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(Translation)

MINUTES *

OF THE 235th MEETING OF THE COMMITTEE OF GOVERNORS
OF THE CENTRAL BANKS OF THE MEMBER STATES
OF THE EUROPEAN ECONOMIC COMMUNITY
HELD IN BASLE ON TUESDAY, 9th MAY 1989 AT 9.30 a.m.

Those present at the meeting were: the Governor of the Bank of Greece and Chairman of the Committee, Mr. Chalikias, accompanied by Mr. Papademos, Mr. Karamouzis and Mr. Brissimis; the Governor of the Banque Nationale de Belgique, Mr. Godeaux, accompanied by Mr. Rey and Mr. Michielsen; the Governor of Danmarks Nationalbank, Mr. Hoffmeyer, accompanied by Mr. Mikkelsen; the President of the Deutsche Bundesbank, Mr. Pöhl, accompanied by Mr. Gleske and Mr. Fischer-Erlach; the Governor of the Banco de España, Mr. Rubio, accompanied by Mr. Linde and Mr. Durán; the Governor of the Banque de France, Mr. de Larosière, accompanied by Mr. Waitzenegger and Mr. Cappanera; the Governor of the Central Bank of Ireland, Mr. Doyle, accompanied by Mr. O'Grady Walshe and Mr. Reynolds; the Governor of the Banca d'Italia, Mr. Ciampi, accompanied by Mr. Dini and Mr. Santini; the President of De Nederlandsche Bank, Mr. Duisenberg, accompanied by Mr. Szász and Mr. Benard; the Governor of the Banco de Portugal, Mr. Tavares Moreira, accompanied by Mr. Pêgo Marques and Mr. Amorim; the Governor of the Bank of England, Mr. Leigh-Pemberton, accompanied by Mr. Crockett and Mr. Price; the President of the Commission of the European Communities, Mr. Delors, accompanied by Mr. Costa, Mr. Carré and Mr. Dixon; the Director General of the Luxembourg Monetary Institute, Mr. Jaans; the Secretary of the Monetary Committee, Mr. Kees. Also present at the meeting was Mr. Dalgaard, Chairman of the Group of Experts. The Secretary General of the Committee, Mr. Morelli, his Deputy, Mr. Bascoul, Mr. Scheller and Mr. Giles, and Mr. Bockelmann and Mr. Dagassan also attended.

In addition, Mr. Lamfalussy, General Manager of the BIS, and Mr. Gros, Head of the Banking Department of the BIS, took part in the discussion of item IV of the agenda.

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* Final text approved at the meeting on 11th July 1989, which incorporates some drafting changes.

The Chairman opened the meeting by informing the Committee that, as from the next meeting, the Commission of the European Communities would be represented either by its President, Mr. Delors or by Mr. Christophersen, Vice-President with responsibility for Economic and Financial Affairs.

I. Approval of the minutes of the 234th meeting

The Committee approved the minutes of the 234th meeting, on the understanding that the editorial amendments suggested would be incorporated in the final text.

II. Monitoring of economic and monetary developments and policies in the EEC based on:

- Preparation by the "Dalgaard Group" and discussion by the Committee of Alternates;
- Statistical charts and tables

A. Statement by Mr. Dalgaard

The "Monitoring Group" had concentrated on three questions: the continuing strength of the dollar, the increase in interest rates in Germany and its repercussions, and the Spanish peseta.

The general feeling was that the foreign exchange markets were continuing to show remarkable confidence in existing exchange rate relationships and that capital flows were therefore to a large extent determined by interest rate differentials.

The dollar had remained at a high level in April and early May, between 1.85 and 1.89 against the Deutsche Mark, and just recently had even risen above 1.90. High US interest rates were the key to the dollar's underlying strength; had it not been for the fear of central bank intervention, it would probably have risen further. During the first three weeks of April the dollar had eased slightly in response to the G-7 meeting, together with intervention by the Bank of Japan and expectations of a slowdown of growth in the United States and consequently a fall in interest rates. It had since strengthened again, reflecting at least partly the markets' belief that the central banks would not, after all, do much to check the movement; official US statements that the dollar's current level was satisfactory had also played a part. The central banks had not in fact done very much to push the dollar down. Total intervention in April had resulted in some 1/2 billion of net dollar purchases, despite small sales by the Federal Reserve and some EC central banks. Other central banks, in particular Sveriges Riksbank, Norges Bank, the Banco de España and the Banco de Portugal, had bought considerable amounts of dollars. In the first week of May net sales of dollars had totalled some 1.4 billion.

There had been some concerted intervention in late April and early May, following a standard procedure, whereby the European central banks would do nothing during the morning but then, when the Federal Reserve entered the market, if the dollar was rising, it would propose concerted action, would itself sell, but only moderate amounts, and the European central banks, often fifteen or sixteen of them, would intervene together, also fairly modestly. For example, the Deutsche Bundesbank had committed only about half the amounts spent by the Federal Reserve, and the other central banks generally symbolic amounts. Moreover, as soon as this intervention had halted the rise of the dollar, the Federal Reserve would stop. The "Monitoring Group" had felt that this technique was the worst possible way of intervening if exchange rates were really to be influenced: not only did this approach have little effect, it tended to undermine the credibility of central bank action. It would be better to intervene less often, but at the right time, namely when the dollar was already falling, and a number of opportunities of this kind had arisen in the past few weeks. The Federal Reserve clearly did not take this view; it now seemed willing to take the initiative and intervene on a larger scale than previously and than the European central banks, but it maintained a defensive attitude and halted its intervention as soon as the dollar stopped rising. Its purpose was not to weaken the dollar, lest the movement should go too far, and to keep the markets quiet so that the US deficits could continue to be financed smoothly.

Within the EMS, the main feature had been the relative weakness of the Deutsche Mark, as demonstrated by the very large intervention purchases, equivalent to US$ 3.7 billion in April and US$ 2.5 billion in the first week of May. The total so far this year was in excess of US$ 20 billion, i.e. almost as much as for the whole of 1988 (US$ 27 billion). The Deutsche Mark was still the strongest currency in the exchange rate mechanism, with the lowest interest rates in the Community, but it was weak measured against the strong fundamentals. This could be explained in particular by the fact that confidence in the present exchange rate relationships within the EMS was such that interest rate differentials were still sufficient to make investments in the other currencies attractive. Special factors had also played a part, for example, in Spain, and also Germany, where political developments seemed to be weakening the Government, even though the general elections were not to be held for another year and a half.

Official German rates had been raised by 1/2 percentage point on 24th April, in order to moderate monetary growth, dampen down price increases and also support the Deutsche Mark. Market rates had risen by only 1/4 percentage point, and only in the case of short-term rates. Long-term rates had even eased somewhat, perhaps as a result of the decision to abolish the withholding tax as from 1st July 1989. However, this measure and the higher interest rates had so far had no effect on the Deutsche Mark exchange rate.

Most EC countries had followed the rise in German interest rates. In some countries it had been necessary to raise official rates, in others, such as France, market rates had increased sufficiently without a change in key rates. Overall, there had been little change in interest rate differentials between the EC countries, and it was therefore not surprising that the impact on exchange rates had been limited.

The effect of abolishing the withholding tax in Germany might be felt later. Residents might be waiting for formal abolition, on 1st July 1989, or even to be sure that the tax would not be reintroduced in a Community context. While repatriation of capital would probably be slow, new outflows should decline, and that, combined with the considerable current-account surplus, should be sufficient to strengthen the Deutsche Mark.

The experts from the EC central banks had not voiced any criticism concerning the repercussions of the increase in German interest rates, but they had felt that it would have been helpful to have been notified of the decision in advance, as it was important to Germany's partners and had come as a surprise to all of them.

The other currencies participating in the exchange rate mechanism had not experienced any particular problems. The French franc had performed well, supported undoubtedly by the positive fundamentals. The Italian lira had also been firm, mainly because of high interest rate differentials, given that the balance of payments and inflation were not developing particularly well. The stability of the lira showed that not only did the market not anticipate a realignment, it did not even expect any major changes within the margin; the lira could at present afford to fall by 5% and still remain within the margin. The market for the Danish krone was again quiet following the pressures of late March. In Ireland interest rates had increased more than in other countries - by 1 percentage point for short-term rates and 1/2 percentage point for long-term rates - because of large-scale capital outflows, amounting to nearly $1 billion since February. The Central Bank of Ireland had for a long time hesitated to raise interest rates, as growth was weak, inflation low and the balance of payments in surplus. In the Netherlands the recent political tension, which meant that the elections would be brought forward to September, had temporarily weakened the guilder slightly. However, a small increase in interest rates had been sufficient to restore the former exchange rate relationship between the Deutsche Mark and the guilder.

The fundamental situation in Spain was unchanged; growth was still strong, no tightening of fiscal policy was expected and therefore monetary policy had to be very restrictive. High interest rates had attracted large capital inflows, and to limit them the Banco de España had allowed the peseta to appreciate, for example, by 10% against the Deutsche Mark since the beginning of 1988, and had raised reserve requirements. This had succeeded in curbing residents' borrowing abroad, but foreign investors had turned to massive buying of Spanish Treasury bills. Although the current-account deficit was growing apace, the market was unperturbed, since it felt that the deficit could easily be financed by new inflows of capital, given that investment in pesetas was still very attractive.

Sterling had recently been under some pressure. It had seemed that higher interest rates might be necessary but up to early May this had been avoided, mainly because of the publication of better-than-expected trade figures. Overall, the sterling/Deutsche Mark rate had remained relatively stable and market interest rates had not moved much.

In Greece and Portugal the policy of gradual, moderate exchange rate depreciation had been continued, but with the difference that it had been accompanied by considerable capital outflows in Greece, while in Portugal there had been substantial capital inflows.

Lastly, it should be noted that, as was mentioned in the monthly report of the Agent for the EMCF, the first transaction with an Other Holder of ECUs had taken place in April, when De Nederlandsche Bank had sold ECU 50 million to the Swiss National Bank.

B. Statement by Mr. Papademos

The Alternates had focused their attention on the effectiveness of recent intervention in the foreign exchange markets, the longer-term outlook for exchange rate developments, and interest rate policies in the Community.

1. The interventions carried out recently, especially by the Federal Reserve, had been judged to be relatively ineffective. They would have been more effective if they had been larger, if they had been better concerted, and if they had been reinforcing exchange rate movements rather than resisting them. It had been pointed out that the Federal Reserve had been reluctant to pursue such a strategy, for fear of provoking a sharp fall in the dollar. If recent intervention practices continued, central banks could lose their credibility in this area.

2. In recent months paradoxical exchange rate relationships had been observed. The currencies of countries with relatively high inflation and current-account deficits had been appreciating, while the currencies of countries with low inflation and current-account surpluses had tended to depreciate. Two explanations could be offered for this. Firstly, markets attached greater importance to interest rate differentials than to fundamentals, partly owing to the perception that the central banks were aiming at nominal exchange rate stability, and this tended to reduce the exchange rate risks. Secondly, countries which were experiencing high growth rates and inflationary pressures were pursuing tight monetary policies that were not adequately supported by fiscal policies, and this kept interest rates high and induced capital inflows.

One Alternate had stressed that in view of the increasing integration of financial markets, the adjustment process had to be seen in a wider context. The developments observed were symptomatic of a difference in cyclical positions between the countries concerned. There was an important trade-off. Countries that were pursuing tighter monetary policies to ease inflationary pressures had contributed to the convergence of inflation rates but at the cost of larger divergences in current-account positions. If current-account imbalances primarily reflected different cyclical positions, they would have to be accepted temporarily. Intervention and interest rate policies would not be successful in dealing with situations resulting from divergent economic performances. It had been suggested that the factors causing these differences in cyclical positions should be re-examined.

Other Alternates had emphasised the structural nature of recent developments in the financial markets. The new financial environment, characterised by the advent of new financial instruments and large capital movements, had implications for the conduct of monetary policies. Some felt that the liberalisation of capital movements might delay rather than facilitate the adjustment process.

3. The German Alternate had pointed out that the recent increases in official interest rates had not had a lasting impact on the Deutsche Mark exchange rate vis-à-vis the major currencies, partly because market interest rates in other countries had increased by an equal or greater amount, thus maintaining or even widening interest rate differentials. On the same subject, another Alternate had observed that, if German monetary policy was to provide the anchor for price stability in the EMS and the exchange rate was no longer available as an instrument to curb inflation, the Bundesbank had to use the remaining instruments, that is interest rates, to preserve price stability. In addition, in view of the inappropriate policy mix in the United States and the high level of capacity utilisation, a dollar depreciation was unlikely to contribute to the adjustment process but might exacerbate inflationary pressures.

Finally, the Alternates had referred to the recent sharp rise in Irish interest rates. The limited liberalisation of long-term capital flows at the beginning of the year had led to capital outflows mainly because institutional investors had diversified their portfolios. The official foreign exchange reserves had fallen considerably, which had reinforced the need to increase interest rates.

C. Discussion by the Committee

The Chairman noted that the appreciation of the dollar despite some slowdown in economic activity in the United States was surprising and raised the fundamental question of whether it was a case of the market "overshooting" and thus a temporary movement or rather a new and lasting upward trend that called for the Governors' close attention. The Governors might also look at recent developments in Germany, viz. the interest rate increases, the abolition of the withholding tax on interest income and the sharp rise in the current-account surplus (+44% in the first quarter of 1989).

Mr. Pöhl offered some comments on a number of points that had been dealt with in the full and balanced reports of Mr. Dalgaard and Mr. Papademos.

The raising of German interest rates had three main reasons, which had already been aired over a number of weeks, in particular within the Committee, so that there had perhaps been an element of surprise in the timing, but not in the measure itself. The first reason related to the stronger-than-expected growth of the German economy, which harboured increased risks of overheating. Bottlenecks were already appearing in certain sectors, and the present position was that of a late phase in a cycle of six to seven years of continued growth. Problems like those affecting other European countries, such as the United Kingdom, had to be avoided. Moreover, even though the next wage negotiations would not be taking place until 1990, there were growing indications that the strength of the economy and other factors would lead to substantial claims, particularly as the price situation was not as favourable as usual. Consumer prices were rising at an annual rate of 3%, which was high by German standards, although account had to be taken of the impact of the raising of consumption taxes. More worrying was the rise in import prices, at an annual rate of almost 12%, which resulted in particular from the increase in oil prices and the deterioration in the terms of trade.

The second reason for the raising of interest rates was the Deutsche Mark exchange rate, which was neither conducive to price stability nor compatible with the current-account surplus. The surplus was growing steadily and might exceed US$ 50 billion for the year as a whole; it was due in part to the depreciation of the Deutsche Mark in nominal and real terms vis-à-vis the dollar and also the yen and other currencies, such as sterling and the Spanish peseta. The trade surplus had narrowed appreciably in 1988 vis-à-vis the United States but had widened again since last autumn; more generally, the surplus reflected the strong demand for manufactures and capital goods in a number of European countries, particularly those experiencing extremely buoyant domestic demand and inflationary pressures. Germany's surplus also had to be seen from the angle of the country's trading partners which, thanks to the freedom of the market, could absorb and counterbalance domestic pressures, but when all countries were overheating this equilibrating process no longer functioned.

Although it was slowing somewhat, monetary growth remained strong and was overshooting the targets for the third year in succession; this was the third reason for the tightening of monetary policy. Following the raising of interest rates in January the market had anticipated further increases in March, which the Bundesbank had not implemented. When official rates had been raised on 24th April market rates, which had risen in the meantime, had hardly moved. Overall, however, they had virtually doubled within eight months at the short-term end. Long-term rates had changed little; the abolition of the withholding tax might have contributed to their stability, but an upward trend had developed recently, probably in connection with the appreciation of the dollar.

The surprising strength of the US currency was related to the weakness of the yen and the Deutsche Mark, which was due in part to political factors but also to other influences, for example the fact that the markets had grown accustomed to the existing large imbalances and to the idea that the world could live with them, which was a dangerous attitude. Another factor, which merited closer examination, could be found in the restrictive policy long pursued by the Federal Reserve and reflected in particular in an undershooting of the targets for the monetary aggregates, whereas the contrary was the case in Japan and a number of European countries.

The central banks' intervention policy had been criticised as being the worst imaginable. This was true in part; for instance, the Federal Reserve and the US Treasury were in fact very anxious not to trigger an uncontrollable fall in the dollar. Apart from this, however, it had to be stressed that the burden of intervention was essentially being borne by the Deutsche Bundesbank. Use of the Deutsche Mark had, in fact, grown considerably. Holdings of that currency were in excess of DM 100 billion in Europe and the United States alone, not counting holdings elsewhere, on which there was little information. Within the EMS exchange rate mechanism, where the Deutsche Mark was naturally the intervention and reserve currency, holdings amounted to 36 billion, which did not appear excessive; the figure for the United States was 34 billion. These large purchases had certainly enabled the Deutsche Mark to remain the strongest EMS currency, despite relatively low interest rates, but they had not prevented its international weakness. At all events, consideration had to be given to the possible consequences of a reversal of the situation, of massive use of these holdings, which represented approximately 17% of global exchange reserves. Moreover, the use of the Deutsche Mark in interventions gave rise to money creation, and thus to an inflation risk depending on the extent to which it was neutralised. There were therefore limits to intervention, and in these circumstances, if the dollar continued to rise and the yen and the Deutsche Mark to depreciate, interest rate differentials would have to be widened, which meant that if the authorities or the market failed to bring about a fall in rates in the United States, they would have to be raised further in Europe.

The Bundesbank's decision to raise its rates had caused some disappointment among its partners because of the lack of prior consultation. The German central bank was in fact a firm believer in co-operation and in monetary policy co-ordination, in particular within the exchange rate mechanism, and had furnished proof of this in the past; however, like its counterparts, it had constraints of its own, and the example of 24th April showed that, in the present statutory institutional framework, ex ante co-ordination of economic and monetary policies had its limits. This example might contribute to speeding up the establishment of a common decision-making structure in line with the report of the "Delors Committee".

Mr. de Larosière thought that the current situation, following the decision of the Bundesbank to raise its key rates, was paradoxical in several respects. That action had been taken essentially on domestic grounds, in response to signs of tensions, but had it been effective? Certainly not as far as the Deutsche Mark exchange rate was concerned, which had depreciated vis-à-vis the dollar over the past two weeks. The dollar's strength, however, had other causes, as had been mentioned, but there was also the fact that in Europe interest rates had risen following the German decision even in those countries where official rates had not been increased. Thus there had been no real change in relative positions. The German measure might have some impact on domestic demand, but was this intended? As Mr. Pöhl had said, one of the essential elements in the German economic boom was the strength of exports and thus of domestic demand in Germany's trading partners, in Europe in particular. For them, the very fact of having followed the increase in German interest rates meant that there was no fundamental change in their relative macro-economic positions, and thus no adjustment of the fundamentals in volume terms such as would enable German exports to be reduced somewhat.

It therefore seemed clear that the real problem that had to be examined was one of more concerted management of the European and international macro-economy. However, such management was faltering at the global level because it was always difficult to incorporate US policy, which lay outside the scope of European economic intervention and currently raised a number of concerns, in particular in the fiscal sphere. The inflationary pressures observed in several countries could ultimately only be alleviated if the slowdown in the US economy, of which there were some preliminary indications, was confirmed. The concerted management of the macro-economy was also faltering at Community level; in particular, there was no genuine discussion of the adjustment of relative macro-economic positions. In this context the Bundesbank could raise its rates following a surprise decision by its Central Bank Council, a decision which might have certain effects and no others but which rather indicated that the EC countries were proceeding blindly. As Mr. Pöhl had pointed out, this example should lead to a reflection on the quality of the decision-making process and of ex ante concertation within the Community. Such concertation had been lacking on 24th April, which was regrettable, but it was at least equally important to establish genuine concertation on the "fundamentals" than to know whether the Bundesbank was going to raise its rates on a particular Thursday or fifteen days later.

As far as interventions on the foreign exchange markets were concerned, Mr. de Larosière recognised their limits but agreed with the criticisms expressed by Mr. Dalgaard. For several weeks now interventions had neither been vigorous enough nor sufficiently well managed. Without seeking to push the dollar into a new downward cycle, the timing of intervention during the day could be varied to secure the best effect. It would therefore be useful to review central banks' intervention techniques and procedures in the days ahead.

Mr. Ciampi agreed that the markets appeared to be accepting the large disequilibria which existed both globally and within the EMS, and that relative macro-economic positions were a major factor behind these imbalances. This accommodation or resignation on the part of the markets regarding the disequilibria meant that the authorities had to do everything, and quickly, to restore equilibrium. Adjustment policies in each country were therefore essential, and it was very important that they should be pursued within a framework of co-ordination and concertation of macro-economic policies.

In Italy the performance of the lira showed that the status quo had become accepted; although there were clear signs of a worsening of the economic situation, in terms of inflation and the current-account balance, there had been no reaction on the foreign exchange markets. On the contrary, the lira remained firm and had even appreciated in nominal and real terms vis-à-vis other EMS currencies. While this was clearly welcome from the point of view of checking inflation, it should not obscure the fact that the fundamental disequilibria were worrying and difficult to correct. Although still inadequate, Italian fiscal policy seemed to be embarking on the right path, and the measures adopted at the end of March should limit the central government deficit for 1989. Moreover, domestic demand could be restrained by the bringing forward, from November to June, of the payment of personal and corporate taxes.

The current problems observed in most countries highlighted the importance of co-ordination of macro-economic, monetary and exchange rate policies. Recent developments had shown that, within Europe, interest rate differentials had not really changed after the German decision, which, for that reason, had remained largely ineffective.

With regard to interventions on the foreign exchange markets, Mr. Dalgaard suggested that both the method and the timing could be improved. It was true that even if they were of limited value, interventions could be made more effective, for example by operating in a procyclical direction rather than defensively, when the dollar was rising.

Mr. Duisenberg observed that De Nederlandsche Bank had immediately followed the increase in interest rates by the Deutsche Bundesbank. As regards the decision-making process, there was not as powerful a Central Bank Council in Amsterdam as there was in Frankfurt. Although the German decision had been surprising, it was quite understandable given the domestic and external considerations underlying it. Similar reasons had been behind the Dutch decision. The inflation rate was low - at 0.8% the lowest in Europe - but it was influenced by the lowering of VAT, which had helped to dampen inflation. Worrying signs were emerging in other areas. For example, some acceleration in wage increases was evident; the agreements concluded recently kept just within the limits of productivity gains, and a number of agreements were due to expire at the end of the year. In addition, the duration of the agreements was becoming shorter, which was a reflection of the tensions on the labour market. In some sectors capacity limits were being reached, and capacity utilisation overall stood at a record level.

The rise in import prices, in particular of raw materials, was also worrying. The main concern, however, was monetary growth. After the United Kingdom, the Netherlands had registered the sharpest growth in M_2 in 1988 - a rate of 14% - and it had persisted since the start of the year. In these circumstances De Nederlandsche Bank, which would not have taken the initiative to raise its interest rates, had taken the German decision as an opportunity to do so; it had even gone further in that it had entered into discussions with the commercial banks to conclude a gentleman's agreement aimed at moderating money creation.

The Chairman said that the increase in German interest rates had also persuaded the authorities in Greece to increase interest rates, in particular on Treasury bills.

Mr. Rubio remarked that in Spain the current difficulties were in large part due to the mix between monetary policy and fiscal policy. The aim of fiscal policy was to reduce the public deficit, which was not very high compared with the other European countries but which was nevertheless playing an expansionary role at a time when domestic demand, particularly investment demand, was very strong. It was not very likely that the Government would be able to change fiscal policy fundamentally in 1989, but certain measures might soon be taken which might alleviate the monetary policy dilemma. The peseta had for quite some time been subject to strong upward pressures and it had appreciated, for example, vis-à-vis the Deutsche Mark by 11% in real terms over the last twelve months. Further appreciation was not desirable, given that the current-account deficit was increasing considerably; for the year as a whole it was expected to be double its 1988 level, reaching approximately US$ 7 billion, equivalent to more than 2% of GDP. However, the Banco de España had to follow a restrictive monetary policy and maintain high interest rates to counter domestic demand pressures and inflationary tensions.

Mr. Hoffmeyer recalled that in April he had argued that the EC countries should not automatically follow the initiatives of the Deutsche Bundesbank in respect of interest rates unless conditions really called for it. In January Danmarks Nationalbank had not followed suit and had been partly successful, but it was aware, as it had pointed out, that it could not hold back if there was a further increase in German interest rates. There had been such an increase, which was not really surprising, and it was important that some countries had shown that it was not necessary to follow it. Even if market rates had risen nearly everywhere, there was a big difference if official rates had not, as they acted as a signal and had a major impact on expectations.

Mr. Hoffmeyer remarked that at present the Deutsche Mark was the strongest currency in the EMS and that the German economy was also expanding rapidly. In these circumstances nothing could be done in a European context. The problem lay basically in the relationship between the Deutsche Mark and the dollar. It was, however, likely that any significant decline of the dollar would give rise to concern. At all events, it seemed that one could not criticise Germany's growth policy and monetary policy at the same time.

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 April and the first few days of May 1989

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

IV. Organisation of the ECU clearing: criteria for extension

The Chairman recalled that this question had been touched on in April but that it had been decided to deal with it in May after further examination by the Alternates. The Alternates had carried out their examination the previous day and Mr. Papademos would be giving an account of it. Before this, however, Mr. Lamfalussy could introduce the subject.

A. Statement by Mr. Lamfalussy

At their April meetings the Committee of Alternates and the Committee of Governors had discussed the problem raised by the question of accession of new banks to the private ECU clearing and settlement system. At the close of these discussions, it had been agreed that the question would be taken up again in May in order to try to reach a consensus on the desirable form and degree of EC central bank involvement in this matter.

It should be recalled that in 1986, when the EC Governors and the BIS Board had decided that the BIS could agree to act as agent for the clearing and settlement system for the "private" ECU, it had been generally accepted by the Governors and the Bank, that - in particular during the system's running-in phase - the rate of increase in the number of clearing banks, and the number itself, should satisfy two fundamental objectives:

- the rate of increase should be sufficiently slow to enable the system to absorb new members without creating technical problems for the efficient operation of the system and without jeopardising its financial integrity;
- yet, at the same time, it should be sufficiently fast to demonstrate that the system was not a closed one - i.e. that it was not to be regarded as one designed to protect the commercial interests of existing members.

It had been to satisfy these objectives that the BIS had done two things. On the one hand, it had set a minimum admission criterion of a balance-sheet total of ECU 30 billion, i.e. six times the minimum level set by the ECU Banking Association (EBA) itself. On the other hand, the Bank had made repeated efforts to ensure that the process of admission should not come to a halt.

It had become apparent from the outset that it would not be easy to reconcile the two objectives, but it had now become well-nigh impossible. A number of the existing clearing banks had grown more and more reluctant to admit new members and to accept a downward revision of the initial ECU 30 BIS billion criterion. They invoked the potential increase in their own credit risks linked to a further enlargement of the number of members, but some of them at least might have other considerations in mind. Be that as it may, the result of their reluctance was likely to be that some quite respectable banks were left out in the cold. This was why the problem was being put to the central banks which clearly had an interest in the efficient, safe but also equitable operation of the system.

There were many difficulties in trying to find a balanced solution, but two should be mentioned in particular.

The first, which was a problem of procedure, derived from the fact that the BIS criterion of ECU 30 billion was part of the contractual arrangements between the BIS as agent and the EBA. This meant that it could not be altered - relaxed or replaced with another - unilaterally. The EBA had to approve any such amendment. In the absence of such approval, and this was precisely how things now stood, the only options left to the BIS were either to live with the present situation, at the risk of appearing to sanction the closed nature of the system, or to apply the shock treatment of withdrawing from the system, something which the agreement allowed but which neither the BIS, nor, certainly, the central banks, would contemplate happily.

The second difficulty was more one of substance, and here three points should be made. From the point of view of the technical operation of the system, it would no doubt be possible to raise the number of clearing banks well above the present thirty-three. Secondly, however, one could not reject as irrelevant the view of those who argued that admitting a large number of banks might present dangers, in the form of increased credit or settlement risks, for the participating banks; such risks were inherent in the way the system worked and existed even with the present number of participants. Thirdly, at the same time, one could not help but feel that this argument was also used by some banks in order to protect their commercial interests. These fundamental difficulties warranted that due consideration be given to all appropriate measures to prevent any increase in the credit and settlement risks inherent in the operations of the system, but without laying it open to the charge of safeguarding vested interests.

In order to carry out such a task, or indeed simply in order to continue to act as agent within the present framework, the BIS needed the support of the central banks concerned. As had been clearly understood right from the beginning, the clearing system should not, and could not, count on liquidity support from the central banks, and the BIS was naturally not asking for support of this kind. What it wanted was support to enable its representatives to act with greater authority in forthcoming discussions with the EBA regarding the operations of the system and, in particular, the rules of access to the status of clearing bank. Such moral and technical support could take different forms, but it was essential if the BIS was to continue to play a useful role in the private ECU clearing and settlement system.

B. Statement by Mr. Papademos

The Alternates had discussed at some length the issues relating to the enlargement of the private ECU clearing and settlement system and had arrived at the following conclusions.

The Alternates agreed that the Governors could confirm their commitment to the private ECU clearing and settlement system as an open system which should develop in accordance with criteria that ensured adequate participation and promoted operational and prudential soundness. It was recognised that the BIS needed support in order to enable it to overcome the present deadlock.

The Governors' commitment could be expressed as follows:

1. The BIS would be provided with a summary of the Governors' discussion. The Alternates felt that this summary should contain, in particular, the following elements:

(a) a reiteration of the principles laid down by the EC central banks in March 1983 governing the participation of the BIS as Agent for the ECU clearing system;

(b) a reaffirmation of the desire to see the system evolve in accordance with well-defined admission criteria which would permit a balanced expansion of the system;

(c) an expression of the desire that, pending the revision of the admission criteria, membership of the system should be extended to include a limited number of banks which were at present excluded for reasons which could not be justified on either credit or prudential grounds;

(d) the creation of a technical working group as outlined below.

2. A working group would be created, comprising experts drawn from the central banks, the Commission of the European Communities and the BIS. This group would assist the BIS in reviewing the criteria governing admission to the clearing system in order to bring about a satisfactory expansion of the membership of the system. The group should also examine the systemic risks in the clearing mechanism, in particular those related to the netting of transactions, taking into account the relevant prudential considerations.

3. Finally, the BIS would be called upon to keep the Committee of Governors regularly informed of progress in its discussions with the ECU Banking Association.

C. Discussion by the Committee

Mr. de Larosière said that he had listened to the statements by Mr. Lamfalussy and Mr. Papademos with great interest and was in complete agreement with the four points put forward by Mr. Papademos. In fact, the Governors had already expressed such a view at their April meeting and the minutes clearly reflected this. The summary and structure proposed by Mr. Papademos were wholly appropriate, reasonable and balanced; they should form the decision or the summary of today's discussion by the Governors, so that Mr. Lamfalussy could act in the way he had indicated.

Mr. Pöhl expressed his full agreement with Mr. de Larosière; the Governors should support the BIS in opening up the ECU clearing system, as it was not in their interest to see the system closed. However, it was perhaps a little too early to decide to set up a new group, as there were so many already, and this also raised the problem of having to find experts and send them to all these groups and meetings. For the time being, it would be sufficient to endorse very clearly what had been said by Mr. Lamfalussy and to authorise him to inform the banks of this and even to tell them that there was a serious risk that the BIS would withdraw from the clearing system.

Mr. Pöhl added that he was not in favour of such an outcome but that the threat could be made. At all events, he thought that the support given by the central banks should impress the banks in the clearing system and persuade them to change their minds; if that did not happen, the Governors could look at the matter again.

Mr. Lamfalussy felt that the support given in this way by the central banks should be sufficient, provided that the BIS could call for ad hoc discussions if there were technical problems. A permanent group was certainly not necessary, but situations might arise in which it would be very useful to seek the views of the central banks on certain technical matters.

Mr. de Larosière suggested that the fourth point made by Mr. Papademos should be amended to read that, if necessary, an ad hoc group could be convened to examine the items in question.

The Chairman noted that the Committee was in agreement on the matter of the ECU clearing system and that the views of the Governors would be conveyed to the BIS in the form of a letter from the Chairman. A draft would be drawn up and circulated by the Secretariat; it could be amended following the written procedure, the final letter then being sent to Mr. Lamfalussy.

V. Longer-term perspective of changes in the exchange rate structure, on the basis of a short presentation by Mr. Bockelmann

The Chairman recalled that the usual procedure would have been for the Alternates to deal with this question first and for their Chairman to report to the Governors, but owing to lack of time they had not been able to do so. He proposed, however, that it should be discussed without waiting for the July meeting, as then the agenda was very likely to include, in addition to the usual items, the examination of Report No. 35 of the "Raymond Group" and the annual note on public finances; the latter was on the agenda of the present meeting, but since the Alternates had not analysed it, it seemed preferable to postpone discussion of this topic.

A. Statement by Mr. Bockelmann

The full text of this statement, which is annexed to the present minutes, was distributed to the members after the meeting.

B. Discussion by the Committee

Mr. Ciampi thought that the analysis of effective exchange rates presented by Mr. Bockelmann was of great interest and that it would in fact be desirable to broaden the study to obtain a more complete picture and to elucidate the links with the principal economic variables. With such an extension of the study in mind, some (essentially statistical) aspects deserved to be highlighted. Mr. Bockelmann had taken the consumer price index and unit labour costs as indicators or deflators. Both had their limitations and imperfections, as did any other benchmark, but one should try to choose the least bad. The first yardstick, prices, was only an imperfect indicator of a country's external competitiveness; the second took no account of the cost of capital and capital goods; moreover, calculations of unit costs varied appreciably between countries. One might follow the example of the Banca d'Italia, which had long used the wholesale prices of manufactured goods. Though not perfect, this benchmark was perhaps better suited to the objective in question and gave results situated between the two extremes obtained on the basis of consumer prices and unit costs.

Finally, it should be noted that the chosen base year, 1979, was a special year for Italy because a depreciation of the lira had deliberately been engineered so as to allow it to hold its position within the EMS for a longer period without realignment. At the time, inflation differentials with the participants in the exchange rate mechanism had been very high, and the Banca d'Italia had wanted the lira to enter the grid at a fairly low level.

Mr. Hoffmeyer observed that it was interesting to review the development of effective exchange rates over a number of years; he pointed out that the theory of purchasing power parity held completely only at times of high inflation. A more subtle analysis should take account of a number of factors such as services and quality, but it was difficult to grasp the reality perfectly. Other independent measures, for instance based on profits and wages, existed and could be used. It had been found, for example, that in nearly all countries the share of wages had tended to increase until the early 1970s and had subsequently contracted.

Mr. Doyle shared Mr. Ciampi's and Mr. Hoffmeyer's reservations regarding the statistics. For instance, in Ireland, the figures based on consumer prices were very strongly influenced by the high incidence of indirect taxes, particularly since 1983. The figures calculated on the basis of unit costs were also affected by the structure of Ireland's economy and industry. The enormous importance of agriculture was not taken into account, while a large part of industry was very capital-intensive. Thus the competitiveness of Irish industry was not measured on the basis of unit labour costs but more on that of wage rates. In all such international comparisons, it was more important to compare similar economic and industrial structures than to undertake rather abstract calculations which gave the impression of being based on objective criteria but in fact did not have a common basis.

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

The Chairman said he had already mentioned that the Alternates had not had time to examine the note on developments in public finance and that he had proposed that the discussion be postponed to the July meeting, at which the new report of the "Raymond Group" on monetary policies was also to be examined. Furthermore, Mr. Raymond, who had been unable to come to Basle this time for health reasons, should be present in July to take part in the meetings.

VII. Other matters falling within the competence of the Committee

There was no other business.

VIII. Date and place of the next meeting

The Committee's next meeting would be held in Basle on Monday, 12th June 1989 at 9.30 a.m., i.e. just before the BIS's Annual General Meeting. By tradition, the June meeting was confined to a few items only, such as the approval of the minutes and of the "concertation report", with the addition, since 1988, of the "monitoring" exercise. The latter would, as usual, be prepared by the experts, but only via the teleconference which took place every month on the Friday afternoon preceding the Committee meeting. So neither the "Monitoring Group" nor the Committee of Alternates would hold a meeting in June, unless of course circumstances required them to meet on the Sunday.

The "Concertation Group", on the other hand, would meet on Monday, 12th June 1989 at 8.30 a.m. in order to finalise the report to be adopted by the Governors.

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

Annex

9th May 1989

Confidential

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

APRIL 1989

This report summarises developments on the exchange markets of the countries whose central banks participate in the concertation procedure[1] and briefly describes their interventions during April and the first few days of May 1989.

I. EXCHANGE RATE DEVELOPMENTS

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

- an easing of the US dollar followed by a renewed strengthening towards the end of the month;
- the continued decline of the Swiss franc.

After reaching period highs on the first trading day of the month, the US dollar eased as market participants adopted a more cautious stance following the Group of Seven meeting and intervention dollar sales against both the Deutsche Mark and Japanese yen. Although investor sentiment towards the dollar remained positive, data pointing to a possible moderation in the pace of US economic growth at times tempered dollar demand. Late in the month, upward pressure re-emerged amid reports of persistent corporate and investment demand for dollars. Thus, the dollar changed little for the month as a whole.

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

In the EMS, exchange rate relations were stable. A moderate increase in German interest rates towards the end of the month was followed by most other EMS countries and therefore it had little impact.

The Deutsche Mark strengthened slightly. Its weighted index vis-à-vis its eighteen most important trading partners (1972=100) rose from 173.8 at end-March to 174.4 at end-April. The strengthening occurred in the first half of the month and was due in part to the weakening of the dollar which took place during this period and in part to the debate on the abolition of the withholding tax. By contrast, the raising of the Bundesbank's discount and lombard rates on 20th April by 0.5 percentage point to 4.5% and 6.5%, respectively, had no lasting effect. During the last days of the month the Deutsche Mark weakened a little.

The French franc continued, on the whole, to hold firm during the period, benefiting from the publication of positive economic results and from the favourable orientation of the French bond market. The increase in the official rates decided by various European countries had only a very brief impact, notwithstanding the narrowing of the short-term yield differential resulting therefrom, and the franc recovered by month's end its initial position in the Community band.

During the month, the Belgian franc remained stable against the Deutsche Mark. The Banque Nationale de Belgique raised both its discount rate and its special advances rate by 0.5 percentage point in the wake of a similar move by the Bundesbank. The Bank acquired foreign currencies during the period.

The position of the Dutch guilder in the upper part of the EMS band underwent little change. Following the rise in German interest rates, effective 21st April, the Nederlandsche Bank raised both its discount and lombard rates by 0.5 percentage point to 5.5% and 6.25%, respectively.

The Danish krone remained the weakest currency in the EMS, placed close to its lower limit. The interest rate differential against the Deutsche Mark was kept almost unchanged as the Nationalbank raised its main interest rates by 0.5 percentage point when the Bundesbank raised its official rates.

The Irish pound remained relatively stable in the upper half of the EMS band during April. The Central Bank responded initially to continued net commercial outflows by net sales of foreign currency. Domestic money-market rates commenced rising from mid-April, and on 27th April the Central Bank increased its short-term facility lending rate by 1 percentage point to 9%.

The Italian lira was mostly stable in the lower part of the EMS band. Large capital inflows occurred during the second week of the month requiring fairly large purchases of Deutsche Mark by the Banca d'Italia.

Adverse press comments triggered a fall in sterling at the beginning of the month, but it recovered well in the wake of robust intervention and growing expectations of a further increase in UK interest rates. When no such increase was forthcoming, sterling became unsettled, amidst fears of a dock strike and concerns about a disruption to oil production in the North Sea. Further support was also provided following the interest rate increases elsewhere in Europe but, helped by the better-than-expected UK trade figures for March, sterling ended on a steadier note. The trade-weighted index fell by 0.4% to 95.1 (1985=100).

The Greek drachma remained stable against the US dollar, but against the ECU it depreciated by 0.7%. The Bank of Greece intervened in the market several times in implementing the current exchange policy. In effective terms the drachma depreciated by 0.7%.

The Spanish peseta again came under upward pressure, due mainly to short-term capital inflows driven by the existing interest rate differential, which resulted in intervention purchases by the Banco de España. It ended 0.4% higher against the ECU and 1.1% higher against the US dollar. On 25th April the Banco de España raised its three-month repurchase agreement rate by 0.4 percentage point to 13.75%.

In effective terms, the Portuguese escudo depreciated by 0.25% as a result of considerable intervention purchases in the framework of the exchange rate policy. Against the US dollar, the escudo rose by 0.26%.

Vis-à-vis all important currencies, the value of the Swiss franc declined further. Against the US dollar, the loss of value amounted to 0.6%, compared with a 1.3% loss against the Deutsche Mark. The export-weighted index of the franc at the month-end was below the March level by 0.9%. In the domestic money market, the interest rate increased once again by roughly 1 percentage point to between 6.75% and 7%. On 13th April the official discount rate was raised by 0.5 percentage point to 4.5% and the lombard rate rose 1 percentage point to 7%.

The reasons for the continued weakness of the franc are not clearly identifiable. The following causes may be of relevance:

- The surplus in the balance of payments on the current account decreased between 1986 and 1988 by roughly 30%. This trend continues to persist.

- Other currencies, in particular those within the EMS, have made distinct progress in achieving stability these past few years. For many investors, the Swiss franc is no longer the outstanding investment currency, but merely a fair alternative along with the others. It must now stand up in a competitive way against similar robust currencies.

- The heavy fall in interest rates in the first quarter of 1988 possibly gave rise here and there to doubts regarding stability determination. These doubts are unfounded. The monetary course taken in recent months unequivocally shows that now as before the price-stability target is given top priority.

The Austrian schilling firmed against the US dollar by 0.7%. Against the Deutsche Mark it fluctuated by only 0.04%. Effective 21st April, the discount rate was raised from 4.5% to 5% and the lombard rate from 6% to 6.5%. The rate for short-term open market operations was increased from 5.75% to 6.25% effective 24th April.

The Norwegian krone strengthened to index values around 111.50 during the first three weeks, but weakened somewhat thereafter, ending the month 0.3% stronger in effective terms. Despite decreasing interest rate differentials against the basket currencies, the krone strengthened due to high oil prices and release of positive economic data.

The Swedish krona continued to strengthen during April due to a persistent revaluation rumour, speculation about an interest rate hike, and a favourable interest rate differential. This caused a relatively large inflow of funds. Effective 28th April the Riksbank raised the discount rate by 1 percentage point to 9.5% to adjust it to the already prevailing higher interest rates in the market.

The Finnish markka continued to firm towards the strong end of its fluctuation range. Short-term interest rates eased by about 0.5 percentage point.

The Japanese yen remained fairly stable against the US dollar over the period. The yen was supported mainly by fear of concerted intervention by central banks, while demand for the Japanese unit was limited in the light of higher oil prices and interest rate differentials between Japan and the United States. In its effort to support the yen, the Bank of Japan stepped in the market at the beginning of the month. The yen depreciated slightly against the ECU.

The Canadian dollar firmed slightly in April in cautious trading ahead of the federal budget speech on 27th April. The leak and subsequent early release of the budget on 26th April gave rise to a pronounced, but brief, period of weakness as participants responded negatively to the news of a larger-than-expected federal deficit in fiscal year 1989 and the political uncertainties linked to the circumstances surrounding the leak.

However, in the last few days of the month, the Canadian dollar strengthened, more than offsetting the weakness on 26th April, as large commercial and investment related demand emerged for the currency. It closed the month at US$ 0.8450, slightly up from the end of March.

II. INTERVENTIONS

A. Interventions in US dollars

Net purchases of US dollars amounted to US$ 0.5 billion, compared with net sales of US$ 4.4 billion during the month of March. A part of the dollar sales was made in concerted interventions. The major net sellers of dollars included the Bank of England, the Federal Reserve, the Bank of Greece and the Central Bank of Ireland. Sveriges Riksbank, the Banco de Portugal, the Banco de España, and Norges Bank made the largest purchases.

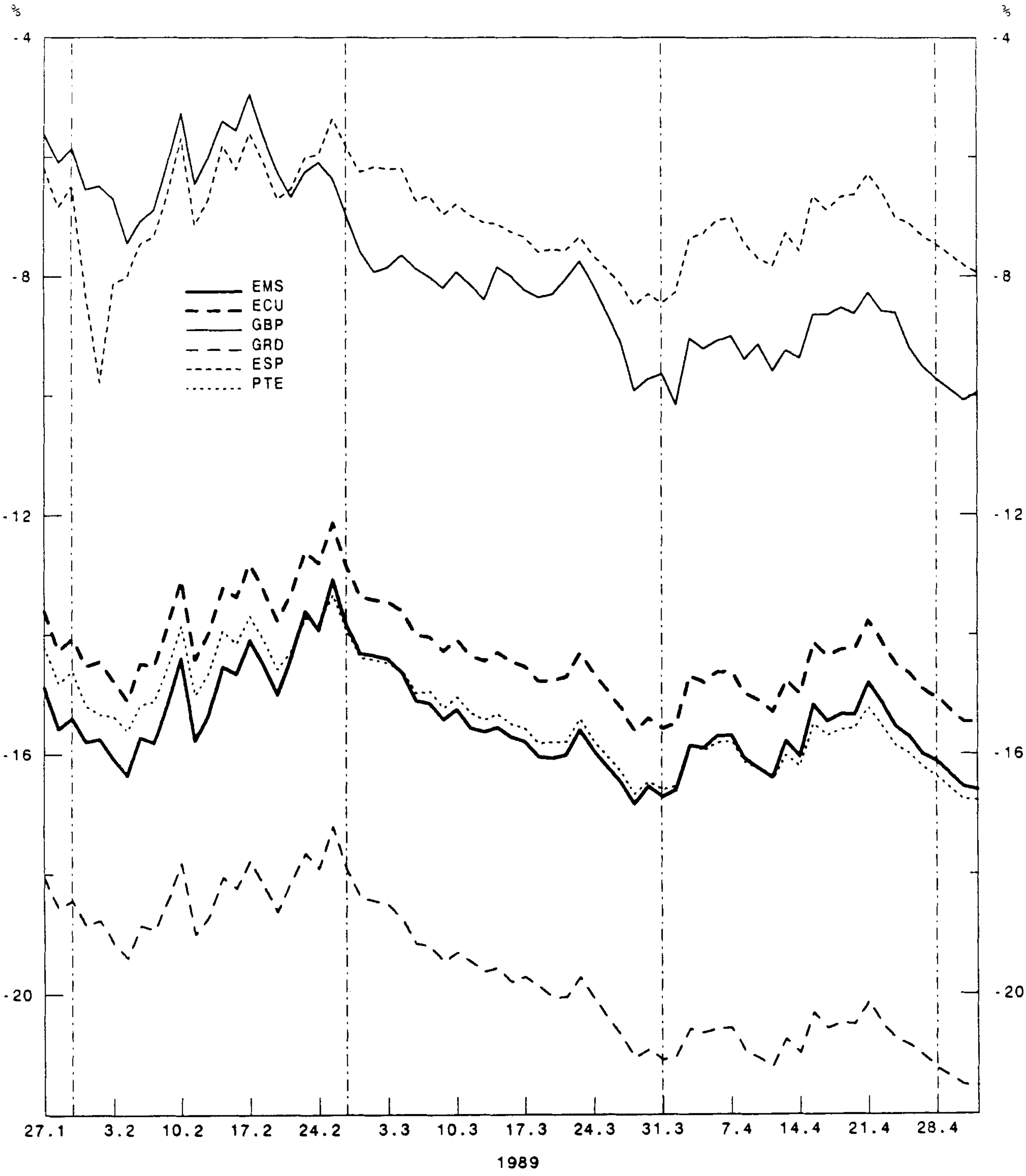
B. Interventions in Community currencies and in private ECUs

Interventions in EMS currencies by Community central banks amounted to the equivalent of US$ 2.3 billion, compared with US$ 2.9 billion in March. The interventions consisted almost entirely of purchases of Deutsche Mark by the Banco de España, the Banca d'Italia, the Banque de France, the Banque Nationale de Belgique and the Central Bank of Ireland. Also the Sveriges Riksbank made substantial purchases.

III. DEVELOPMENTS IN THE CURRENT MONTH, UP TO 5TH MAY

Upward pressure on the dollar persisted in the first few days of May, tempered by several rounds of concerted central bank intervention. The dollar firmed amid reports of strong corporate and investor demand for dollars and a marked absence of dollar sellers. Thin markets, due to holidays in Europe and Japan, at times exacerbated the effect of large orders to buy dollars on exchange rate levels.

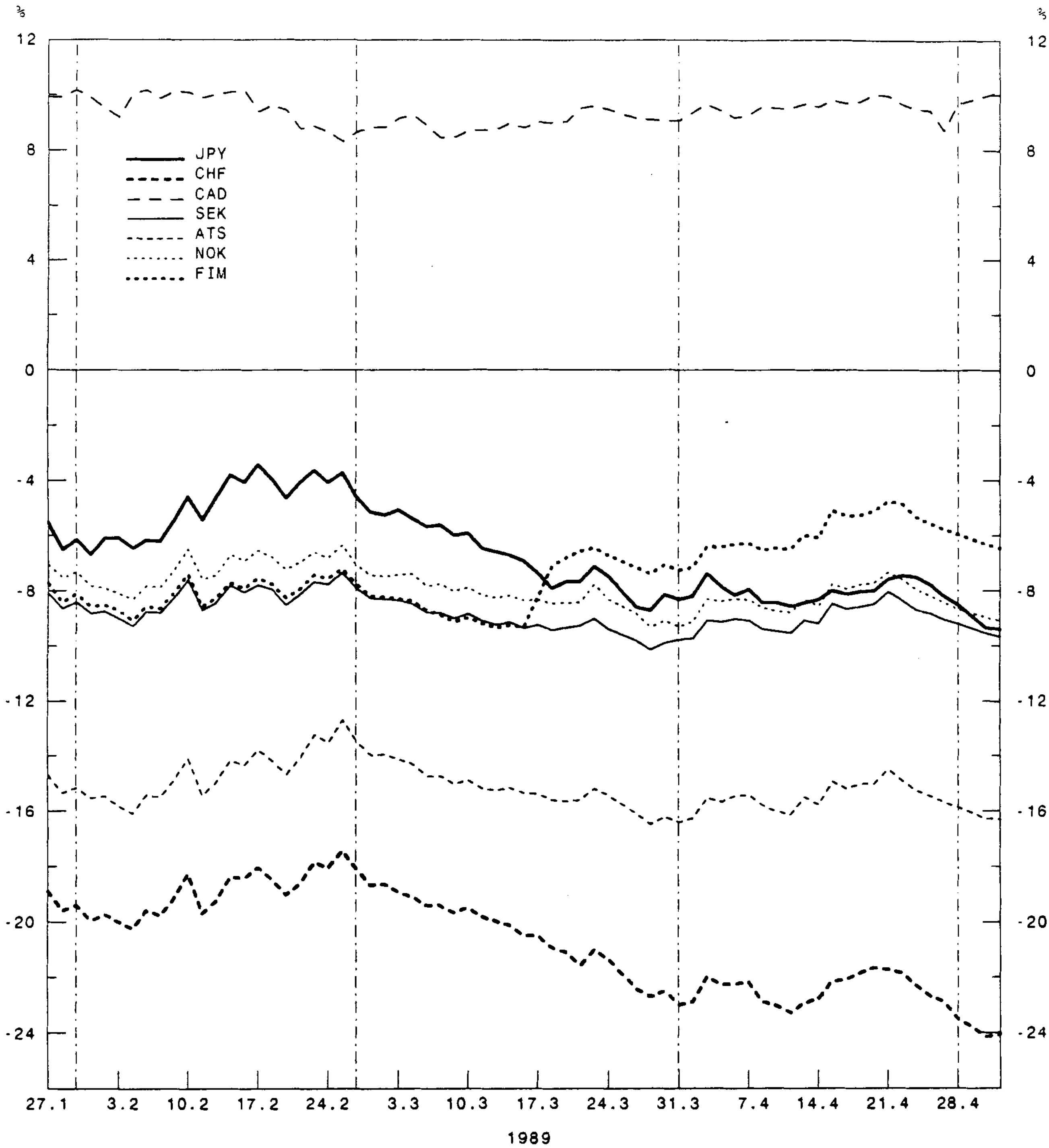
EVOLUTION OF THE ECU, THE MIDDLE RATE OF THE CURRENCIES PARTICIPATING IN THE EXCHANGE RATE MECHANISM OF THE EMS, AND THE CURRENCIES OF THE EEC CENTRAL BANKS WHICH DO NOT PARTICIPATE IN THAT MECHANISM, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* See next page.

5.5.1989

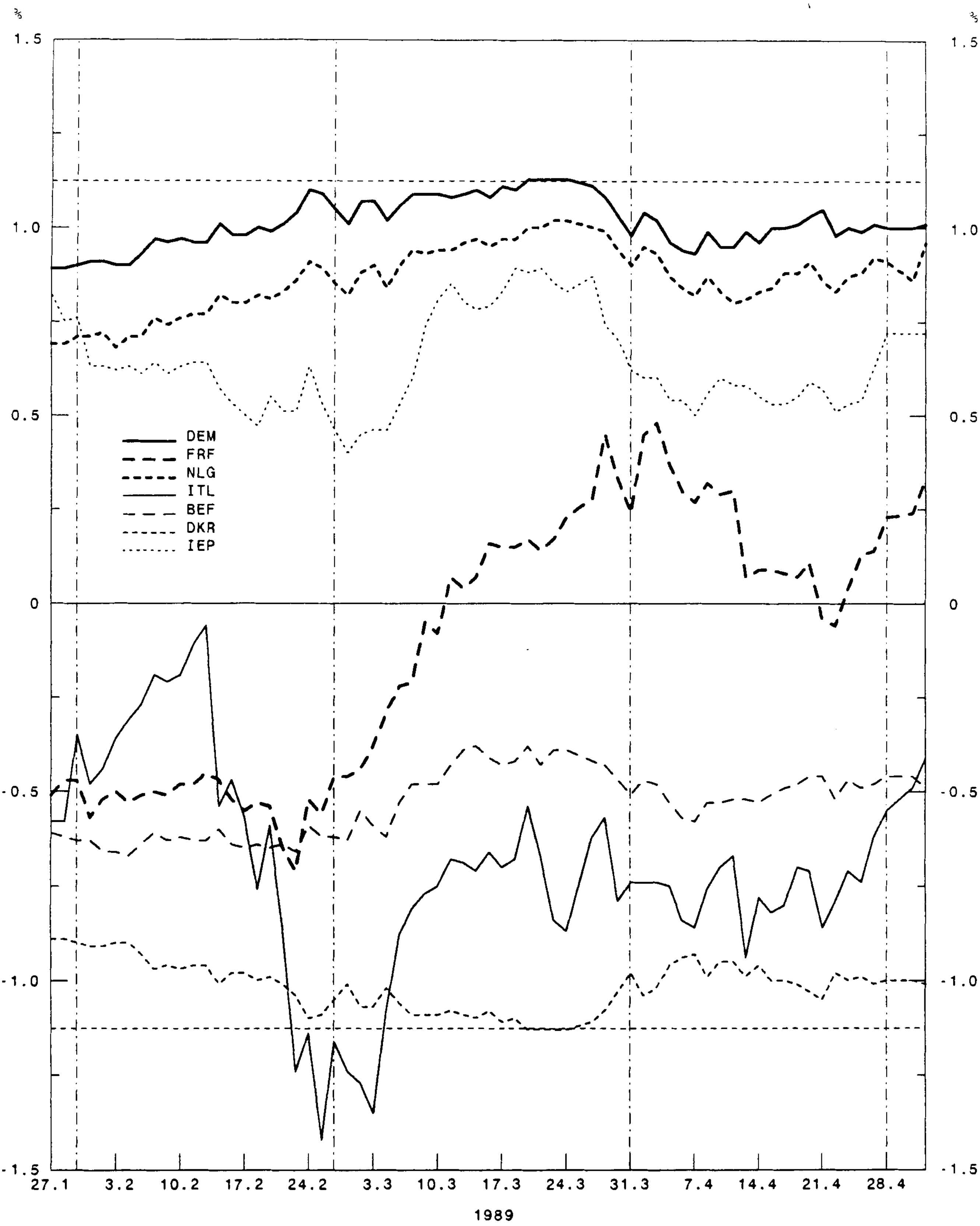
EVOLUTION OF THE CURRENCIES OF THE NON-EEC CENTRAL BANKS PARTICIPATING IN THE CONCERTATION, ON THE BASIS OF THE EXCHANGE RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE USD*



* ECU 0,767254; GBP 0,5346; GRD 126,2002; ESP 107,8498; PTE 130,0242; FIM 3,945; CAD 1,302; CHF 1,2775; JPY 121,4501; SEK 5,795; NOK 6,233; ATS 11,129; middle rate of the currencies participating in the EMS 0,77324. The middle rate of the currencies participating in the EMS represents the daily average of the exchange rates of those two currencies which have the largest divergence from their current bilateral central rates, with a maximum fluctuation of 2.25%.

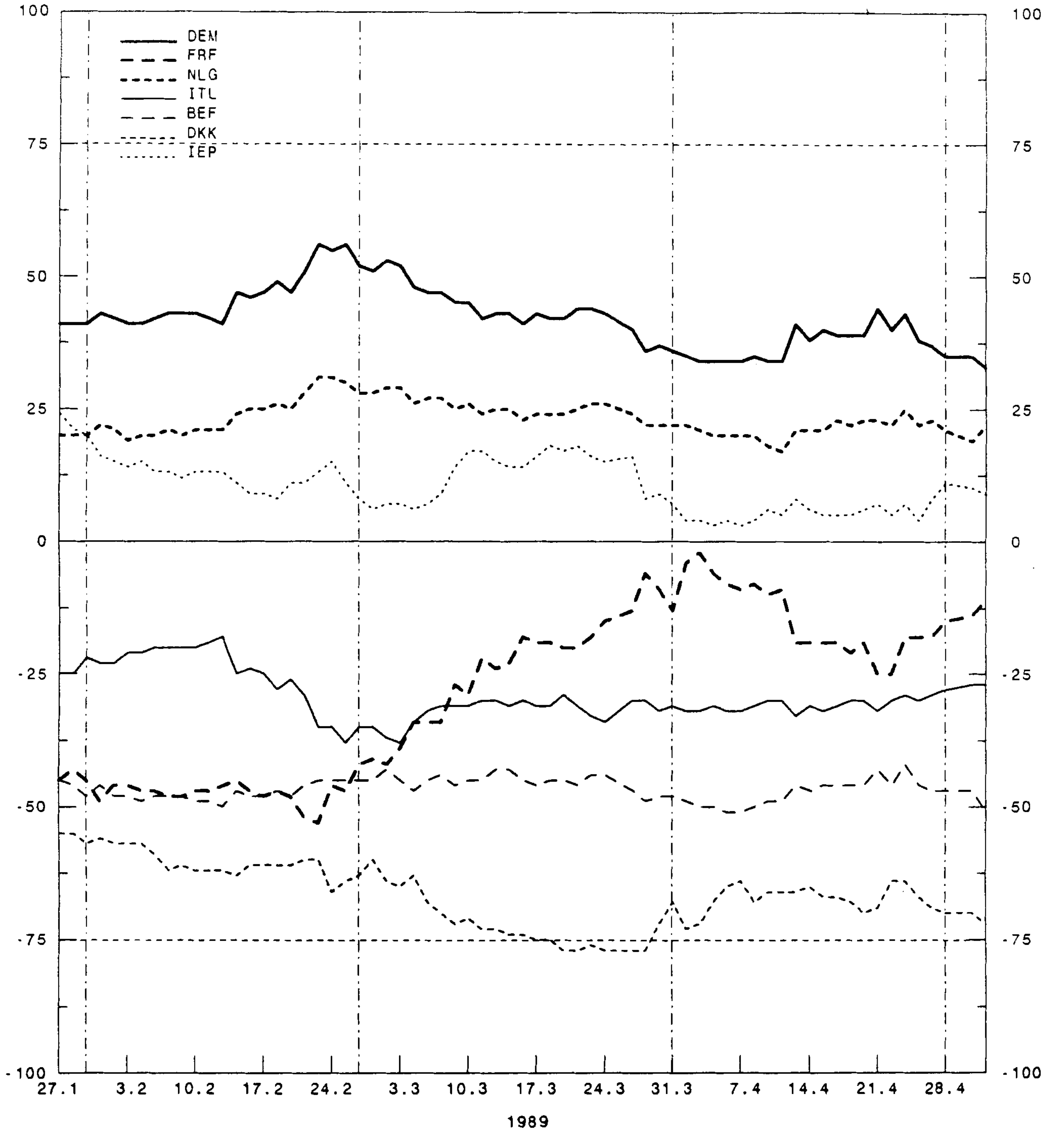
5.5.1989

MOVEMENTS IN THE EMS PARITY GRID



5.5.1989

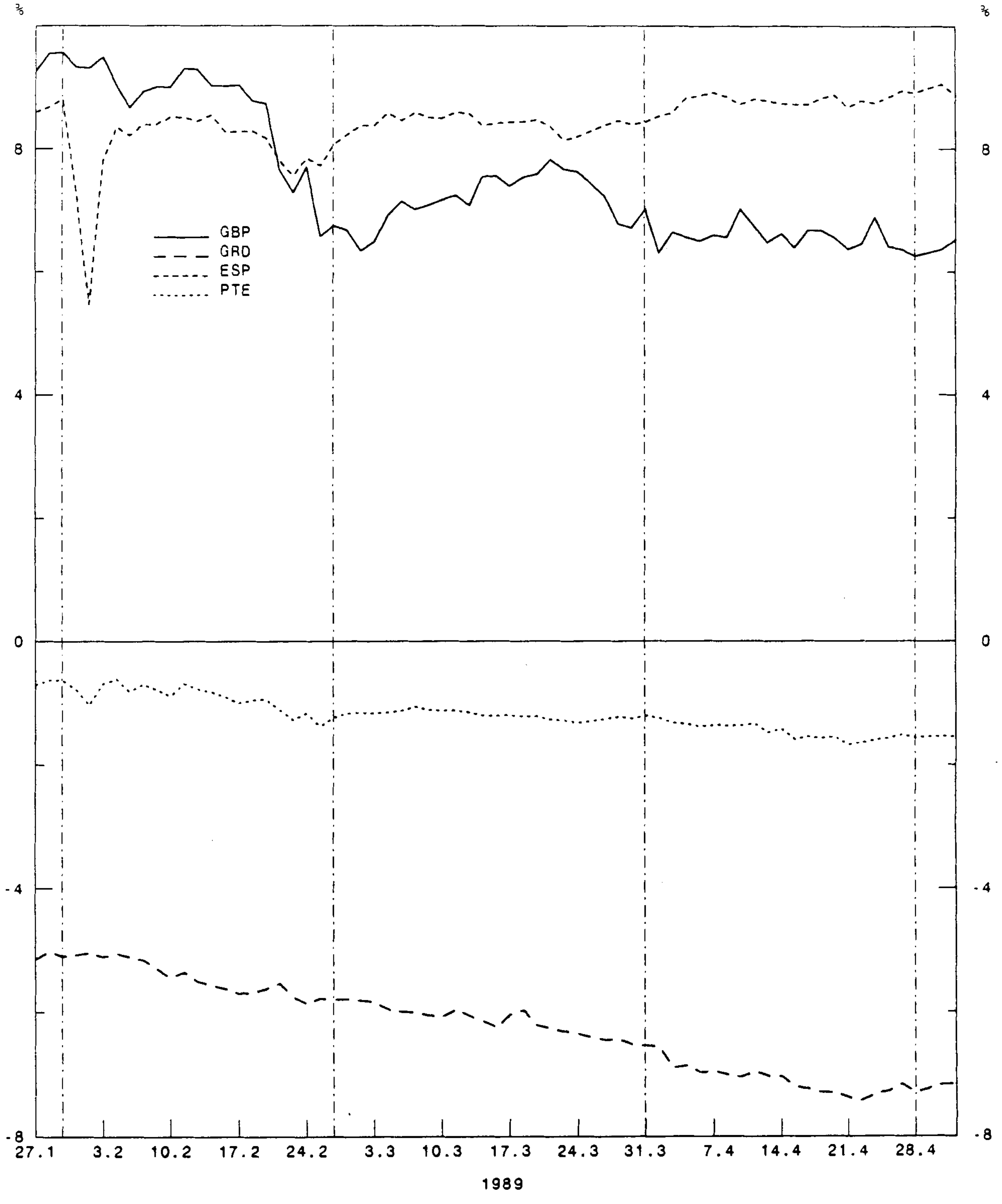
EVOLUTION OF THE DIVERGENCE INDICATOR*



* The divergence indicator provides a uniform measure of a currency's position in relation to its ECU central rate. The maximum divergence spread is the maximum percentage by which a currency's market rate against the ECU may appreciate or depreciate in relation to its ECU central rate; it is expressed as +/-100, the divergence threshold being +/-75. The data which has been used to draw this graph are the ECU rates against the different currencies, adjusted to eliminate the effect of the fluctuation of the Italian lira, the pound sterling and the Greek drachma outside the 2.5% margin against the other currencies participating in the EMS.

5.5.1989

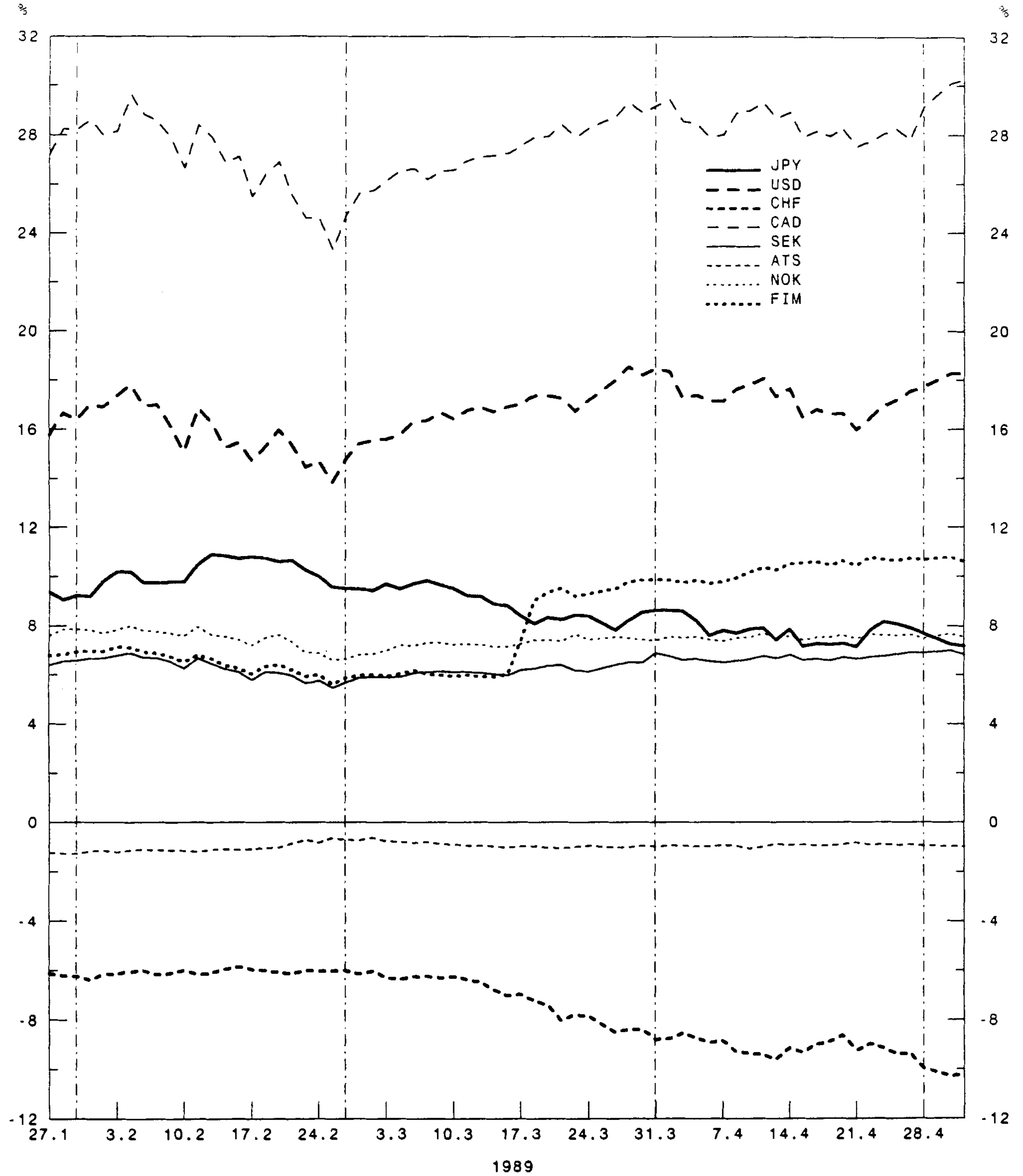
EVOLUTION OF THE POUND STERLING, THE GREEK DRACHMA, THE SPANISH PESETA AND THE PORTUGUESE ESCUDO, ON THE BASIS OF THE MARKET RATES PREVAILING ON 31ST DECEMBER 1987 AGAINST THE ECU*



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

5.5.1989

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



* USD 1,30335; CAD 1,69696; CHF 1,66503; JPY 158,292; SEK 7,55292; NOK 8,12378; ATS 14,5050; FIM 5,14172.

5.5.1989

Annex

Horst Bockelmann 7th April 1989

Speaking notes for a presentation to the
EEC Governors, on 11th April 1989,
on exchange rates in a longer-term perspective

- The tenth anniversary of the EMS seems an appropriate occasion to reflect on longer-term exchange rate developments, but as the EMS is a regional agreement within a wider international context, I shall enlarge my perspective to include all EEC currencies and the two major currencies outside of the EEC, the US dollar and the Japanese yen.

- Let me explain briefly how I have approached the subject. Exchange rates as a market phenomenon are bilateral by nature. However, when a large number of currencies are being considered, it becomes rather difficult to keep track of the bilateral relationships, even though they vary widely in importance. I shall look at <u>effective</u> exchange rates for the currencies concerned, based on trade weights calculated from export and import flows for twenty-one industrialised countries, and also taking into account third-market competition on the export side. For some time the BIS has been using its own method for this calculation which has, however, been revised recently. The decision to employ our own formula was taken in view of the fact that no clear "winner" has emerged so far from among the different approaches. In the absence of a broad consensus, one has to use one's own judgement to decide how best to combine the maximum number of advantages with a minimum of disadvantages. Our method differs from that of the OECD and the IMF mainly in its definition of "goods" (which is wider, not just confined to manufactured goods) and in its treatment of trade with countries for which effective rates are not calculated (i.e. LDCs, OPEC and eastern bloc countries).

- Exchange rates are, of course, strongly influenced by inflation differentials. If inflation differentials are large and consistent, they will, over time, assume dimensions which completely dominate exchange rate developments. As the different inflation performances of different countries is not our subject we shall look at real effective exchange rates. Statistically this implies an additional complication; it necessitates using the trade weights of the effective exchange rate also to construct the price indices abroad in order to obtain an effective inflation differential.
- One question in this context, to which there is no obvious answer, is which price index to use. The two most commonly used indices are the consumer price index and the index of unit labour costs, with a slight preference, it seems, for the latter, even though it is subject to much greater statistical problems than the former. The choice has, clearly, to do with the purpose of the calculation. If one calculates real exchange rate changes as a guide to changes in competitiveness, the index of unit labour costs in manufacturing or industry is obviously the better one, as productivity gains - which, together with wages, are reflected in unit labour costs - are of prime importance for competitiveness, although they do not, by any means, include all cost elements (interest rates, raw material prices, etc.)..
- There is, however, a different way of looking at what the inflation-adjustment of exchange rates is about. One can simply use purchasing power parity as a benchmark, as Rudiger Dornbusch put it, by which to judge the level of an exchange rate. Except in rather special circumstances, the best indicator for the development of purchasing power is the consumer price index. Deflating

effective exchange rates by relative consumer price indices best serves the purpose of eliminating inflation differentials so as to be able to concentrate on the other elements that contribute to changes in real exchange rates over time. In fact, most of the not particularly extensive discussion of these other elements in the literature has grouped them under the heading of "factors explaining deviations from purchasing power parity". I do not like that way of putting it because it implicitly assumes that purchasing power parity prevails over the longer term, or, to put it in normative terms, that real effective exchange rates should be stable. As we shall see, the factual statement proves to be the exception rather than the rule. The list of reasons for effective exchange rates not being stable is long and there are perfectly good reasons alongside less good or even bad ones. As there is not always a consensus on what is "good" or "bad" in any particular area, it may be more useful to distinguish between reasons on the real side and reasons on the monetary side.

- It must suffice for the moment just to indicate a few reasons for a permanent change in real effective exchange rates on the real side of the economy. The most striking reason is obviously higher productivity growth, which is often linked to higher growth in general and to a strong export orientation. The next most important reason may be terms-of-trade changes, particularly for exporters of raw materials. For other countries it can be conceptually difficult to distinguish between cause and effect as changes in real effective exchange rates themselves have terms-of-trade effects. Perhaps it may now become clearer why I prefer deflating by the consumer price index rather than by unit labour costs. The latter method offers more than inflation adjustment, it also contains an element of productivity adjustment, but it is done in a somewhat untidy way. From a practical point of view it may still, in the short run, provide an acceptable approximation for evaluating changes in competitiveness, but interpretation becomes difficult. I shall come back to this a little later.

- Nobody would argue, though, that the changes in real effective exchange rates which we observe are predominantly, or even solely, due to developments on the real side of the economy. Particularly in the short run, exchange market dynamics, such as overshooting, and influences of monetary and fiscal policy are clearly the dominant factors. A country that shifts unilaterally in the direction of tight money must expect a real appreciation, and vice versa. The effect of changes in fiscal policy is more controversial as the experience of the US differs from that of other countries. Factors which influence international portfolio decisions also have a bearing on real exchange rate changes. Fürstenberg argued in 1985 that portfolio holders have a preference for the currencies of low-inflation countries, which he found causes these currencies to appreciate. It appears, however, that this held true only at a time when real interest rates were low or negative in high-inflation countries. More recently this has certainly ceased to be the case. In addition, expectations of stability in nominal exchange rates seem to have tended to cause a real depreciation of low-inflation currencies.

- May I now ask you to look at Table 1 of the statistics which I have distributed. The year 1979 has been taken as the base year (= 100); the data are annual averages. 1979 has been used as the base year not only because it marks the birth of the EMS, but also because it was a year when current-account imbalances were on the whole relatively modest. There can be no perfect base year, but 1979 seems less imperfect than any other.

- Over the period from 1979 to 1988 real effective exchange rates remained stable only in the case of Portugal, which may merely demonstrate that the escudo is managed, presumably on a trade-weighted basis, in a way not dissimilar to that used for our calculation. Four of the thirteen currencies appreciated in real terms over the same period; these are, in descending order, the currencies of Japan (+ 36 %), Italy (+ 18 %), Ireland (+ 13 %) and the United Kingdom (+ 4 %). That leaves eight currencies which depreciated; again, in descending order, they are the currencies of Belgium (- 15 %), Germany (- 13 %), Greece (- 11 %), the Netherlands (- 9 %), France (- 8 %), Spain (- 7 %), the United States and Denmark (- 4 %). The fact that the appreciation rates were higher partly accounts for the asymmetry between the number of appreciating currencies (four) and the number of depreciating currencies (eight). (Another reason is the fact, mentioned earlier, that these effective exchange rates are calculated on the basis of twenty-one countries, as against only thirteen shown here; those missing from this table include Canada, Australia and Switzerland.)

- Table 2 gives for comparison the same results for unit labour costs. As you can see, they are quite different for a number of currencies, such as the Irish pound (which drops from third to twelfth place) and the Portuguese escudo (from fifth to eleventh). Strong movements in the opposite direction can be observed for Germany and Greece. Otherwise the "league" table is similar, with Japan in the lead, and United Kingdom and Italy towards the top and Belgium at the bottom of the list, but the actual figures are nevertheless quite different.
- The interpretation of these differences - as I mentioned earlier - is not easy. It may be necessary to look at developments in profits in manufacturing on a country-by-country basis. The fact that the appreciation of the yen is lower in CPI terms than it is in terms of unit labour costs might suggest that profit margins in manufacturing in Japan have been reduced. The fact that the Deutsche Mark is shown to have been stable in unit

labour cost terms but to have depreciated in CPI terms might well be explained by the restoration of profit margins. But this is certainly not the whole story, as the consumer price index does not include export prices and, indeed, may be dampened by import prices. Price performance in the export sector and in the rest of the economy can differ widely.

- Table 3 takes the time series for the CPI-deflated real effective exchange rates of the thirteen currencies back to 1960, well into the time of the Bretton Woods system. It would not be surprising to find that changes in real effective exchange rates turned out to be larger between 1960 and 1973 because of the stickiness of nominal exchange rates under a fixed exchange rate system. That was, -taking the period as a whole - not generally the case, but it does hold true for quite a number of countries, including the UK, the Netherlands, Denmark and Greece, with Germany, Italy, Spain and Portugal on the border-line. In six countries, the US, Japan, France, Spain, Denmark, Greece, the direction of change was the same before and after 1973, in other words: if these currencies had been depreciating or appreciating in real terms over the period 1960-73, they continued to do so over the period 1973-88. Clearly, it would be very difficult to attribute such a long-term trend to anything other than quite fundamental characteristics of the economies concerned. Neither speculative capital movements nor fiscal or monetary policies qualify as explanations. Things would, no doubt, be different if we looked at the year-on-year changes, which, however, we cannot do here.

- Table 4 shows instead the variability of changes in real effective exchange rates based on the consumer price index for the periods 1960-73 and 1973-88. There is not a single currency whose variability was not substantially greater during the latter (floating) period than in the period before; in some cases the increase is dramatic. The smallest increase in the variance of changes is observed for the currencies of Ireland and Germany, with multipliers of 1.1 and 1.2. The largest increase is that of the yen, where the variability of changes in the real effective exchange rate is three times what it had been under the Bretton Woods system. For the US dollar the variability has been multiplied by 2.2; for the currencies of most EEC countries the increase in variability is smaller.

- Even more interesting than the contrast between the two periods is the actual level of variability in the later period. Here we can see demonstrated the well-known fact that real effective exchange rates have fluctuated less for the currencies of the EEC countries than for the yen or the US dollar. The currencies of those EEC countries not participating in the EMS - the United Kingdom, Spain, Greece and Portugal - have, however, figures for variability which are close to that for the US dollar, but still well below that for the Japanese yen.

- I should draw your attention to the fact that we have been looking at the variability of changes from year to year (based on annual averages). Short-term volatility from day to day, week to week or month to month has been left out of account. You all know the verdict on the floating rate system: that, while high volatility can be tolerated, severe misalignments cause trouble because of the wrong signals they imply for investment in capital goods. Given the increased changes from year to year, one must conclude that severe misalignments have become more frequent. Non-misaligned real effective exchange rates may well have to change over time, but certainly not by as much as we have observed here. But this is only a tentative observation. To discover whether any particular effective exchange rate is "out of line" at a particular time requires, clearly, a much broader analysis than one which looks at exchange rates and nothing but exchange rates.