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MINUTES
OF THE 281ST MEETING OF THE COMMITTEE OF GOVERNORS
OF THE CENTRAL BANKS OF THE MEMBER STATES
OF THE EUROPEAN COMMUNITY

HELD IN BASLE ON TUESDAY, 14TH DECEMBER 1993

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List of participants attached

The *Chairman* opened the meeting by welcoming Mr. Boutos and by congratulating Mr. Crockett and Mr. Papademos on their appointments as General Manager of the BIS and Deputy Governor of the Bank of Greece, respectively. To mark the retirement of Mr. Boot, one of the Dutch Alternates, the Chairman thanked him for the contribution he had made to the Committee's work.

I Approval of the minutes of the 280th Meeting

The *Committee* approved the minutes of the 280th meeting.

II Issues relating to the establishment of the EMI

Mr. Lamfalussy reported on the preparatory work carried out since the November meeting with regard to the setting up of the EMI (the text of his exposé had been circulated to the Governors before the meeting) and asked the Governors to take decisions on four matters.

Firstly, he proposed that the EMI should have four departments: a Monetary, Economic and Statistics Department, which would analyse economic, monetary and financial and exchange rate developments, provide analytical support in various areas of the preparatory work and draft the EMI's annual report; a General Secretariat, which would prepare the meetings of, and provide support to, the EMI Council and its committees and working groups, carry out the advisory functions of the EMI and prepare the annual report on the state of preparations for Stage Three; an Administration Department; and an Information and Communications Systems Department. There would also need to be a press service and an internal audit function. Overall, the EMI could be operational with between 125 and 150 staff, excluding translators and interpreters. A separate Financial Department would probably be needed if and when national central banks entrusted the EMI with the management of foreign exchange reserves; until that time, the financial functions of the EMI could be carried out either in the General Secretariat or in the Administration Department.

Secondly, five key individuals needed to be recruited: a Director-General, who would report to the EMI President; and four Heads of Department, each of whom would report to the Director-General. Together with the President, these senior individuals would prepare a detailed organisation chart. He invited the Governors to let him know by Christmas of their nominations to fill the five positions; he would then submit proposals to the EMI Council in January. He suggested that appointments below the level of Head of Department should be made on his own responsibility.

Thirdly, broad agreement on the salary structure was needed in order to recruit the five key individuals. The question was complicated by the fact that the life-expectancy of the EMI was uncertain and that the organisation would be relatively small so that career prospects would be limited. Whilst the five key staff need not necessarily be seconded to the EMI from national central banks, in practice most of them might come from that source. He suggested that some alterations be made to the proposals which had been made by the Heads of Personnel. In particular, the Heads of Department should be offered a salary similar to the Commission's A2 category salary scale, ranking them as equivalent to a Director in the Commission. Allowances would be comparable with those in the Commission and compensation for the difference in the cost of living between Brussels and

Frankfurt would be granted if it was found to be significant. The Director-General's salary should be half-way between the A2 band and the President's emolument.

Fourthly, he proposed that the existing sub-committee and working group structure should continue for the time being with their existing mandates. In this regard, he said that he wished to ask Mr. Rey to continue as Chairman of the Committee of Alternates until the summer, by which time it could be determined how the structure should be changed when the EMI moved to Frankfurt. Since the EMI would not simply be a secretariat, he invited the Governors to consider what future changes might be implemented.

Another issue which would need to be addressed was the relationship between the EMI and other Community institutions. While he would attend the ECOFIN meetings as the Chairman of the Committee of Governors had done, the EMI Statute provided that, in addition to a member of the Commission, the President of the Council could attend the EMI Council's meetings; that had not been the case in the context of the Committee of Governors and the practical arrangements would need to be given consideration.

With regard to the EMI Council's first meeting, arrangements were being made for the transport of participants from Basle to Frankfurt on 11th January. Together with President Duisenberg and Mr. Baer, he had visited two buildings on 6th December. He had asked Mr. Andreoli, who was in charge of the maintenance of the BIS building, to prepare a report on the relative technical attributes of the two buildings; the financial implications of adapting the buildings to meet the EMI's needs would also have to be analysed. An unexpected difficulty which had been encountered had been the location and suitability of possible meeting rooms. The EMI would be "meeting intensive" and about three meeting rooms would be required, each of which would need to be flexible and able to accommodate interpretation facilities. The two buildings, together with the respective technical and financial assessments, could be considered by the Governors at the EMI Council's meeting in January.

With regard to preparing an Annual Report for 1993, he said that he would be against the publication of a report by the EMI in April 1994 since it could hardly cover anything else than developments which had taken place before the EMI had been created; a report on the monetary and financial situation in 1993 could be covered in the first Annual Report of the EMI, which would be published in April 1995. This had been indicated in the draft press communiqué which had been tabled for the Governors' consideration. A further issue which needed to be resolved was the organisation of the meetings of the EMI in relation to those of the BIS once the move to Frankfurt had taken place. He suggested that the Governors should channel their views on the organisation of the BIS' meetings to Mr. Crockett and those relating to the EMI to him; the various alternatives could then be assessed.

After a short discussion, the ***Committee***:

- agreed with Mr. Lamfalussy's four proposals concerning the departmental organisation of the EMI, the procedure for the recruitment of the five key individuals, the remuneration of those individuals and, for a transitional phase, the maintenance of the infrastructure which had been built up by the Committee of Governors;

- agreed that the first meeting of the EMI Council be held in Frankfurt on 11th January 1994, and noted that details of the arrangements would be circulated as soon as possible; and
- approved the draft press release which included a small amendment requested by the German Alternate.

With respect to the inter-institutional co-operation, the ***Chairman*** suggested that representatives of the Council and of the Commission should not participate as a general rule in the EMI's committee structure. His view was supported by Messrs. ***Tietmeyer, Trichet*** and ***Fazio*** who underlined in particular that the EMI was an independent body and should guard its independence.

Finally, the ***Committee*** agreed with Mr. Lamfalussy's proposal to postpone the release of the EMI's first Annual Report to April 1995. This report would also cover developments in 1993. ***Mr. Doyle***'s suggestion of preparing a condensed Annual Report for 1993 in the form of a record of events with some comments was not accepted.

Mr. Lamfalussy said that, on the one hand, it would not be possible to produce a substantial report within a couple of months while, on the other hand, a report which simply comprised a bland description of facts would be open to the criticism that it was not up to the standard of the two Annual Reports prepared by the Committee of Governors. Mr. Lamfalussy's view was shared by the ***Chairman*** and Messrs. ***Tietmeyer, Trichet*** and ***Fazio***.

Mr. Boutos suggested an account of the developments in 1993 could be included as a prologue in the EMI's Annual Report for 1995.

Mr. Jaans also agreed that there were good reasons for the EMI not to produce a report in 1994; however, the Council and the European Parliament should get interim reports from the EMI President during the year. This would avoid any criticism that the EMI was eschewing public accountability.

III Adoption of the Committee's report to the EC Ministers of Finance on developments on the foreign exchange markets of the nineteen countries participating in the concertation procedure during November 1993 and the first few days of December 1993

The ***Committee*** adopted the report, which would be sent to the EC Ministers of Finance in the usual way.

IV Renewal of the Swap agreements with Norges Bank

The ***Committee*** approved the renewal of the bilateral swap agreements with Norges Bank for a further one-year period in accordance with the current terms and conditions.

V Monitoring of economic and monetary developments and policies in the Community

1. Statement by Mr. Papademos, Chairman, Monetary Policy Sub-Committee

Mr. Papademos introduced the ex ante report prepared by the Monetary Policy Sub-Committee. His introductory statement focused on the report's conclusions, some policy issues and on the general assessment.

The decision to widen the ERM bands implied that there was, at least in principle, more freedom to conduct monetary policy in line with domestic conditions. In practice, however, the ERM countries were following a cautious approach and continuing to focus monetary policy primarily on exchange rate stability. This had been reflected in gradual reductions in official or key interest rates while maintaining a positive differential vis-à-vis German rates, which had also followed a downward trend. As a result, ERM currencies were now trading close to, or even within, their former ERM bands. Furthermore, long-term interest rates had continued their downward movement and were currently at their lowest levels since the early 1960s.

A consequence of the widening of the bands was that the attainment of price stability would have to rely more on sound domestic monetary and other policies, and on voluntary co-ordination between central banks, than on the discipline of the EMS. The "appropriate" monetary policy strategy differed between Community countries, partly depending on their respective economic and financial structures. For many countries, the price stability objective might still be best achieved by using the exchange rate as a nominal anchor and keeping it close to the central parity. For some others, monetary policy could continue to rely, or could place more emphasis, on domestic variables such as monetary aggregates. When sufficiently reliable intermediate variables were not available, monetary policy could focus directly on explicit inflation targets. The relative merits of these alternative approaches had been discussed in the Sub-Committee's report on the Single Monetary Policy of the ESCB. One issue, however, which could become increasingly relevant was the presentation of monetary policy intentions to the public. So far, most Community countries had not announced monetary targets for 1994; there was a risk that, in some cases, it might not be clear to the markets what were the relative weights attached to the monetary aggregate, the exchange rate and to other indicators. Although the leeway for monetary authorities might be increased by not specifying the monetary strategy explicitly to the public, such an approach might impair the credibility of monetary policy with adverse effects on inflation expectations.

Owing to the importance attached to exchange rate stability following the widening of the bands, the ERM continued to function de facto as a framework constraining national monetary policies. Consequently, it was still possible to define and assess the common monetary policy stance for the Community. The Sub-Committee considered the monetary policy stance in the Community to be appropriate. Moreover, as economic growth and inflation for 1994 were likely to become more uniform among the Member States, there seemed to be less need for monetary policy differentiation than there had been in previous years. A continuation of gradual reductions in short-term interest rates seemed consistent with a further slowdown in inflation without stifling an economic upswing. However, the extent and pace of interest-rate reductions depended on several factors and some caution was warranted: price stability in the Community had not yet been achieved despite the depressed economic situation; monetary growth was currently above target levels in a number of countries; there was a risk of inflation accelerating in the Community as economic recovery gathered momentum; and the expected progress in fiscal consolidation might not be achieved. The Sub-Committee had felt that the main risk was related to the prospects for a sustained recovery; the recession might be deeper, or more prolonged, than currently projected. In that case, faster or larger interest-rate reductions would be appropriate if monetary growth and inflationary pressures were to weaken accordingly. More generally, the Sub-Committee had stressed that monetary policy should retain its medium-term orientation.

On the assumption that the monetary policies of ERM countries would continue to aim at exchange rate stability, and that interest rates would be reduced gradually and cautiously, national monetary policies could be considered to be mutually compatible. However, if the economic recession turned out to be more protracted in some Community countries, it might be difficult to sustain a stable exchange rate through interest-rate policy, and the currently envisaged national monetary policies might prove to be incompatible. This would also be the case for non-ERM countries if their currencies' exchange rates deviated substantially and persistently from long-term equilibrium levels.

It had in general not been easy to assess the overall stance and mutual compatibility of monetary policies in the Community due to the divergent economic conditions of the various countries and the effects of other economic policies. The assessment was now all the more difficult as monetary policy co-ordination had to take place in a framework in which exchange rates could now fluctuate within wider bands. The strengthening of monetary policy co-ordination in the context of the EMI would require further progress both on conceptual and practical issues. Finally, the assessment of monetary policy could be improved if use was made of alternative scenarios and if it were to take place within a longer time horizon given the uncertainties and the long lags with which monetary policy influenced the final objectives.

2. Statement by Mr. Saccomanni, Chairman, Foreign Exchange Policy Sub-Committee

Mr. Saccomanni introduced the Foreign Exchange Policy Sub-Committee's report "Annual review of developments in the European Monetary System" and reported on the discussions held in the Monitoring Group.

a) The annual review of the EMS had been conducted by the Foreign Exchange Policy Sub-Committee in the awareness that the causes and implications of the EMS crisis of July 1993 were more difficult to analyse than those of the crisis of September 1992. Factors such as changes in intra-EMS competitive positions or the decline of the US dollar had not played as large a role in 1993 as they had in 1992. Instead other factors had been more influential: the markets' perception of policy dilemmas and of inadequate co-operation among the monetary authorities; the eroded credibility of the ERM; and the changes in the expectations and hedging behaviour of market participants. These factors, however, were difficult to quantify and involved a largely judgmental element; the Sub-Committee had resisted the temptation of giving an over-simplistic explanation of the crisis and putting all of the blame on the wrong perceptions of anxious market participants. The Sub-Committee had recalled its 1992 EMS report in which it had stated that intense pressures could develop again, also in countries without real exchange rate misalignments, unless "markets saw a strong backing of the parities by all the monetary authorities with the appropriate support from other areas of economic policy within an appropriately co-ordinated framework".

With regard to the policy responses to the recent crisis, the Sub-Committee had agreed that the use of the Basle/Nyborg instruments had successfully countered the tension up until July 1993 but that their effectiveness had been progressively undermined in the climate of adverse market perceptions and eroded credibility. In particular, the use of interest-rate changes had been resorted to with mixed results. Some members had considered that the interest-rate instrument would have been effective had the national authorities been willing to increase interest rates at an early enough stage. However, the majority of members had maintained that its effectiveness had been blunted because interest-rate increases would have been regarded as creating or exacerbating policy dilemmas and, therefore, as unsustainable. This conclusion had differed from the one which had been reached earlier in 1993 by the Monetary Committee and the Committee of Governors. The Sub-Committee had also noted that despite the very large amounts involved, intervention had not proved successful in containing market pressure as it had been regarded as unsustainable. The Sub-Committee had felt that the impact of large-scale intervention on the conduct of domestic monetary policies deserved further analysis, particularly as regards the sterilisation process; the Sub-Committee stood ready to co-operate with the Monetary Policy Sub-Committee as appropriate.

The Sub-Committee had also reviewed the implications of the widening of the ERM bands. The decision of 2nd August had ended a severe episode of tension and had resulted in a new trading environment in which daily exchange rates had become more volatile and exchange market liquidity had been reduced. Market participants had not yet fully unwound the speculative positions which they had taken before the crisis. Only preliminary conclusions had been reached about the effectiveness of the Basle/Nyborg instruments under the new ERM setting because of the limited period of observation, although there were indications that exchange rate flexibility might have become more effective by enhancing the perception of a two-way risk. However, the ability of interest-rate changes to stabilise exchange rates in periods of tension might be limited since they might make the markets' perception of policy dilemmas more acute. In conclusion, the widening of the bands might not have removed all of the underlying sources of tension in the ERM and exchange market pressure might resurface. However, the continuing reliance on stability-oriented monetary policies by member countries should help to rebuild the ERM's credibility.

b) The Monitoring Group had discussed the outlook for the US dollar and the situation in the EMS. The expected strengthening of the dollar had not transpired in the last few weeks, although the Group continued to believe that the dollar would firm as a result of the likely evolution of interest-rate differentials between the USA and Europe. However, in the short run, market participants seemed unwilling to increase their already substantial long dollar positions as the outlook for inflation in the USA, and the recent decline in oil prices, seemed to exclude a need for a tightening of monetary policy in the immediate future by the Federal Reserve. The firming of the dollar that morning vis-à-vis the Deutsche Mark, therefore, seemed to be related to the result of the Russian general elections.

Further progress in achieving exchange market stability had been reflected in the narrowing both of the ERM band and of interest-rate differentials, and the market perception of a policy dilemma was beginning to fade. A main factor behind the easing of tension in the EMS was the confidence of market participants that a cautious monetary policy stance would be followed by the national central banks in the period ahead. An additional factor, however, was the profit-taking sales of Deutsche Mark by those who had opened long Deutsche Mark positions before July 1993. The

Group had recognised that a number of risks had to be taken into account. Firstly, market participants would watch closely the evolution of economic activity and convergence; any significant departure from the current moderately optimistic scenario might reignite the policy dilemmas and, therefore, tensions. Secondly, exchange rate stability in the EMS was dependent on the expectation of a continuing decline in German interest rates. Some members had expressed the concern that political uncertainties related to regional elections in Germany might postpone or slow down the easing of interest rates in that country. Finally, there was the risk that political pressure to ease monetary conditions might intensify and lead to an unwarranted stimulation.

3. Statement by Mr. Rey, Chairman, Committee of Alternates

The Alternates had expressed their appreciation for the reports of the two Sub-Committees and for the supplementary contributions made by the Economic Unit. Five issues had emerged from the Alternates' discussion: a general, but not unanimous, feeling of satisfaction with respect to recent developments in the foreign exchange markets; a question mark over the prospects for interest rates in the Community; the formulation of monetary policy strategies under the new environment; the relevance of an aggregate monetary policy stance in the Community; and how temporary was the present "temporary" regime.

Firstly, it had been noted with satisfaction that a degree of stability had returned to the ERM: several currencies were trading again within their former fluctuation bands, interest rates were gradually declining and interest-rate differentials were progressively narrowing. There had been relief that the decision to widen the ERM bands had worked out quite well and that the authorities had been successful in demonstrating their attachment to the objective of exchange rate stability. The Danish Alternate, however, had expressed regret that political will and co-operation had been lacking during the summer to defend the former ERM regime.

Secondly, the ex ante report had made the point that a further decline in interest rates seemed consistent with a further slowdown in inflation. Some Alternates had suggested that in case a further lowering of interest rates occurred in Germany, other ERM participants should allow for some strengthening of their currencies in the band to enhance the markets' perception of a two-way risk. The prospects for, and timing of, further interest-rate reductions in Germany remained uncertain. A decline could be hampered if, for instance, the US dollar were to rise too rapidly. To the extent that market expectations of a decline in German interest rates were then disappointed pressure might again resurface in the ERM. A question therefore remained: how far could the exchange rate consciousness of ERM participants be sustained if the perception of a policy dilemma, which had faded recently, again became acute?

Thirdly, the ex ante report had examined the implications of the widening of the ERM band for the formulation of monetary policy. It had suggested differences in strategy between small, open economies and larger, less open ones; the former continued to rely on the exchange rate as a nominal anchor, while the latter put more weight on monetary aggregates or on explicit inflation targets. The French Alternate had stressed that the dividing line was not clear-cut and had emphasised the commitment of the French authorities to both internal and external monetary stability. The German Alternate had pointed out that the wider ERM band should allow for some monetary policy differentiation, but that the question of how much scope there was to use the width of the band without endangering credibility deserved more analysis.

Fourthly, there had been some discussion of the concept of the aggregate monetary policy stance in the Community. It had been argued that, given the voluntary acceptance of the exchange rate constraint in a number of Community countries, monetary policy had been tighter in the Community as a whole than in a theoretical situation in which external considerations would have played a lesser part in determining the policy stance. It had been noted that this overall stance was at the centre of a transatlantic dispute; it was important for the authorities in Europe to stress that the expected longer-term benefits of exchange rate stability in the Community by far outweighed the short-term advantages of using the room for manoeuvre offered by the larger fluctuation band. Finally, one Alternate had expressed the view that, if exchange rate stabilisation had been made easier by the widening of the bands, the "temporary" regime should be allowed to last until full monetary union was achieved; this issue could be examined by the Foreign Exchange Policy Sub-Committee.

4. Discussion by the Committee

Mr. Rojo said that the Spanish peseta had replaced the Danish krone as the weakest currency in the ERM in the last two weeks as a result of the controversy between the government and the trade unions in Spain. Since the last general election, the government had tried without success to obtain an agreement with the unions on wage increases in 1993 and on the need for a series of reforms. On 3rd December, the Spanish cabinet had approved a number of draft laws, which had been sent to parliament, relating to a substantial modification in the collective wage agreement system and to new types of labour contracts. The trade unions had reacted by calling for a general strike. The effects of the strike were not likely to be significant but the peseta had declined in the last two weeks on the markets' perception that the position of the government might be weakened and that the draft reform laws could possibly be watered down. The central bank had not intervened in the markets.

Mr. Fazio said that since mid-October bond prices in Italy and the value of the Italian lira had declined owing to the uncertain Italian political situation. The new budget was likely to be passed by 20th December and would be a further step towards improving the public finances. General elections were likely to be held in three months time; the Banca d'Italia would monitor monetary developments closely in the interim. With regard to the question raised by Mr. Rey on the general stance of monetary policy in the Community, he agreed that it seemed strange to make an overall assessment when responsibility for monetary policy remained in the hands of the national authorities. There was a growing amount of money which was not captured in national monetary targets; developments in the euro-lira market partly explained the recent evolution in the Italian exchange rate. While the current trends in the euro-lira market were on a much smaller scale than those which had occurred on the euro-dollar market in the 1960s and 1970s, the phenomena were similar and deserved to be studied.

With regard to the widening of the ERM bands on 2nd August, ***Mr. Trichet*** said the French authorities held the following view: the ERM had been preserved; it had been reaffirmed that the central parity grid was in line with the economic fundamentals and with the harmonious working of the Single Market; and two-way risk had been re-introduced into the ERM. In the case of the

French franc, the Banque de France had disabused the markets during August and September of their perception that the ERM had been abolished. The monetary targets for 1994 would be finalised at the beginning of the year. For the last ten years, France's monetary policy had aimed at price stability and had been guided by two elements: domestic targets and ERM participation. These did not present a policy dilemma; indeed, the French authorities were of the opinion that policy dilemmas only existed in theory. In this respect, there were some sentences in the EMS report which could be misinterpreted by the markets were it to be published. With regard to the reference in the EMS report about "future risks and dangers", if the authorities publicised their fears rather than their self-confidence, this might reinforce the view that they were more vulnerable than they actually were. Those officials who had spoken out in favour of moving back to narrow bands, or of monetary policy initiatives, could lead the markets to infer that the authorities did not feel confident.

Mr. Beleza said that a new Finance Minister had been appointed in Portugal as part of the government reshuffle announced twelve days previously. The results of the nation-wide local government elections, held on 12th December, had been in line with expectations with a defeat for the government slightly worse than the polls had indicated; this had led to some reaction in the markets. Following an easing of interest rates in other Community countries, the Portuguese authorities had continued with their cautious monetary policy stance. The results had been positive; intervention had remained limited and the ten-year fixed-bond rate had fallen in recent months despite some temporary upward movements, reflecting uncertainty about fiscal developments. Both the government and the central bank felt that they did not have any more room for manoeuvre than they had at the end of July.

Mr. Hoffmeyer made three points. Firstly, convergence in 1993, particularly with regard to inflation, had turned out to be better than had been foreseen a year earlier. Secondly, the "policy dilemma" which had dominated the Governors' discussions in 1992 and 1993 had not been as severe as the markets had anticipated. Thirdly, the relationship between intervention and money supply (which had not been analysed in the report) was less close than generally thought since speculation could now be undertaken in ways which only had a small impact on the money supply. In his view, the ERM had been virtually suspended for the wrong reasons because all three elements had been misjudged. There had been an interaction between monetary policy and exchange rate policy in the former ERM arrangements; no alternative policy strategy had yet been found which could unite the Member States in pursuing co-operative policies in the wide band. Price stability alone as a monetary policy objective was not necessarily sufficient for that purpose.

Mr. Verplaetse said that when the decision to widen the ERM bands was taken, reaffirmation had been given to the existing parity grid in order to go on pursuing a stable monetary policy. The Belgian franc, which had performed well for the past three years, had come under speculative attack despite unchanged fundamentals. Firstly, competitiveness had deteriorated in the order of magnitude of 3% as a result of the depreciation of the lira and sterling. Secondly, there had been question marks over Belgium's ability to control its public sector deficit, in particular the deficit of the social security system. It had been clear that the credibility of Belgium's policies could be restored only if measures were taken in two areas. The Belgian government's plan to cope with the crisis had triggered-off some strikes; however, the markets had realised that it was a serious programme. The plan consisted of reducing wage costs by about 8% and of restoring the social security system to balance by increasing the contributions made by private households by 3.5% (of which 2% would be transferred to businesses and 1.5% to the public sector). Although the plan would have a negative impact on economic growth, the credibility of Belgium's economic policy would have diminished in the eyes of the markets if the announcement of the measures had been delayed.

Mr. Boutos said that he had long held the view that price stability and growth were complementary objectives; indeed, price stability was a necessary condition for sustainable growth. His main objective would be to bring inflation in Greece down to a low and irreversible level. Greece's economic developments in 1993 formed a mixed picture. On the one hand, the inflation rate was falling and the current account was showing a substantial improvement while, on the other hand, the large fiscal deficit constituted a pressing problem. The higher than expected deficit, which imposed serious constraints on the conduct of monetary policy, could be attributed to various factors: revenue collection problems; the reduction of income tax rates in 1992, which had not been accompanied by the expected broadening of the tax base; the implementation of the Single Market directives concerning intra-European trade, which had had an adverse effect on VAT revenue from imported goods; delays in the privatisation process; and slower than expected economic growth. Real interest rates had risen over the last few months; nevertheless, domestic credit expansion and the increasing growth in M3 in Greece would result in the monetary targets being exceeded. Economic policy in 1994 would be based on: a tight budget; a non-accommodating exchange rate and monetary policy; a policy aimed at improving the economy's infrastructure and enhancing productivity; and speeding up the privatisation of selected public corporations through the stock market. A primary surplus of around 2% of GDP was projected for 1994; this was to be achieved mainly by expenditure cuts, measures aimed at broadening the tax base, and by the imposition of new taxes. A bill would be submitted to parliament in January aimed at curbing tax evasion. Exchange rate and monetary policy in 1994 would be set consistent with a deceleration in the inflation rate to below 10% by the end of 1994 and the continuation of the expected favourable trend in the balance of payments in 1994. A target for broad money growth would be announced in January. Interest rates were likely to remain high in order to contain the expansion of liquidity and to support a disinflationary exchange rate policy. Finally, the public investment programme in 1994, partly financed by the European Community's structural funds, was expected to mitigate the adverse effects of restricted macro-economic policies on aggregate demand and to contribute to a moderate economic recovery.

In response to the remarks made by Mr. Hoffmeyer, ***Mr. Tietmeyer*** said that the reasons that had led to the decision being taken to widen the ERM bands had not been the wrong ones. It was true that the convergence of inflation rates had been better than expected, but domestic discussions had led the markets to believe that there was a policy dilemma, which they had put to the test. He recalled that the German Alternate had proposed in March 1992 that the ERM bands should be temporarily widened in times of tension. With regard to whether there was a link between money supply and intervention, he said that the German authorities had managed to sterilise intervention; however, had the phase of compulsory intervention been longer, the monetary aggregates in Germany would have "exploded" as they had done in August 1992. There was a need to continue studying this issue. He did not agree with the suggestion in the ex ante report that the wider bands presented problems for the co-ordination of monetary policy. Credibility was now being established on the strength of domestic policies, which was a sounder and a more durable basis than the exchange rate constraint alone. He agreed with Mr. Trichet that there was a need for caution before new initiatives were embarked upon; the situation ought to be reassessed after a period of consolidation. The Basle/Nyborg Agreement had always been interpreted as though the most important thing was to have more common funding while the possibility of adjusting parities had rarely been mentioned. Furthermore, while the interest-rate instrument could be difficult to use at the last moment during a crisis, it could be very effective if used in good time.

Turning to the situation in Germany, there were increasing signs that the recession had bottomed out although the Bundesbank had yet to be convinced that the economy had picked up. However, GNP for western Germany had shown an increase of 0.5 percentage point in the third quarter of 1993 compared with the second; the preliminary figures for October also indicated a slight improvement. Order book entries, particularly from abroad, had increased and the building sector was doing well owing to the low interest-rate levels. In the eastern part of Germany, demand during the third quarter had increased by 25% over the same period in 1992 and production output for the same periods had increased by 15%. Growth in eastern Germany was forecast to be around 8% to 10% in 1994. With regard to the monetary situation, German money-market interest rates now stood at 6%; long-term interest rates were currently at 5.5%, close to an all-time low (5.25%, which had been achieved at a time when the inflation rate had been negative). The inflation rate was 3.6% at present and the underlying rate was about 3%. The reference in the ex ante report that there was room for manoeuvre which would allow further interest-rate cuts to be made needed to be studied closely. German M3 was still expanding too quickly and remained above the target range. The Bundesbank would need to consider the figures for November and December and also monitor exchange rate developments and capital inflows; it would not be justified to expect German interest rates to be cut further in the near future. When lowering its repo rate to 6%, the Bundesbank had announced that it would keep the rate unchanged until 5th January 1994 in order to dampen any market expectations of a further interest rate decline. The monetary target for 1994 would be decided by the Central Bank Council on 16th December. It would continue to be based on medium-term considerations; the M3 target range might return to its "traditional" levels, reflecting a slightly lower production potential and an unchanged "normative price increase" of 2%. In addition to domestic M3, the Bundesbank would also monitor broader indicators which included euro-Deutsche Mark.

Mr. Trichet said that he agreed with Mr. Tietmeyer's comments about the ERM. He added that the authorities had at times not been sufficiently lucid in their policy intentions. Furthermore, if any indication had been given to the markets that intervention limits existed which could not be transgressed, this might have resulted in a collective weakening of the system.

Mr. George said that there were differences of emphasis in the reports by the two sub-committees relating to the relative weight put on external and internal factors and the degree of tension which existed between them. With regard to comments that policy dilemmas did not exist, the reality was that there were no absolutes in this matter. The extent to which tensions existed and could be accommodated within a regime, and the extent to which they produced undesirable exchange rate effects, depended on the underlying economic situation. Although tension in the exchange markets had diminished since the ERM bands had been widened, it would be misleading to believe that this step had been inevitable. The conjunctural situation had evolved in a way which had enabled the German authorities to bring down their interest rates; without this decline in German interest rate tensions would have remained. It would be dangerous to assume that tensions would not re-emerge, particularly given the current level of unemployment in the Community. With regard to the suggestion that some countries should lag any further decline in German interest rates in order to assert the two-way risk, he hoped that this would be contingent upon it being an appropriate policy for the lagging country in the prevailing economic climate and not done for demonstrative purposes. It had also been suggested that it should be clarified to the US authorities that the expected longer-term effects of exchange rate stability by far outweighed the temporary benefits of using the scope for interest rate flexibility that now existed; that stance also had to be contingent on the prevailing economic situation.

Mr. Jaans said that he supported Mr. Hoffmeyer's suggestion to undertake a study of the impact of speculative operations on the money supply and on the conduct of monetary policy. Such a study could also consider what instruments, including derivatives, would be appropriate to meet the needs of market participants who wished to hedge a portfolio; in so doing, it might be possible to reduce the volume of outright intervention sales and purchases.

Mr. Doyle noted that there was general satisfaction about the calm that had prevailed in the markets since August and about the way there seemed to be a self-equilibrating mechanism at work. However, he cautioned against being complacent; if the rate of unemployment did not fall at a satisfactory rate the markets might perceive a further policy dilemma and currencies could again find themselves coming under pressure. He was also uneasy about the conclusion drawn in the EMS report that the Basle/Nyborg instruments had been adequate. During the periods of tension, the instruments had not been sufficient to restore exchange rate stability even though the action that had been taken in a number of countries had in many respects gone beyond the Basle/Nyborg Agreement. He agreed with Mr. George's remarks about not taking an absolute stance either in respect of interest rates or exchange rates. Given the present uncertainties, he ranked exchange rate stability higher than most other factors since, without it, the Single Market could be undermined.

The ***Chairman*** said that the policy dilemmas and the evaluation of whether the Basle/Nyborg instruments had been applied correctly would again be considered by the EMI in the context of preparing its first Annual Report. He noted that on page 20 of the EMS report, it was stated: "two points seemed to the Sub-Committee as worthy of further analysis: firstly, the threshold beyond which the impact of intervention becomes more difficult to sterilise, without materially affecting the normal operation of monetary policy; secondly, the monetary side-effects of intervention." He suggested that a study into the impact of interventions on domestic monetary developments be included in the EMI's work programme. This could be linked to Mr. Fazio's suggestion to study the Euro-currency markets.

VI Preparatory work for the move to Stages Two and Three of EMU

1. Statistical issues

Mr. Rey said that the Alternates had recommended that the Committee endorse the Working Group's latest interim report; this did not imply that the Governors would have to agree on all specific matters. One Alternate had observed that issues such as the harmonisation of consumer price indices and the need for detailed geographical breakdowns of balance-of-payments data would require further consideration. The Alternates had also suggested that the report be released to the EFTA central banks and to the Committee on Monetary, Financial and Balance of Payment Statistics.

The ***Committee*** endorsed the report on this basis and agreed to release it to the EFTA central banks and to the Committee on Monetary, Financial and Balance of Payment Statistics.

2. Determination and implementation of the Single Monetary Policy in Stage Three

The ***Committee*** agreed that consideration of the report by the Monetary Policy Sub-Committee should be postponed until an early meeting of the EMI Council.

3. Payment arrangements for Stage Three of EMU (incorporating item VII: "Current issues relating to payment systems and means of payment")

Mr. Padoa-Schioppa said that three reports had been submitted to the Committee: "Payment Arrangements for Stage Three of EMU"; "The Oversight of the ECU Clearing and Settlement Systems in 1993"; and "Prepaid Cards".

The main conclusion of the report on payment arrangements for Stage Three of EMU was that the settlement system for processing large-value payments in Stage Three of EMU should be decentralised. There would be no need to build a system from scratch; the real-time gross settlement systems that were being created in most EC countries could be linked. There were a number of related issues concerning the extent to which national systems should be made homogenous but these did not need to be resolved at the current time. The Working Group had proposed that the Governors should accept this report as a basis for consultations between the Working Group and those responsible for monetary policy, information systems and accounting issues. It was also suggested that the report could be transmitted to the EFTA central banks and to the members of the G-10 Committee on Payment and Settlement Systems. No clear recommendation had been made as to whether the report should be circulated in the banking community; the pros and cons had been set out in a cover note.

The report on the ECU Clearing and Settlement System had been prepared in response to the Governors' request to receive an annual report on the oversight of this system. The report described the progress made in improving the system and suggested that the ECU Banking Association (EBA) needed to do more to bring the system up to the "Lamfalussy standards".

The report on prepaid cards contained the qualified conclusion that such cards should probably be issued only by credit institutions. The Working Group had not been completely satisfied with the analysis done so far and had not been ready to recommend the conclusion as a firm policy suggestion. However, initiatives by non-banks were underway in several Member States and, therefore, a policy position should be taken as soon as possible.

Mr. Rey said that the Alternates had endorsed the general orientation of the report on payments arrangements for Stage Three of EMU. They had agreed that it should serve as the basis for future work and be examined by other central bank experts, particularly those in the field of monetary policy, information systems and legal issues. The Alternates had been in favour of distributing the report to the EFTA central banks and to the members of the G-10 Committee on Payment and Settlement Systems. However, the publication of any part of the report had been felt to be premature. The Alternates had noted the report on the ECU Clearing and Settlement System and had encouraged the Working Group to continue to exert pressure on the EBA so as to accelerate the reform of the system. The German Alternate had emphasised that this system was a private undertaking and had expressed reservations on the involvement of the national central banks as lender of last resort. The Alternates had also expressed interest in the issues raised by the prepaid cards report; they had encouraged the Working Group to continue its work so that more definitive conclusions could be reached in the near future.

Mr. Tietmeyer said that there were three points in the report on payment arrangements for Stage Three of EMU on which he had reservations. Furthermore, he did not agree with paragraph 36 of the report on the ECU Clearing and Settlement System which stated that "a large-value system such as the ECU Clearing would probably have to merge into the EMU-wide RTGS system".

The ***Committee*** noted the three reports. It was agreed that the Working Group should undertake further study of whether the issuance of prepaid cards should be limited to credit institutions so that the EMI Council could reach a decision by March 1994. The report on payment arrangements for Stage Three of EMU would not be released to the EFTA central banks or to the G-10 Committee on Payment and Settlement Systems until the German reservations had been lifted.

4. Status of preparatory work

The ***Committee*** took note of the status report which had been prepared by the Secretariat.

VII Current issues relating to payment systems and means of payment

This item had been dealt with under Item VI(3) of the agenda.

VIII Monetary questions in the enlargement negotiations

Mr. Rey said that the Alternates had discussed the elements to be incorporated into the opinion requested by the Commission on issues relating to the current enlargement negotiations. The Alternates had agreed on a number of points relating to: Article 16 of the EMI Statute (the procedure for determining the shares of the new Member States' central banks in the key for the financial resources of the EMI); the freezing of the ECU basket; the structure of the commitment ceilings in the mechanism for medium-term financial assistance which would also be relevant for the quotas to be assigned to the new Member States' central banks in the short-term monetary support; and the capital and foreign exchange reserves of the ECB. There had been two issues on which no agreement had been reached. Firstly, several Alternates had objected to the Commission's suggestion that the number of Executive Board members should be increased in order to maintain a ratio of 1:2 between them and the members of the Governing Council. They had argued that a large Executive Board would lose efficiency and that all members of the Governing Council would carry out their duties in a personal capacity and would not represent their countries of origin. Furthermore, there would be a risk that the Commission's approach would introduce a geographical element; a split between the members of the Executive Board and national central bank Governors could be an unwelcome precedent. Moreover, a precedent might be established for enlargement negotiations with other countries. Other Alternates had been inclined to support the Commission's proposal so as to safeguard the weight of the Executive Board members relative to the national central bank Governors; such a balance had played a role when the Governors had formulated their proposal in this regard for the ESCB Statute. The second point of disagreement concerned ERM membership as a convergence criterion. According to the Commission's proposal, an applicant country's exchange rate performance would be assessed in terms of its currency's relationship with the ERM currencies if it joined the Community within the two years prior to the decision to move to Stage Three (and thus did not have the possibility of being a member of the ERM for the full two-year period). Some Alternates had expressed the view that existing and new members of the Community should be treated equally. This principle had been reflected in the amended text which had been distributed to the Governors. and might form the basis for a compromise among the Governors.

Mr. Tietmeyer said that the question of whether the ECU basket should include the currencies of new members should be left open to the negotiations with applicant countries.

Mr. Rey said that the Alternates had shared the Commission's view that the ECU basket should not be changed so as to include the new currencies for reasons relating to the credibility of the ECU. The representative of the Commission in the Committee of Alternates had confirmed that applicant countries were not currently insisting that their currencies be included in the ECU basket.

Following this discussion, the ***Committee:***

- approved the amended text concerning the convergence criterion relating to participation in the ERM;
- agreed on the common view that the enlargement of the Community should not lead to an enlarged Executive Board of the ECB. It was noted that a Board of six members had been agreed in the Treaty on European Union on the basis that this number would be adequate to run efficiently the ECB's day-to-day business. The enlargement of the Community would not in itself create an extra workload and, therefore, would not necessitate an enlargement of the Executive Board.
- decided to communicate its views on monetary questions raised in the current enlargement negotiations to the Commission.

The Secretariat was asked to draft an opinion which was to be finalised by the Alternates on behalf of the Governors by written procedure or, if necessary, during a teleconference.

IX Other matters falling within the competence of the Committee

1. Release of the final report of the Working Group on Information Systems to non-EC members of the G-10 Group of Computer Experts

The ***Committee*** approved Mr. Barroux's request (set out in his letter dated 2nd December) to release the final report of the Working Group on Information Systems to the Federal Reserve Board, the Federal Reserve Bank of New York, the Bank of Japan and the Bank of Canada.

2. Appointment of professional staff in the Secretariat

The ***Committee*** approved the appointment of Mr. Dinand as a professional member of the Secretariat.

X Epilogue

To conclude the last meeting of the Committee, which had existed for almost 30 years, the ***Chairman*** noted that it marked the end of an important body in the European Community. He thanked all of the Governors for their co-operation in the context of the Committee's work.

Mr. Hoffmeyer, as the Chairman's immediate predecessor, expressed the Committee's gratitude and appreciation for the excellent way in which Mr. Duisenberg had chaired the Committee's meetings.

281ST MEETING OF THE COMMITTEE OF GOVERNORS
14th December 1993

Chairman	Mr. Duisenberg
Banque Nationale de Belgique	Mr. Verplaetse Mr. Rey[1] Mr. Michielsen
Danmarks Nationalbank	Mr. Hoffmeyer Mr. Hansen
Deutsche Bundesbank	Mr. Tietmeyer Mr. Schieber Mr. Rieke
Bank of Greece	Mr. Boutos Mr. Papademos Mr. Stournaras
Banco de España	Mr. Rojo Mr. Linde Mr. Durán
Banque de France	Mr. Trichet Mr. Hannoun Mr. Robert
Central Bank of Ireland	Mr. Doyle Mr. Reynolds
Banca d'Italia	Mr. Fazio Mr. Dini Mr. Santini
Institut Monétaire Luxembourgeois	Mr. Jaans
Nederlandsche Bank	Mr. Szász Mr. Bakker Mr. Boot
Banco de Portugal	Mr. Beleza Mr. Costa Pinto Mr. Gaspar
Bank of England	Mr. George Mr. Crockett Mr. Clark
Commission of the European Communities	Mr. Pons
Chairman of the Working Group on Payment Systems	Mr. Padoa-Schioppa
Chairman of the Foreign Exchange Policy Sub-Committee	Mr. Saccomanni
Secretariat of the Committee of Governors	Mr. Baer Mr. Scheller Mr. Alders

Mr. Lamfalussy attended the discussion under Item II of the agenda.

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[1] Chairman of the Committee of Alternates