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MINUTES *

OF THE 245th MEETING OF THE COMMITTEE OF GOVERNORS

OF THE CENTRAL BANKS OF THE MEMBER STATES

OF THE EUROPEAN ECONOMIC COMMUNITY

HELD IN BASLE ON TUESDAY, 15th MAY 1990 AT 10.15 a.m.

Those present at the meeting were: the President of the Deutsche Bundesbank and Chairman of the Committee, Mr. Pöhl, accompanied by 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. Papademos and Mr. Karamouzis; 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 and Mr. Reynolds; the Governor of the Banca d'Italia, Mr. Ciampi, accompanied by Mr. Dini and Mr. Santini; the Director General of the Luxembourg Monetary Institute, Mr. Jaans; 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. Borges and Mr. Amorim; the Governor of the Bank of England, Mr. Leigh-Pemberton, accompanied by Mr. Crockett; the President of the Commission of the European Communities, Mr. Delors, accompanied by Mr. Pons. 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.

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* Final text approved at the meeting on 11th June 1990, which incorporates some drafting changes.

I. Approval of the minutes of the 243rd and 244th meetings

The Committee approved the minutes of the 243rd meeting on the understanding that the editorial amendments suggested would be incorporated in the final text. Approval of the draft minutes of the 244th meeting had been held over until the next meeting.

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

Mr. Dalgaard's statement is summarised very briefly below, with the focus on his commentary on the dollar and the Deutsche Mark.

Developments in the foreign exchange markets since the April meeting fell into two distinct periods: in April and the first week of May the previous trends had continued, whereas some important changes had been observed subsequently. Recently, for example, the dollar had weakened appreciably against the Deutsche Mark and the yen.

It was worth noting that, despite erratic movements, the dollar had been basically weak in relation to the Deutsche Mark for a year, falling from about DM 2 to 1.63-1.64, i.e. by about 18%. In fact, except for a brief period towards the end of 1987/beginning of 1988, the dollar was now at its weakest level ever.

The relationship between the dollar and the yen had developed quite differently: the US currency had continued to appreciate until early May, when it fell back, although to a level which remained very firm. In fact, the yen's real effective exchange rate had fallen by around 30% since early 1988. The yen had depreciated in particular against the Deutsche Mark, against which it now stood at its lowest level since 1983.

The development of the dollar was attributable mainly to the fact that there was now much less market expectation of a decline in US interest rates.

On the whole the experts had considered that the present dollar/DM rate was acceptable; however, prospects for the dollar remained uncertain: it might continue to weaken but might also recover if the present budget discussions failed to lead to a substantial reduction in the US deficit and the next set of figures pointed to stronger growth of the US economy.

As usual, the experts had felt that, even after the recent slight appreciation, the level of the yen was clearly too weak but that there was nothing that Europe could do about it.

Within the EMS, in April and early May the previous trends had persisted, i.e. the Italian lira had remained near the top of the narrow band, with all the other currencies close to the bottom; there had in fact been a further slight weakening of the Deutsche Mark, principally in connection with capital outflows (DM 35 billion in the first quarter of 1990, compared with a DM 15 billion inflow in the fourth quarter of 1989).

In the past week the Deutsche Mark had strengthened sharply, together with the Dutch guilder, and the French franc had weakened, almost reaching its lower limit against the lira.

Developments within the EMS in the near future would depend in particular on market sentiment regarding the Deutsche Mark. Should the Deutsche Mark weaken again, the other central banks would be ready to intervene and perhaps to lower their interest rates. It was, however, not to be ruled out that the German currency would remain firm or strengthen further. Such a development would be welcomed by the Deutsche Bundesbank, but if it became too pronounced the other central banks would have to respond with intervention, changes in interest rates and/or exchange rate movements. Intervention could be most useful and effective if it could be carried out quickly, which implied a swift response on the part of the central bank of issue of the currency used. With regard to interest rates, it seemed unlikely that, in the present circumstances, the Bundesbank would feel able to lower interest rates significantly, which meant that the other central banks would have to raise their interest rates in order to increase the differentials vis-à-vis the Deutsche Mark. If the German currency were to rise to the top of the band, there could be speculation about a realignment.

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

The Alternates' discussions had been characterised by the feeling that for many countries and currencies the situation had so far been by and large satisfactory but that uncertainties and imbalances clearly remained in certain countries.

1. The Alternates had welcomed the complete removal of exchange controls in Italy. The Italian Alternate regretted, however, that this measure could not take place in the context of a greater degree of harmonisation of taxation of income on savings. As far as the forthcoming budget package was concerned, the cash effect would amount to 0.7% of GDP and thus bring the budget almost back into line with the targeted outcome for the current fiscal year.

2. The Greek Alternate had outlined the main features of the adjustment programme announced by the newly elected authorities, as well as the first set of measures that had been adopted. The fiscal measures would result in a reduction in the budget deficit of 4% of GDP for the first year, obtained both through an increase in taxes - which would initially boost the inflation figures - and through expenditure savings.

3. The German Alternate had noted that, after the signing of the intra-German Treaty, attention had shifted from the conversion rate to the budgetary implications of the agreement and to the risks of higher unemployment in the GDR. There were no grounds for pessimism, however, given the Federal Republic's excellent position in terms of price stability, budget balance and external payments.

4. The recent weakening of the French franc, following a period of remarkable strength, was linked to the firming of the Deutsche Mark and to specific domestic political events. The French authorities had handled the situation flexibly, combining a movement of the currency within the fluctuation band with a moderate amount of intervention.

5. The UK Alternate had noted that, after the complete removal of exchange restrictions in Italy, the conditions for sterling's participation in the exchange rate mechanism relied entirely on reducing the inflation rate in the United Kingdom. As had already been explained, the latest rise in retail prices, which had brought the annual figure to 9.4%, was not quite as bad as it looked. The annual rate was unlikely to fall over the next two or three months - indeed it might reach 10% - but a sharp decline was expected to take place after the middle of the summer.

6. In the rest of the world, the fall of the dollar had brought it to a level which was considered appropriate, but some Alternates saw a downside risk in present circumstances. Although the yen was at its weakest level against the Deutsche Mark, its recovery against the dollar could mark the end of the downward slide. This positive correction had been interpreted

by some as a delayed effect of the G-7 deliberations at the beginning of April.

C. Discussion by the Committee

Mr. Ciampi noted that long-term capital movements had already been liberalised completely since the autumn of 1988 and that since then, capital inflows, attracted by exchange rate stability and high interest rates, had more than offset outflows. It was regrettable that it had not been possible to reach agreement in the Community on harmonising the tax treatment of income on financial assets, and this might in due course have repercussions on market stability. The lira's present strength was helping in the fight against inflation; following liberalisation this strength should be confirmed in time as the full impact of market participants' responses is felt. The Banca d'Italia did not intend to change its policy before general economic, and in particular budgetary, policy had been tightened. A package of fiscal measures should be adopted by the end of May and would make it possible to correct the overshooting of the deficit target; this was a prerequisite for action by the Banca d'Italia.

Mr. Chalikias said that pressure on the drachma, which had been increasing for some months, had eased considerably at the end of April, after the Government's economic programme had been launched and certain measures had been adopted. The programme involved primarily fiscal consolidation, aimed at eliminating the primary deficit in 1993, and structural adjustment measures to improve market efficiency and competitiveness. The budget deficit should be cut within a year, by about 4% of GDP, 2.5% of which would result from increases in VAT, indirect taxes and public utility prices and 1.5% from changes in the system of wage indexation in the public sector and from reductions in subsidies. The Government was also considering privatisation of some state-controlled enterprises; it had been decided to abolish wage indexation in 1991 and, in the meantime, to reduce the effects of higher taxes and prices on wages. Monetary policy would of course remain restrictive and contribute to this anti-inflationary process.

The Chairman presented some data on recent developments in Germany. The Treaty on economic and monetary union had just been concluded and would have to be ratified by the two parliaments in the Federal Republic and the GDR, probably by the end of May. Difficulties might arise, particularly in the GDR, where the Government was a coalition, but as this Treaty could not be changed (it was a question of either take it or leave it) it was likely to be ratified. Monetary union would therefore commence on 2nd July, and the main problem did not appear to be inflation; the additional demand was likely to be moderate and could probably be met by the Federal Republic and the rest of the world. The addition to the money supply - which would be around 10% - should more or less correspond to the GDR's GDP. It was impossible to forecast exactly how GDR residents would allocate their disposable income between consumption and saving.

A major problem was the competitiveness of the GDR economy, both agriculture and industry, which was at present very weak. The changes could be brutal and lead to social and political unrest, but this might only be temporary. The fiscal question also seemed to be a major problem. The additional transfers of public funds from the Federal Republic to cover the budget deficit of the GDR, whose revenue and borrowing capacity were low, could amount, very roughly, to around DM 50 billion over the next two years. The amount would depend on the size of private capital transfers, which in turn would depend on the propensity to invest in the GDR. At all events, of this 50 billion, about 10 billion could be saved by cutting certain expenditure in the Federal Republic, 10 to 15 billion could come from the increase in revenue resulting from vigorous economic expansion, and the balance of 20 to 30 billion would have to be financed by borrowing. Such an amount was quite manageable without resorting to the Japanese market, as some newspapers had suggested, which in any case would be ridiculous for a country with a sizable surplus, whose capital market was large and could perfectly well absorb demand of that order of magnitude. The question that arose was the effect on interest rates and, in this connection, the rumours spread by the press were damaging. The market, however, appeared to have already largely discounted the expected increase in the demand for capital (after all, since the discussions had started in October 1989, interest rates had risen by about 2%), so that interest rates might remain fairly stable. The high interest rates in the Federal Republic were helping to stabilise the Deutsche Mark exchange rate, but the German currency continued to be weak within the EMS. In the face of this weakness intervention could only be temporary solution, while an increase in interest rates, which were already very high, particularly in real terms, did not appear to be desirable. It was to be hoped that this would not be necessary or, alternatively, that interest rates would be lowered in other countries, but they too had domestic problems, not least inflation.

Mr. Duisenberg observed that the weakness of the Deutsche Mark had enabled De Nederlandsche Bank to gradually lower its interest rates in six stages over the last two months; he wondered whether the results of the recent state elections in the Federal Republic were not going to affect the ratification of the German Treaty by the Bundesrat.

The Chairman stated that ratification by the Bundesrat was scheduled for 22nd June and he thought that the Social Democratic Party (SPD), which now had a majority in the upper house, would not vote against it; the unification process might even be accelerated. However, these uncertainties and the possibility of social unrest might have an effect on the Deutsche Mark exchange rate.

Mr. de Larosière noted that the situation in Germany highlighted more than ever the importance of the EMS. The system could now be managed in a global, coherent manner. Countries such as France and the Netherlands had been able to lower interest rates and it was to be hoped that Italy would do likewise as soon as possible. This more collective management of the EMS had helped the Bundesbank and made it possible to avoid undesirable changes in German interest rates or in exchange rates. Such flexibility in interest rate and intervention policy was a very positive development in the EMS and it should be pursued with discretion.

The Chairman shared Mr. de Larosière's opinion and added that this flexible and effective management of the EMS had certainly changed the German attitude to the system. Nevertheless, it was necessary to avoid giving the impression that the Deutsche Mark was becoming weak. So far the EMS had benefited from the weakness of the dollar, but the dollar/DM parity remained crucial and if the Deutsche Mark depreciated against the dollar the Bundesbank might be compelled to respond.

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 April and the first few days of May 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.

IV. Exchange of views on the legal foundations of a European Central Bank System (ECBS) on the basis of the list of questions prepared by the Chairman

The Chairman suggested that the meeting concentrate on procedure and see whether the Governors felt that the list of questions he had distributed was useful as a starting point; he mentioned that the previous day he had received a note from the Commission.

Mr. Delors explained that the note in question (which was distributed at the meeting) was intended as a contribution to the discussion on the institutional aspects of Economic and Monetary Union and that he had wanted to submit it to the Governors before it was discussed by the Commission the following day, 16th May. In accordance with the mandate given by the European Council, this paper had been prepared for the Foreign Ministers, who were due to discuss it the following weekend; it was less comprehensive than Mr. Pöhl's questionnaire and intentionally did not cover points such as the European central bank's capital, its balance sheet or where it was to be sited. The note dealt with the final stage of EMU and was based on the Council's opinion that a monetary institution must be created - the European Central Bank System - while on the economic side the institutions, namely the Council of Finance Ministers, the Commission and the European Parliament, would remain unchanged. If a second Inter-governmental Conference was convened by the European Council it could lead to changes in the relations between the principal Community institutions, and this would affect the course of work on EMU. In addition, the Commission paper took account of the major differences of opinion that existed regarding the degree of budgetary constraint that should be imposed on countries in parallel with the monetary constraints and confined itself to recording the consensus on two rules, namely no monetary financing of budget deficits and no bailing out or unconditional Community guarantee.

With regard to monetary union, two problems arose. The first related to the decision-making process within Eurofed; the paper proposed weighted voting analogous to that practised within the Community. Some favoured the principle of "one man, one vote", and the Commission would appreciate the Governors' reactions on this point. It was also proposed that the Board should vote with a single, weighted vote, in order to compel it to remain united and not become divided. The second, more difficult question related to reconciling Eurofed independence with democratic control. The European Parliament wished to exercise such control but this seemed unacceptable and the Commission proposed that it should provide the "scapegoat" or "fuse" as it were; if the European Parliament disagreed with the policy being followed by Eurofed, it could table a motion censuring the Commission, as at present. Lastly, it was proposed that external monetary policy should be decided jointly by the Finance Ministers and the Governors.

The Governors' reactions to this paper would be useful for the Commission in the work that lay ahead of it. The European Council meeting to be held at the end of June was to decide whether preparations for the Inter-governmental Conference were full and adequate, and so there was a certain urgency about the work, particularly on the difficult issues where views diverged. Of course the contentious questions could be dealt with by the Conference but, since some of these questions were regarded as vital by the Governors, it was in their interest to settle them as far as possible before the start of the Conference.

The Chairman pointed out that the large number of documents and volume of work involved gave rise to some confusion. The Governors should concentrate today on the kind of contribution they wished to make to the Inter-governmental Conference; they could hardly give replies to the questions raised by the Commission and, besides, they had already done so within the "Delors Committee", whose report was still the basis for the Treaty that was the subject of the Conference. Indeed, the Governors should prepare for the Conference a legal text which would have to clarify a whole range of questions, such as the role of the national central banks and the issuing of ecus, and which should be ready before the Conference started.

Mr. de Larosière was also of the opinion that, as they had already decided, the Governors should concentrate on drafting the statutes of the European central bank. The questionnaire drawn up by the Chairman was wholly appropriate, and the work must now be speeded up. At this stage, Mr. de Larosière confined himself to a general remark and a procedural proposal.

In the legal texts to be prepared, a distinction needed to be made between the basic principles, which must be included in the Treaty, and the organisational and structural issues, most of which could be dealt with in the accompanying texts. Without claiming to be exhaustive, these principles should be the following:

- the fluctuation margins should eventually be abolished, i.e. parities should be irrevocably locked;

- there should be a single monetary policy, which would be conducted by the institution to be set up;
- the priority objective was price stability;
- the institution should be independent from both national governments and other Community bodies;
- the payment system should operate smoothly;
- a single currency should ultimately be created;
- there should be no monetary financing of public sector deficits;
- there should be no bailing out.

In addition, the principle of subsidiarity and federalism could also be incorporated in the Treaty. The organisation of the institution's powers should, however, be dealt with in a supplementary agreement, which would have the advantage that it could be amended, if need be, in a more flexible manner than the Treaty, where unanimous agreement was required.

With regard to procedure, the Alternates should meet fairly soon to draw up a preliminary draft of the statutes, taking into consideration the report of the "Delors Committee", the Chairman's questionnaire and the discussions held so far by the Governors; the preliminary draft could be discussed by the Governors before the summer.

Mr. Leigh-Pemberton observed that all the questions contained in the Chairman's list were important but some required particular attention. The procedure suggested by Mr. de Larosière was a good one; the Alternates should start work, possibly assisted by a small group of experts. An initial set of replies could be discussed by the Governors in July and their reactions would enable the Alternates to present a second version in September and, since there was no Committee meeting in October, the Governors could finalise their definitive text in November, i.e. prior to the Inter-governmental Conference which was due to start in December. Such a timetable might appear protracted but it was reasonable and realistic. Certain constitutional matters were particularly complex, and it was quite possible that the Alternates would not be able to reply to all the questions in July, and it was not even certain that the Governors would be able to conclude their work in November, given the complexity of the issues involved. For instance, question I.2. - "Which ECBS regulations are to be laid down in the EEC Treaty and which provisions are to be included in a separate instrument?" - was fundamental. If the substance of the statutes was not incorporated in the Treaty, would a protocol similar to that concerning the European Investment

Bank be the best formula? Or should the statutes be submitted to a Council decision, which would therefore presuppose a Commission proposal.

Question II.1. concerning the structure of the European central bank was also fundamental and it might be asked whether there was general agreement on a structure maintaining the existing national central banks and conferring only the formulation of monetary policy on the central institution.

Mr. Leigh-Pemberton stressed the importance he attached to the principle of subsidiarity for moving forward during what would be a lengthy apprenticeship period. It would be a mistake to include in the Treaty, or even in the statutes, unnecessary operational details or details which might subsequently hamper the operation of the ECBS. It was important that the powers should reflect the functions, that the authority of the ECBS as an independent Community institution should be firmly established and that the system should be able to evolve in line with the changing needs of the Community.

The Chairman agreed that there was a considerable amount of fundamental work to do. However, there was no question of negotiating with a view to achieving agreement on every point, otherwise possibly two years would be needed. It was a matter of formulating the options, with their implications, and presenting them to the governments, which had to negotiate. For instance, a crucial point was whether the governments would be prepared to relinquish their sovereignty in monetary policy in favour of a supranational institution. Mr. Pöhl considered that responsibility for monetary policy was indivisible - he had already said so at a conference in Paris - but some might not take that view and might propose other solutions. The Alternates therefore had to work, perhaps with two or three special meetings between now and July, to present replies that contained certain options. The Governors should consider a one-day meeting in July and then decide the further procedure; it could not be ruled out that one or two special one-day meetings might be necessary, as had been the case for the "Delors Committee".

Replying to a question from Mr. Rubio about when the Governors should complete their document, Mr. Delors said that October seemed appropriate. New initiatives could be taken during the Italian Presidency, and the second Inter-governmental Conference might bring complications and possibly have implications for the independence of Eurofed. The Governors and the Commission should therefore be alert.

Mr. Rubio felt that arrangements should therefore be made to present replies by October. Nevertheless, as Mr. Leigh-Pemberton had pointed out, certain questions were very difficult, however much time was available to address them, the difficulties arising in particular from the existence of widely differing opinions.

The Chairman remarked that it would be relatively easy to formulate replies in the case of the principles referred to by Mr. de Larosière, for instance, but the question of the independence of the ECBS would, along with other matters, raise problems and perhaps lead to several replies.

Mr. Ciampi expressed his agreement with the procedure proposed by the Chairman and hoped that the Alternates would, by July, submit a document which should not be a new report but a draft of the statutes of the ECBS. Such a draft, which was an ambitious undertaking, would undoubtedly have to present options or alternatives on a number of fundamental points. It was important for the Governors to organise themselves in order to meet short deadlines and for them to make it clear what kind of document they were preparing in order to avoid duplication with other bodies, such as the Monetary Committee.

Mr. Doyle expressed his concern about the procedure and the timetable. It was undoubtedly highly desirable that the Governors should present their views by October, i.e. before the Inter-governmental Conference. However, the Conference would bring new ideas and suggestions to which the Governors would have to react and they might also reconsider the views expressed in their initial document. The Governors should therefore state their position by October, it being clearly understood that this would not be their final word on the matter and that they reserved the right to continue their work and make the results known in due course.

The Chairman observed that the Conference which was due to begin at the end of 1990 would perhaps last two years and that, during that period, the Governors would be called upon to put forward contributions.

Mr. Jaans agreed with Mr. Ciampi and said that the Committee must be perfectly clear about the nature of the final product that it intended to present, given the variety of terms used. In fact, the Committee should build on experience with the amendment of the 1964 Decision, which had been a success, i.e. it should prepare legal texts for the ECBS. Such an ambitious approach implied that it should to some extent transform itself into a negotiating group concerned with much more delicate and fundamental subjects than the relatively insignificant revision of the 1964 Decision. The Governors should therefore be prepared for a considerable amount of work, but there was no need to be too concerned about a deadline, since, after all, the Conference would not start until the end of the year and would last for some time.

The Chairman confirmed that he himself was against producing a new report to add to many others. The maximum objective would be to agree on the legal texts of the ECBS statutes; this was very ambitious and would be difficult to achieve by October, given the differences of opinion that existed. The Governors should therefore identify those points on which they agreed - it seemed, for instance, that there was already a broad consensus on the basic principles of the system - and, beyond that, present alternatives in respect of those questions on which they were not unanimous because they were in many cases political. For instance, the Governors might very well not be in agreement on the location of the ECBS but could put forward, as a basis for the political decision, certain arguments such as the importance of its being located in a financial centre, or in a country participating in the exchange rate mechanism. The draft ECBS statutes should not be a lengthy document (the Deutsche Bundesbank had already prepared such a document), but unanimous acceptance by all the Governors was another matter.

Mr. Tavares Moreira was of the opinion that the Governors should concentrate on those points that they felt it necessary to incorporate in the Treaty, i.e. the principles in particular; other, more detailed questions could be discussed at a later stage, although they could already be broached in the course of the debate on principles.

The Chairman remarked that it was not enough to deal with the principles. The Governors should, for example, state their views on the instruments that could be conferred on the ECBS: would the ECBS have competence to fix interest rates and take decisions regarding liquidity, or would those prerogatives be retained by the national central banks? This was not only a principle but also a question of efficiency.

Mr. Rey stated that the Alternates would of course work in accordance with the wishes expressed by the Governors and would endeavour to present a short document; he added that, depending on progress and the difficulties encountered, the Alternates might, on specific points they had identified, call upon the assistance of legal or monetary policy experts. Mr. Rey asked the Alternates to remain in the room for a few minutes at the end of the Committee's meeting in order to agree on the special meetings to be held.

V. Examination of the Special Report on a common framework for the monitoring of monetary policies prepared by the Group of Experts chaired by Mr. Raymond

A. Statement by Mr. Raymond

The work of the Group of Experts had been guided by Governor Hoffmeyer's letter of 28th July 1989, the note on Governor Hoffmeyer's proposal by Mr. Mikkelsen, and various letters or public statements by members of the Committee of Governors.

This mandate had placed a clear emphasis on the need to co-ordinate monetary policies more closely during Stage One of the move towards monetary union and to make this co-ordination visible - tangible - for the public at large and for politicians. A public relations effort was indispensable in order to control the expectations of market operators and to secure credibility for the approach towards a common monetary policy and acceptability of adjustment measures where these proved necessary.

The experts had drawn two conclusions from these considerations.

1. The complex task of drawing the central banks closer together had to be accompanied by the periodic publication of simple illustrative points of reference, be they policy intentions, explicit targets or merely assumptions.
2. What was said and done should appear not as a political compromise but as the expression of a coherent strategy.

Monetary policy only had meaning if it strangled inflation. Thus European co-ordination could not aim only at convergence of inflation rates at any level but should tend to bring inflation rates down towards a common target close to zero. This had been reaffirmed on several occasions since the inception of the EMS.

The experts had therefore based the approach on a set of consumer price increases in the member countries for the year ahead, but clearly as part of a strategy aimed at convergence between zero and 2%, to be achieved over a reasonably brief period by eliminating existing divergences or any which might result from shocks within the European economies or from outside.

These normative price increases could not be dissociated from growth assumptions, and the Governors would wish to examine payments balances and fiscal policy in their countries at the same time.

More particularly, the experts had been called upon to examine whether it would be possible to translate this strategy into intermediate objectives co-ordinated ex ante among the central banks which would be sufficiently meaningful that any deviation would be indicative of future imbalances and therefore justify - in principle, and subject to case-by-case examination - a review of the monetary policy of the country concerned.

A positive reply could not be taken for granted, since wide divergences existed within the Community in structures, experiences, practices and doctrines.

On the negative side, the experts had noted that it was not possible today to construct a single series of aggregates meaningful both for individual countries and, combined, for the Community as a whole. This was chiefly due to the national differences, likely to diminish but still considerable, in monetary and quasi-monetary assets; this heterogeneity reflected the continued existence of marked national particularities in the financing of the economy, legal and fiscal arrangments and types of financial institution and their behaviour. Moreover, the behaviour of banks and the public was not uniform. Finally, certain assets (foreign currency, cross-border holdings) were not measured everywhere.

On the positive side, however, the experts had noted that many countries utilised broad monetary aggregates comprising, in addition to bank-notes, sight accounts at banks (chequing or savings accounts) and certificates of deposit, but excluding Treasury bills in general circulation. The four largest economies in the EMS exchange rate mechanism would be in a position to co-ordinate annual targets for this kind of aggregate, which was already in existence or could be adapted.

The small open EMS economies were not able to control their money stock directly given the major impact of the external counterpart on money stock changes. However, two of them (Denmark and the Netherlands) would set a target for domestic money creation corresponding approximately to a broad money aggregate excluding the change in the external counterpart. Three other countries in this group would not follow this path, namely Belgium, Luxembourg and Ireland. All five would clearly reaffirm the priority they gave to maintaining their exchange rate stable against the four large economies, thus in a sense importing these economies' monetary stance.

Outside the exchange rate mechanism, Greece and Portugal would participate in the exercise on the basis of broad monetary aggregates.

The United Kingdom would not participate in the collective targeting exercise and would continue with current practice.

Where there was a quantitative target, it would be calculated on the basis of the announced inflation rate, the rate of growth objectively consistent with this and, for money, assumed changes in velocity.

This ex ante co-ordination would result in a decision in each country, announced jointly at the end of the calendar year for the year ahead. This would be followed up, four times a year, by a multilateral surveillance exercise to ascertain whether any general correction or a differentiation of monetary policies was necessary. The development of the target variables would be examined in the light of other monetary indicators (domestic counterpart of the money stock, interest rates, exchange market), fundamentals and all other available data. It was suggested that an assessment be made public twice a year.

To show that they had not been thinking in purely abstract terms, the experts had gone so far as to propose an annual communiqué publishing the targets for prices (with a reference to growth) and the intermediate objectives to be announced. The aim was simply to demonstrate to the Governors that such an announcement was feasible; it could of course be carried out differently.

To put the scheme into practice by the end of the year, the content of the aggregates adopted would have to be defined and the ex ante and surveillance procedures laid down. It was recommended that studies be undertaken with a view to tighter co-ordination based on a concept of the money supply and its counterparts that was valid for the Community as a whole and could be broken down by country.

B. Statement by Mr. Rey

The Committee of Alternates had congratulated Mr. Raymond and the Group of Experts on producing an outstanding report; they had recognised the importance of this exercise as well as the challenge which it represented for the central banks and for the Committee of Governors. The general approach of the report had been endorsed by the Alternates, more precisely:

- the overwhelming priority given to the goal of price stability;
- the need to take account initially of the existing diversity in the intermediate objectives used by central banks;
- the need to convey a self-disciplinary message to the public;

- the evolutionary character of the exercise and the usefulness of carrying out further studies with the help of the Economic Unit.

That having been said, the Alternates had expressed reservations on some of the proposals made or had suggested further investigation in some specific areas.

Without being exhaustive, mention could be made, among the analytical issues to be explored further, of the question of the robustness of the assumed stable money demand function in an environment of financial innovation and deregulation, and of the failure of money supply targets to accommodate satisfactorily situations where capital was moving rapidly from one currency to another.

Besides, important policy issues had been raised, such as:

- the consistency of price inflation targets with the statutory objective of price stability, which at least one central bank was entrusted with achieving;
- the risk of conflicting price inflation targets if both central banks and governments set such targets;
- the requirement to spell out the non-monetary data, in particular the budgetary assumptions on which monetary targets indirectly relied.

A range of questions also arose in connection with the proposed publication of a yearly press communiqué. Should the central banks first embark on a non-publicised experimental exercise before exposing their credibility? Assuming that a public message was an integral component of the exercise, could a less ambitious format be devised which would combine the necessary caution and yet a convincing degree of commitment?

With the permission of the Governors, the Alternates would wish to explore these issues further with a view to formulating their conclusions in due time for the July meeting of the Committee. This calendar would in no way hamper the prospect of arriving at a first implementation of the common framework at the end of the year.

Finally, strong resentment had been expressed at the fact that the document prepared by the "Raymond Group" had been leaked to the press. This was a source of great discomfort and irritation, and it was highly unusual for working papers of the Committee of Governors. Although it went without saying that those working papers were confidential, the Secretariat had been requested to add an explicit mention on all such documents that they were confidential and not for publication.

C. Discussion by the Committee

The Chairman endorsed Mr. Rey's remarks on the leak, the source of which would obviously never be known. The central banks had to be very careful not to create expectations that could not be fulfilled; this was not the style of their co-operation. At most, it might be made known that the Governors were working on these subjects, but no details should be given.

Mr. Duisenberg welcomed the proposals of the Special Report for improving monetary policy co-ordination. It was particularly appropriate to introduce ex ante consultations on monetary policies while maintaining national sovereignties for the time being and stressing the final objective of price stability. If such an ex ante exercise was to be meaningful, the central banks should not publish their monetary targets before the Committee of Governors had done so. The announcement of normative price increases was useful for focusing public attention on the need to reduce inflation, but it carried the risk of a loss of credibility if the targets were not met year after year. The experts might perhaps examine whether reference could be made, for example, to an unavoidable rate of inflation or some such concept. As had already been said, for some countries setting targets for monetary aggregates and the exchange rate at the same time posed the occasional risk of a policy dilemma. This risk could be reduced by setting targets not for broad monetary aggregates but for domestic counterparts, which was precisely what Danmarks Nationalbank and De Nederlandsche Bank intended to do.

Finally, it was desirable to be cautious both in the exercise, whose experimental nature should be emphasised, and in the press communiqué, so as not to arouse excessive expectations.

Mr. Leigh-Pemberton thought that the exercise was both very important and extremely sensitive and that, if it succeeded, it would represent the greatest contribution the Governors could make to Stage One of Economic and Monetary Union. To illustrate its sensitivity, it sufficed to point out that in the United Kingdom monetary policy targets and forecasts were published in conjunction with the budget and that the Government was responsible for publication, even if these targets were the result of consultation with the central bank. In these circumstances publication by another source, namely the Committee, would be politically extremely delicate. Moreover, a balance had to be found between the quality of the Governors' discussions and the publicity given to them. To the extent that the strengthening of co-ordination between the central banks was accorded priority, it was absolutely essential to have very frank discussions, which would only be inhibited by publicity.

The new procedures proposed by the experts should be applied on an experimental basis and without giving them a high public profile. It had to be asked, in addition, what effect collective statements by the Governors would have on economic agents at this stage. The draft communiqué proposed in the report was deliberately maximalist. In fact, during Stage One of EMU the setting and publication of targets would remain clearly within the competence of the national authorities, and consequently a communiqué by the Committee could only be very general, without figures. Moreover, recent UK experience of the variable and uncertain relationship between monetary aggregates and the real economy militated in favour of caution.

As far as the United Kingdom was concerned, the most productive course would be to undertake the ex ante exercise within the Committee without any publicity; the Governor of the Bank of England could then submit to his Government the concerted views of the Governors, in particular on what the United Kingdom should do. A discreet procedure of this kind would have far more influence than a public exercise that would appear to be an infringement of national sovereignty.

The Chairman noted that, in his capacity as President of the Deutsche Bundesbank, he to some extent endorsed Mr. Leigh-Pemberton's comments and concerns. A press communiqué should never contain normative price increases; this would give the impression that a certain rate of inflation was being aimed at, whereas the objective was in fact to reduce it. It was perhaps essentially a question of presentation. For example, when the Bundesbank published its monetary targets, it explained that they had been calculated taking account of the potential growth rate (or assumed real growth) and the unavoidable inflation rate. This latter concept had been abandoned as being too defeatist, and reference was now made to real growth and nominal growth, which in effect implied a certain rate of inflation.

The object of the exercise was in fact primarily to make monetary policies compatible, especially for the ERM countries. This could be said publicly, but without stating quantified targets. In the Federal Republic it was the Bundesbank's Central Bank Council which set and published these targets; thus any publication by the Committee could only relate to the figures already published by the Bundesbank.

The Committee could nonetheless make it known that it was working towards more compatible monetary policies using monetary or exchange rate objectives. A first exercise of this kind could be carried out towards the end of the year; in the meantime the Economic Unit could, as its first task, undertake work on the questions outstanding and the data to be compiled.

Mr. de Larosière expressed some disappointment at the reservations made concerning the monetary policy co-ordination exercise proposed in the experts' excellent report. The same procedural situation existed in France in that the monetary targets were published at the end of the year following a formal meeting of the National Credit Council and it was therefore difficult to imagine that these national procedures could be preceded by a publication by the Committee. Nonetheless, as the Governors had intended in the 1964 Decision, ex ante co-ordination of monetary policies constituted the most important exercise in Stage One of EMU, and it should not be hindered by such procedural problems. It was thus important to embark on this exercise at the end of this year so that the Governors could then, as some of them had already said, refer in a national context to the Committee's views and to the objectives they had discussed and adopted. On the other hand, it would be wise not to publicise the exercise too soon, as knowledge of exact figures could be damaging, especially in some countries; in this connection the leak concerning the experts' report was very regrettable.

The Chairman noted that there was no disagreement between the various speakers. It was recognised that it was difficult or impossible at this stage to publish quantified targets, but it was proposed that in November there should be, within the Committee, a comparison of the different countries' monetary targets and inflation and growth forecasts with a view to arriving at a concrete set of more compatible objectives. This exercise would be conducted before the national authorities published their targets.

Mr. Leigh-Pemberton said that he had no doubts as to the value of the exercise but wished to make clear the procedure that was likely to make it the most effective.

The Chairman noted that he would be appearing before the European Parliament in Strasbourg in a few hours' time and that, if the Governors had no objections, he would mention diplomatically the work the Committee was conducting on this subject.

Mr. Hoffmeyer said that two questions arose: the diplomatic question of how to approach the exercise and refer to it, and that of the follow-up to be given to the commitments made, whether they were published at national level or jointly. If it were to emerge from the ex post surveillance that some countries had not fulfilled their commitments and certain measures were urged upon them, the Governors concerned would have to say this to their Governments so that the latter could take the necessary action. A process of this kind could only improve convergence.

Mr. de Larosière acknowledged the need to proceed diplomatically, but the exercise should not be held up, and the first such exercise should be carried out for the 1991 targets, whose adoption and publication would obviously still fall to the national authorities. Following this the Committee could prepare a summary document establishing the coherence of the various national targets in a kind of European grid. Such a document could be published, since this would only be after publication at national level.

The important thing was to continue the work in this field and to co-ordinate national methods and procedures. In France, for example, there could be a changeover from M_2 to M_3 to be in particular more in line with the other EMS countries.

Mr. Rubio thought that the Alternates should discuss in detail the organisation of the exercise to be conducted in November and indicate, for example, the date by which each central bank's data and comments should be submitted. Good organisation was necessary for productive discussion, even if publication of the results, this year at least, did not seem advisable.

The Chairman returned to the delicate question of publicity. On the one hand, the Governors had decided to give their Committee and its work a higher and more transparent profile; on the other, they feared that too much publicity would inhibit their discussions or raise excessive expectations.

The Chairman said he would endeavour to strike a reasonable balance in what he said in Strasbourg, and later at the ECOFIN meeting on 11th June, regarding the two major issues currently being addressed by the Governors, namely the European Central Bank System and the ex ante monetary policy co-ordination exercise.

Mr. Delors referred to the leak concerning the experts' report and wished to point out that, following inquiries, he had good reason to believe that the three Commission officials who had been in possession of the report could not be held in suspicion. At all events, the security rules within the Commission would be tightened with respect to both the distribution of the Governors' documents and the circulation of comments on those documents.

VI. Adoption of the Rules of Procedure of the Committee

The Chairman proposed that, in view of the arrangements made by the Governors before the meeting, the adoption of the Committee's Rules of Procedure should be postponed until the next meeting.

VII. Exchange of views on recent developments in public finance and policy implications

A. Statement by Mr. Raymond

Strong economic growth and a tighter fiscal stance in most member countries had brought about a decline in the Community's aggregate general government borrowing requirement as a percentage of GNP in 1989. This decline had been accompanied by an equivalent contraction in public expenditure.

Some of the countries with substantial budgetary imbalances (Ireland, Belgium, the Netherlands and Portugal) had continued their adjustment, in some instances adding structural reforms to the cyclical effects. The two countries with the largest deficits, namely Greece and Italy, had not, however, made any progress. Germany, temporarily, and Spain, as part of a medium-term strategy, had considerably reduced their public sector deficits.

A reduction in the deficits and sustained economic growth had combined to stabilise the public debt/GNP ratio, except in Greece and Italy.

Direct monetary financing, by the central bank or by borrowing abroad, had been insignificant, except in Greece.

The prospects for 1990 varied widely from country to country. The main developments forecast were as follows:

In Greece, an effort would have to be made by the new Government to reverse the unfavourable trend.

In Italy, the authorities aimed to stabilise the public debt/GNP ratio by 1992.

In Portugal, however, after the good results of 1989 the public sector deficit was expected to deteriorate significantly.

In the Netherlands, the new Government wanted to reduce the deficit to less than 3% of GNP in 1994.

Ireland would continue its adjustment, as would Belgium.

In Germany, the outlook was uncertain with, on the one hand, tax cuts, and on the other, cyclical factors that were likely to boost revenues.

For the purposes of the Committee of Governors, two conclusions were to be drawn:

- despite some progress, and because that progress was uneven, there was still a conflict in some countries between budgetary and monetary policy; given the constraints placed on interest rates by the foreign exchange market, this resulted in difficulties in controlling domestic demand;
- in these circumstances, the consistency of budgetary policies in the Community was unsatisfactory.

B. Statement by Mr. Rey

Two specific remarks were called for.

Some Alternates would have liked further details on the impact of German monetary union on the Federal Republic's budgetary policy, but it had been acknowledged that the experts' reports could not be based on uncertain information and that it would be some weeks before the impact could be properly assessed, given that the German Treaty had only just been signed. In this context, it had been stressed that budgetary stringency was desirable on a very general level, in order to confront the reduction in the saving rate, a trend which appeared unlikely to be reversed in the near future.

Secondly, it had been pointed out that the annual review of public finances would be of greater informative value if the document was not confined to analysing the financing of public sector deficits over the past year but also considered recent developments, particularly where direct or indirect financing by the central banks was involved.

Mr. Rey reminded the meeting that in the past the Committee had always drawn its annual review of public finance to the attention of the Finance Ministers. The review, amended where appropriate via the usual written procedure, should be sent to each Minister, with an accompanying letter from the Chairman of the Committee summarising the main conclusions.

The Chairman noted that, in view of the late hour, a detailed examination of the document on public finance was not possible; he proposed that the Committee take note of it and forward it to the Finance Ministers in accordance with the procedure referred to.

VIII. Principles concerning prior agreement on interventions in Community currencies

Mr. Rey pointed out that, pending a satisfactory outcome of the discussion concerning prior agreement on interventions in EEC currencies, it had not yet been possible to formalise 100% intra-Community settlements in official ecus. The Alternates had prepared a draft statement of principles on this subject, which had been adopted after concessions had been made by all the central banks. Unfortunately, it had not been possible to reach unanimous agreement on the text, since a reservation, namely on the part of the Banco de España, appeared on the first page of the statement of principles (footnote 2). It was understood that the contents of this statement had been approved on a basis of confidence, precisely in order to strengthen mutual confidence among the central banks in the field of intervention, and that it should be applied in keeping with this spirit of general confidence.

Given the late hour, Mr. Rubio agreed to the Chairman's suggestion that his statement and the discussion of this question should be postponed until a later meeting and that a bilateral talk should be held in order to find a solution.

Mr. de Larosière emphasised that he was able to agree to the principles contained in the statement prepared by the Alternates, provided that it was understood that a certain amount of flexibility would be needed in the day-to-day application of those principles.

The Chairman shared this opinion but stated that the partners should also understand that the use of a currency in interventions could create problems for the issuing central bank. It was therefore necessary to find a satisfactory solution that took account of the existing rules and agreements and, to that end, a broader discussion could take place at the next meeting.

IX. Other matters falling within the competence of the Committee

1. Participation by the Committee's Chairman in the ECOFIN Council meeting to be held on 11th June 1990

As he had already mentioned, the Chairman said that he was likely to be called upon to participate in the forthcoming ECOFIN Council meeting, given in particular that the half-yearly multilateral surveillance exercise was due to take place at that meeting.

2. Banking Supervisory Sub-Committee

The Chairman said that on 9th May Mr. Quinn, Chairman of the Banking Supervisory Sub-Committee, had sent him a letter (see annex) describing the Sub-Committee's preliminary conclusions concerning the role which a European Central Bank System might play with regard to banking supervision. The contents of the letter did not call for any comment and it was proposed to take note of the letter and of the intention of the "Quinn Sub-Committee" to present a report for the Committee's September meeting.

3. Note from President Delors putting forward some suggestions on possible exchange rate arrangements between the Community and non-member countries

The Chairman said that the note from Mr. Delors was very interesting; he proposed that the "Dalgaard Group" should be given a mandate to study this note with a view to the Governors' discussion at a forthcoming meeting.

4. Improving the transmission of information between EEC central banks

Mr. Rey informed the Committee that the Alternates had examined the report drawn up by a special group of experts chaired by Mr. Bourguignon from the Banque de France on the improvement of non-voice information transmission in the framework of co-operation between EEC central banks. The Alternates had adopted the report's conclusions, which suggested that an electronic mail system be implemented linking the central banks of the Community; they had invited the special group of experts to submit a definitive proposal to the Committee of Alternates for the September meeting.

X. Date and place of next meeting

The Chairman proposed that the Committee should follow the practice that was customary in connection with the BIS Annual General Meeting of holding only a brief meeting; this would therefore take place on Monday, 11th June at 9.30 a.m., i.e. after the meeting of the Board of Directors of the BIS at 9.00 a.m. and before the Annual General Meeting at 11.00 a.m.; the main items on the agenda should be "Monitoring" and the adoption of the concertation report, although other urgent items could also be included.

In reply to a question from Mr. Rubio, who asked whether subjects which it had not been possible to examine today, such as interventions in EEC currencies, would be discussed in June, the Chairman said that the time available would be very limited and that it was therefore likely that this would have to wait until the July meeting, unless agreement was reached in the meantime on the principles governing interventions in Community currencies.

Bank of England
London, EC2R 8AH

Brian Quinn
Executive Director

9 May 1990

Herrn Karl Otto Pohl
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Dear President Pöhl

SUPERVISORY SUB-COMMITTEE

THE ROLE OF THE EUROPEAN CENTRAL BANKING SYSTEM IN BANKING SUPERVISION

Following your request at the March meeting of the Committee of Governors, the Supervisory Sub-Committee recently held a preliminary meeting to exchange views on whether there was a role for a European Central Banking System (ECBS) in banking supervision. The purpose of this letter is to provide you with a brief interim report on the proceedings at this preliminary meeting.

It is the consensus of the members of the Sub-Committee that there is a role for an ECBS in the area of banking supervision. The nature and any development of this role should fully respect the principles of subsidiarity and plurality, described in the Delors Report, to the extent that these principles remain appropriate in the progress towards monetary union. It was felt that the initial responsibilities of an ECBS in the field of banking supervision would rest primarily in the area of Community-wide co-ordination, consultation and policy formulation. By this means, it would seek to maintain stability and promote the soundness and competitiveness of the Community's financial intermediaries. The Committee felt that further analysis was required to determine the precise nature and degree of this involvement beyond the initial stage. It will be necessary to study, inter alia, the relationship of an ECBS with other Community bodies.

It was considered that it would also be necessary to examine the procedures for transferring responsibilities to an ECBS, and in this context the Sub-Committee took the view that there should be provision in a new Treaty for such a transfer.

There will be a further discussion of the subject at the July meeting of the Sub-Committee, with the aim of submitting a final report to you in time for the September Meeting of the Committee of Governors.

Yours sincerely,

[signature]