

Committee of Governors' Alternates
(11th/12th March 1990)

Short Report

I. EMS associate membership

Two views on the question became apparent during discussions:

- Several Alternates (F, I, E) see the EMS as very different now compared to 1979 when the possibility of association was opened. Economic integration has become an essential element of the EMS and is brought about by convergence efforts in a whole series of procedures in different fora. In addition, Mr. Lagayette stressed that the EMS is at the basis of EMU and progress towards closer monetary integration. This means that any association must be very strong and involve the associate member closely in all aspects of the EMS. There is thus little or no difference between associate membership and full EMS membership, since anything less would pose risks for the stability of the system.
- The other Alternates (including Mr. Tietmeyer) supported Mr. Szasz who views the EMS as an important method of extending the area of exchange rate stability in Europe, which would bring benefits to the Community. There is also a need, in his view, to show that the EC is not closed to the outside. For these reasons, as long as potential associate members are prepared to accept the policy obligations, they should be welcomed. These Alternates also see strong association as the only viable option.

Both sides agree that the criteria for associate membership should be strict:

- similar view of economic policy;
- full capital liberalisation;
- stability-oriented policy.

Though Mr. Dini would add a link between association and the process of becoming a full EC member (which Mr. Tietmeyer was prepared to

accept, though he would not require it), Mr. Lagayette even thought support for the goal of EMU was necessary.

Mr. Tietmeyer clearly supported the Austrian application for EMS associate membership. Mr. Szasz warned that setting application for full EC membership as a kind of criterion risked prejudicing the future decision on adhesion if an EMS associate member was accepted.

In discussing technical aspects, there was agreement that a two-stage realignment procedure was appropriate, whereby associate members cannot block the decision of full members. Various formulae for participation in meetings of Community fora were suggested, with little apparent disaccord. The need for a rule allowing termination of EMS association was seen as necessary.

To resume in conclusion, the Alternates all agreed that strong association is necessary for technical reasons (stability of the system, need for convergence, etc.) but the French, Italian and Spanish saw it as irrealist to propose that kind of association to countries which are not full members of the Community. The Chairman, Mr. Rey, will present a written report to the Governors.

II. Rules concerning intervention in Community currencies

The Alternates went into the question of the exact rules for when prior accord on the part of the issuing central bank is needed for the use of its currency for intervention purposes. At the root of the problem lies the theoretical veto power of the Bundesbank to all Deutsche Mark interventions and the widespread circumvention of this rule in practice (particularly during fixing sessions). A link has been made between this question and agreement to permanently raise the acceptance limit for official ecus in settlement of VSTF debts to 100%.

The discussion showed a large gulf between the Bundesbank and others, although Mr. Tietmeyer did offer to recognise a principle of presumption of acceptance of any request provided certain criteria were met. Prior agreement should, however, nevertheless still always need to be obtained. Others (F, I, E, GR) found this offer rather disappointing.

The Alternates will continue their deliberations next month.

III. Exchange rate and monetary developments

The reports of both the Dalgaard and Raymond groups were discussed jointly. Mr. Dalgaard's report concentrated on the German situation, noting the abrupt change to weakness shown by the Deutsche Mark following the FRG's monetary union offer to the GDR on 7th February. While it is understandable that the conversion rate remains undecided, the markets are already making their judgement on the likely costs of unification.

The dollar's strength is a reflection of the weakness of the yen and the Deutsche Mark. Although its present level is not worrying, interventions involving dollars should rather be sales, not purchases.

The position of the yen, which has lost -25% of its value against the Deutsche Mark over the past year, is unreasonable, but there is little that can be done if the Japanese do not raise interest rates.

The lack of convergence in economic fundamentals experienced in 1989 and to be expected in 1990 was stressed in Mr. Raymond's report. Convergence of monetary policies and current accounts will not improve, budgetary adjustments appear also to be stalled, except in E and IRL, or are even diverging (GR, P). Inflation rates are expected to converge slightly within the ERM but divergences of unit labour costs remain larger than those of consumer prices.

The prime impact of events in eastern Europe is to be seen in the FRG where capital utilisation is already high for three reasons:

- high demand in other EC countries;
- high domestic demand in the FRG;
- demand from the GDR.

The Bundesbank may have to increase interest rates.

The DM yield curve has steepened either because of expectations of higher inflation or because of the increased demand for capital. If the first case is true then an increase in short-term rates will help bring down long-term rates, but, if the second case is correct, then a rise in short-term rates would only accentuate problems.

Mr. Tietmeyer announced that the report of the expert group on German monetary union will be finalised tomorrow (13th March). The situation is extremely complicated, with the 1989 figures showing an economic deterioration apparent since 1988. The report will include no conclusion on the conversion rate, but there will be some cornerstones for institutional reform. There will be at least several weeks' negotiations necessary with

the new Government after next Sunday's GDR election before agreement can be reached.

Mr. Tietmeyer complained about the concentration on problems in Germany. Excessive inflation expectations are unrealistic. This talk on dangers will only raise interest rates. What is needed as well is an effort to restrain demand in the rest of the EC, otherwise imbalances will not be corrected, in which case monetary policy in the FRG will need to become more restrictive.

Uncertainty due to slow political decision-making is at the root of the yen's weakness. Intervention may even be counter-productive while uncertainty remains.

This assertion was challenged by Mr. Lagayette, who thought that the Bank of Japan interventions at least showed that the authorities want a stronger yen; otherwise it could slide further.

DM weakness was minor in his view, but information is not used enough as a weapon. The market is not convinced by Mr. Tietmeyer's (welcome) assurances that inflation is not a danger. Of course, other European countries have a role to play in co-ordinating policies, but we should stay calm - there is no need to raise short-term rates, this would be the wrong instrument.

There are two main uncertainties in Germany according to Mr. Crockett: the size of net transfers and how they will be financed. The markets need guidance on both questions. On the yen, perhaps we are underestimating the change in the structure of the Japanese balance of payments due to overseas production and to equity investment abroad. Mr. Crockett also pointed to the Greek situation which is showing signs of unsustainability.

Mr. Rey concluded by noting the Committee's legitimate interest in the German situation, but reminding members that there are also worrying situations elsewhere. It is difficult for the Germans, negotiating in public, since markets are uncertain. They should not be fuelled by unnecessary declarations. There will be a need to make room for transfers to the GDR by adjustments in the FRG, but also in other EC countries. The policy mix will be important.

IV. Liquidity facility for the ecu clearing

The Alternates agreed to ask the Governors to give a green light to the BIS to negotiate a scheme with the ecu commercial banks similar to

those proposed by the Bank of England and the Banque de France. Mr. Tietmeyer was clearly reluctant to support the ecu in this way, but preferred to have a BIS scheme instead of national schemes. This was acceptable to the Bank of England as long as the scheme could be put in place by next month, but Mr. Lagayette reserved the right of the Banque de France to implement its own proposal even if the BIS scheme was agreed.

ECB-PUBLIC

DOCUMENTS TO BE INCLUDED ON SATURDAY MORNING
IN THE ENVELOPES FOR THE MONTHLY MEETINGS

Monitoring

Graphs (monitoring)
New Table 2
Effective exchange rates

Concertation

Report(s)
Tables
Small table from Danmarks Nationalbank

Alternates

Graphs (monitoring)
Concertation report
Concertation tables
Supplement to Report 69
Rules of Procedure
Graphs on Effective Exchange Rates

Governors

Graphs (monitoring)
Supplement to Report 69
Graphs on Effective Exchange Rates