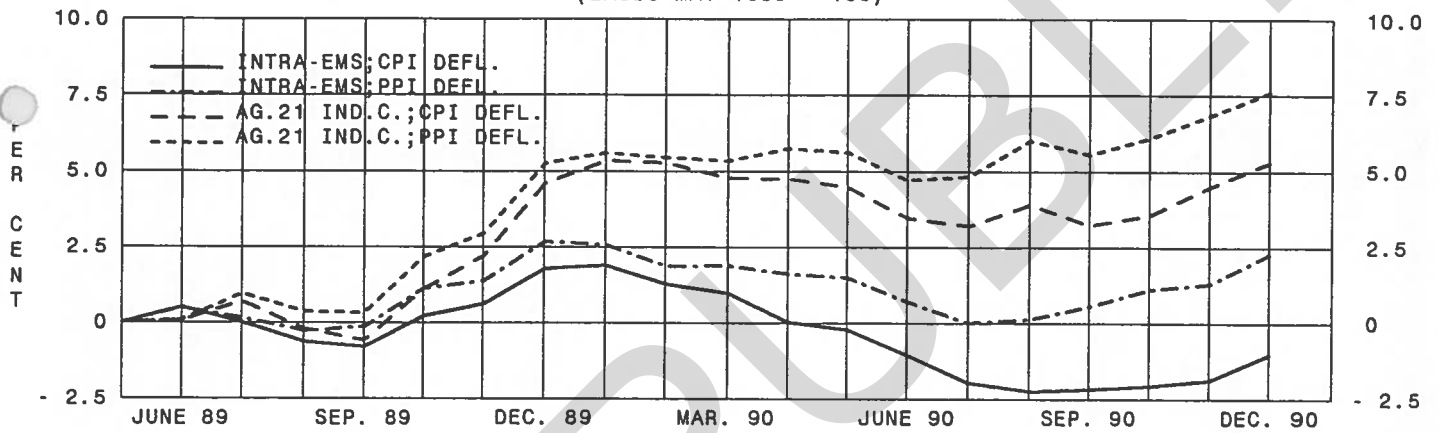
Source: Monetary Policy Sub-Committee Report No.1 Table 4.

GERMANY

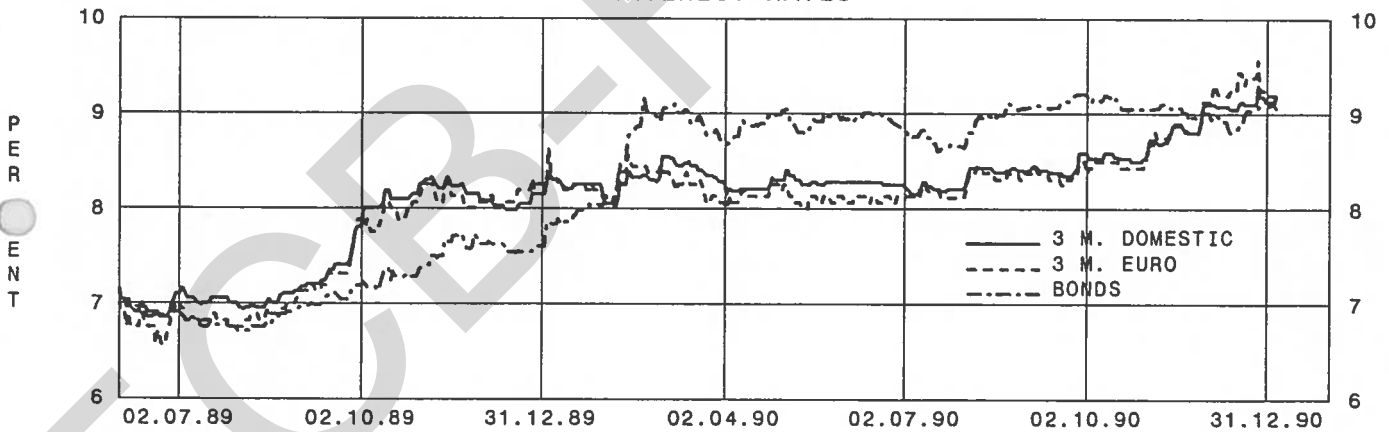
POSITION IN THE EMS BAND



REAL EFFECTIVE EXCHANGE RATES
(BASIS MAY 1989 = 100)



INTEREST RATES



INTEREST RATES DIFFERENTIALS : DEM - EMS

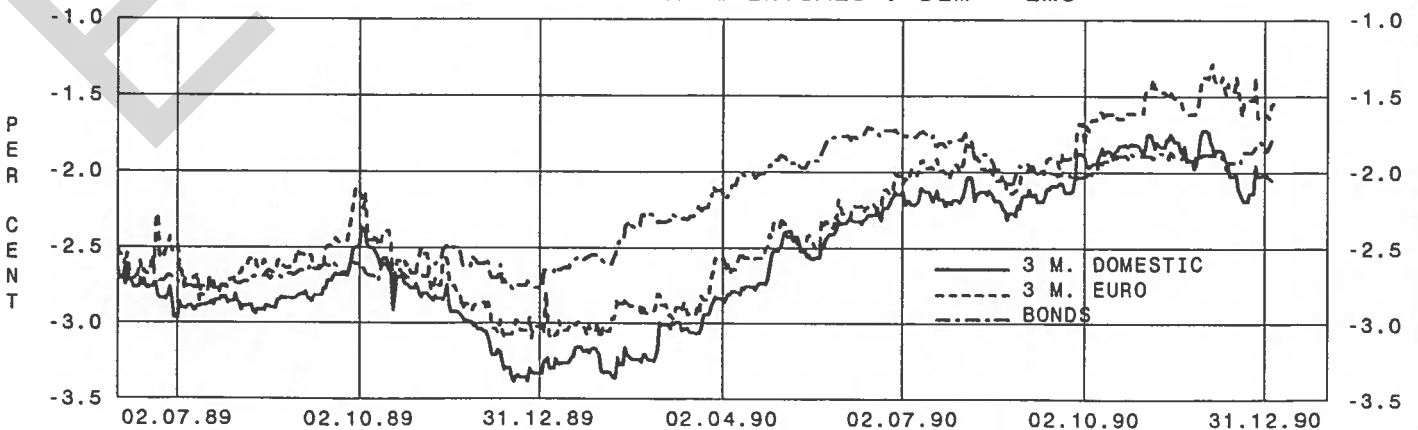


TABLE 3: INDICATORS FOR THE EX-ANTE EXERCISE 3rd December 1990

| Countries | Oil price in 1991 (\$ p.b.) | Consumer price inflation (in percentages) 1989 | Consumer price inflation (in percentages) 1990 | Consumer price inflation (in percentages) 1991 | GDP growth 1989 | GDP growth 1990 | GDP growth 1991 | Current account (in percentages of GDP) 1989 | Current account (in percentages of GDP) 1990 | Current account (in percentages of GDP) 1991 | Fiscal policy (in percentages of GGBR/GDP) 1989 | Fiscal policy (in percentages of GGBR/GDP) 1990 | Fiscal policy (in percentages of GGBR/GDP) 1991 | Intermediate monetary objective for 1991 |
|-------------------|-----------------------------|--|--|--|-----------------|-----------------|-----------------|--|--|--|---|---|---|---|
| Belgium | 25-30 | 3.1 | 3.4 | 4.0 | 4.0 | 3.6 | 2.0 | | | | 6.8 | 6.4 | 6.1 | Exchange rate |
| Luxembourg | 25-30 | 3.4 | 3.5 | 3.8 | 4.0 | 3.5 | 3.5 | 1.8 | 1.0 | 0.8-1.0 | | | | Exchange rate |
| Denmark | 30.0 | 4.8 | 3.0 | 3.8 | 1.3 | 0.8 | 1.0 | -1.3 | -0.5 | -0.3 | 2.3 | 1.8 | 2.9 | Exchange rate/ Krone M2 4-7% |
| Germany | 25-30 | 3.2 | 2.5 | 4.0 | 3.3 | 4.0 | 3.0 | 4.7 | (b) | (b) | 1.2 | 4.0 | | Under review (M3 for whole of Germany?) |
| Spain | 25.0 | 6.8 | 6.7 | 5.6 | 5.0 | 3.5 | 2.9 | -2.9 | -3.5 | -3.9 | 2.6 | 2.9 | 2.0 | ALP+CP 7.5-9.5% (ALP 8-12%) |
| France | 25-30 | 3.6 | 3.5 | 3.5 | 3.7 | 2.7 | 2.7 | -0.4 | -0.6 | -0.8 | 1.4 | 1.5 | 1.5 | M3(including short-term UCITS) |
| Ireland | 30.0 | 4.0 | 3.5 | 3.5 | 5.9 | 5.0 | 2.3 | 1.6 | 2.3 | 1.0 | 2.0 | 1.8 | | Exchange rate |
| Italy | 22-26 | 6.3 | 6.0 | 5.0 | 3.2 | 2.9 | 2.7 | -1.2 | -0.8 | -0.9 | 11.1 | 10.7 | 9.3 | M2: 5-8% PSCE: 10% |
| Netherlands | 20.5 | 1.1 | 2.3 | 2.5 | 4.0 | 3.3 | 2.5 | 3.6 | 3.3 | 3.8 | 5.3 | 5.1 | 4.6 | Exchange rate/ Net money creation by banks (6%)(or 4% in terms of M2) |
| Greece | 28.0 | 13.7 | 20.7 | 19.3 | 2.9 | 1.2 | 1.4 | -4.7 | -5.0 | (m) | 17.1 | 17.5 | (m) | M3 - 14-16% |
| Portugal | 25.0 | 12.6 | 13.3 | 9.5 | 5.4 | 4.0 | 3.5 | 0 | -0.9 | -2.1 | 5.6 | 6.3 | 5.5 | PSCE around 14% L-: 12% (preliminary) |
| U.K. | >25.0 | 7.6 | 10.3 | 5.5 | 2.2 | 1.0 | 0.5 | -3.7 | -2.8 | -1.8 | -1.3 | -0.5 | | Under review Likely to be MO (0-4%) |
| EC (weighted av.) | | 5.3 | 5.7 | 4.8 | 3.4 | 2.8 | 2.3 | | | | | | | |
| (unweighted av.) | | 5.9 | 6.6 | 5.8 | 3.7 | 3.0 | 2.3 | | | | | | | |

(a) Indirect Tax reduction knocked 0.5% off Danish Inflation in 1990.

(b) Estimates for the current account surplus/GDP ratio for the whole of Germany vary considerably. OECD: 3.5% in 1990 and 3% in 1991. Five Institutes: 2.5% in 1990 & 0.5% in 1991 (implausibly low)

(c) Private sector forecast of Five Institutes (October 1990) Figures are for the FRG.

(d) As % of FRG (GDP)

(f) Or larger deficit (up to 0.7% points of GDP higher)

(g) If oil price is \$30 per barrel in 1991, CPI inflation in the Netherlands would be 3%, GDP growth 1.2%.

(h) Monetary target likely to be set with this goal in mind.

(j) Assumed to fall back to around \$25 per barrel by end 1991.

(k) Twelve months to the fourth quarter. Excluding the housing component U.K. inflation figures are 1989 5.5%, 1990 8.3%, 1991 5.3%.

(l) Debt repayment likely to continue - but may undershoot the target in 1990/91.

(m) CPI inflation in Greece is expected to fall from 23% at end 1990 to 17% at end 1991, with an improvement in the current deficit to around 4% of GDP. A 5 percentage point cut in the PSBR/GDP ratio is expected in 1991.

(n) Data for BLEU

Remarques sur la note de l'Unité Economique du Comité des Gouverneurs intitulée :
"Policy Dilemmas in the Exchange Rate Mechanism in 1991"

1) Si l'on se réfère aux statistiques annexées au document, et compte tenu des difficultés à appréhender exactement les évolutions d'une année sur l'autre, notamment pour l'ensemble de l'Allemagne, le graphique 4 ne fait pas apparaître de divergence cyclique nette des taux de croissance européens : mis à part les cas du Danemark et du Luxembourg, les autres pays de la CEE et spécialement l'Allemagne semblent se caractériser par des taux de croissance en baisse.

2) Quels sont les éléments qui expliquent, à l'heure actuelle, la forte pression de la demande en Allemagne ?

- La demande externe, dont l'importance est significative pour la RFA, faiblit actuellement, comme l'a récemment indiqué le rapport des Instituts de Conjoncture allemands.
- Quel est le rythme réel de la progression de la demande interne pour l'ensemble de l'Allemagne début 1991 ?
- L'importance des pressions qu'engendre une forte demande doit s'évaluer en relation avec les tensions sur les prix et les capacités de production qu'elles créent, or :
 - * les prix allemands sont demeurés stables sur la période récente, alors même que la croissance en RFA était forte et que le déficit budgétaire augmentait ; Même si le prix du PNB a augmenté plus rapidement que d'ordinaire, les prix à la consommation sont restés stables du fait de la baisse des prix à l'import ;
 - * compte tenu des investissements réalisés ces deux dernières années, dans quelle mesure les capacités de production en Allemagne peuvent-elles répondre à l'augmentation de la demande ?

3) Il serait utile d'analyser les anticipations des marchés en matière d'inflation, notamment :

- prendre en compte l'évolution de la courbe des taux en Allemagne ;
- vérifier si les demandes d'augmentation salariales actuellement enregistrées en RFA sont exceptionnelles et si les hausses de salaire du bâtiment se transmettent effectivement aux autres secteurs. L'an dernier, des craintes semblables avaient été exprimées : quels effets de transmission ont été constatés ? En quoi la situation début 1991 est-elle plus grave ?

4) L'étude de l'Unité Economique ne signale pas que l'élargissement du déficit public français, qui aurait comme but d'accompagner une politique budgétaire allemande exagérément laxiste, ne serait pas acceptable et marquerait un recul de la progression vers une Union Economique et Monétaire aux finances publiques équilibrées. En effet, compte tenu de la permanence d'un déficit extérieur en France, il serait tout à fait contre indiqué de stimuler la demande interne par la voie du déficit budgétaire.

5) Ne pourrait-on envisager la possibilité de recourir à des interventions sur les marchés de change, dans le cas où des tensions temporaires se manifesteraient au sein du SME sans pour autant remettre en cause l'orientation stricte de la politique monétaire ? Si le déficit budgétaire allemand devait se résorber rapidement, des interventions stérilisées ne pourraient-elles permettre de contenir des pressions essentiellement spéculatives ?