

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

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GROUP OF EXPERTS UNDER THE  
CHAIRMANSHIP OF M. RAYMOND

SPECIAL REPORT ON  
MONETARY POLICY IMPLICATIONS OF THE  
LIBERALISATION OF CAPITAL MOVEMENTS WITHIN THE COMMUNITY

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29TH MAY 1987

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List of participants

## INTRODUCTION

The present report has been drawn up by the group of experts (see the attached list of members) in accordance with the mandate in Annex I. The report is divided into five chapters:

- Chapter I presents some preliminary remarks;
- Chapter II deals with some technical issues raised by the liberalisation of capital movements;
- Chapter III considers the consequences of the liberalisation of capital movements as well as of dollar and yen movements for exchange rate management and monetary policies in the EMS exchange rate mechanism;
- Chapter IV analyses the situation of EEC countries not participating in the EMS exchange rate mechanism;
- Chapter V presents some conclusions drawn by the group.

## CHAPTER I PRELIMINARY REMARKS

### 1. Main goals

1.1 The progressive abolition of exchange controls, to the point of the complete freedom of capital movements, is an objective actively pursued by the authorities of the European Community. This process is a vehicle of progress, in that it will improve the allocation of financial resources, reduce the cost of the financial system by heightening competition and create a market which is broad, efficient and consequently attractive to operators in all countries.

1.2 At the same time, it is a European project which ought not to be taken out of the context of the long-term perspectives of an Economic and Monetary Union. The measures under study must, therefore, not divide member countries, but bring them closer together. They must not jeopardise existing achievements with regard to price and exchange rate stability.

## 2. Scope of the subject

2.1 Not only the abolition of exchange controls but also the free provision of financial services has implications for capital movements. This reform, however, is less directly linked with monetary policy, and it has a different logic.

2.2 The removal of foreign exchange restrictions between member countries cannot be divorced from an opening-up vis-à-vis countries outside the Community. As soon as just one member country has no exchange control at all, the removal of any restriction in another member country has to apply erga omnes and not only to intra-EEC capital movements. It is necessary to see capital flows in this wider context in order to measure the impact of the dismantling of exchange controls in countries linked by special exchange rate commitments.

2.3 Because of the present disparity in conditions among member countries, technical factors (see Chapter II) may be a source of disturbance and certainly lend themselves to considerable improvement.

## 3. The current position

3.1 An examination of the facts reveals that, even within the group of countries belonging to the exchange rate mechanism, there is a diversity of situations (see Annex II). Some are entirely without exchange controls. Where restrictions do exist, they apply only to residents, generally do not limit their borrowing abroad, and may be circumvented by fraud and by economic behaviour such as leads and lags.

3.2 The compartmentalisation of the European financial markets has not yet completely disappeared. Nevertheless, the process of integration is already underway. Financial innovation has been contributing to it for several years. The national authorities have deliberately accelerated and guided it.

3.3 Full liberalisation will reinforce an external constraint which already exists in exchange rate and interest rate management for all the countries in the European exchange rate mechanism. In this sense there will be a certain loss of autonomy in domestic monetary, fiscal and, more generally, economic policies.

## CHAPTER II TECHNICAL CONSIDERATIONS

### 1. Elaboration of monetary policy

1.1 Capital liberalisation will enable residents in the countries under consideration to hold more of their assets outside the national borders. Thus, in order to assess monetary and financial conditions it might become desirable to have, in addition to the statistics provided by the national financial system, information concerning residents' positions abroad. It would also be useful to have information on non-residents' national-currency holdings with foreign banks. Data supplied by the BIS, balance-of-payments analysis or other sources may be of service here. For the moment, residents' liquid assets held abroad are generally considered to be of little importance - and changes in them of little significance - for purposes of domestic monetary regulation; however, expatriation of monetary assets by residents played a significant role in Germany last year.

1.2 The instruments of monetary policy cannot but evolve progressively towards an increased role for money market rates, along the lines indicated in the Group of Experts' Special Report of November 1986.

### 2. Regulations

Consideration will have to be given to differences in tax regimes (certain member countries consider that a pre-condition for further liberalisation of personal capital movements may be some mutual system of reporting interest income for taxation purposes), certain rules relating to monetary policy such as compulsory reserves (which, by imposing constraints on the banking system, influence its borrowing and lending rates) and, finally, banks' supervisory ratios. The statuses of certain financial institutions may also pose a problem, as may particular financing mechanisms (e.g. re-discount window at preferential rates).

This does not mean that it is necessary, nor indeed would it be possible in the short-term, to reach a state of complete identity in every field. Stable exchange rates may be maintained between countries with different administrative regimes. In any case, portfolio diversification considerations may lead the residents of a country abandoning exchange controls to transfer part of their savings as soon as they are free to do so to a

newly-opened market. Thus an initial adjustment of portfolios would be likely even if equilibrium were re-established subsequently. This portfolio adjustment would of course be even more substantial if residents were gaining access to markets where they would receive better treatment than at home.

It would therefore be necessary to identify the reforms entailed by each stage of liberalisation with a view to eliminating the chief sources of distortions likely to set off large-scale arbitrage activity.

CHAPTER III EXCHANGE RATE MANAGEMENT AND MONETARY POLICY IN THE EMS  
EXCHANGE RATE MECHANISM

1. Repercussions on exchange rate stability

1.1 The fundamental issue that arises today relates to the theoretical impossibility of combining more than two of the following three characteristics:

- complete freedom of goods, services and capital movements;
- fixed exchange rates;
- autonomous monetary policy.

If one adheres to the first of these terms as a working hypothesis, the other two become incompatible. Fixed exchange rates could only be maintained, therefore, by renouncing autonomy in monetary policy. In the EEC this incompatibility will be especially acute during a transitional period since socio-economic convergence remains incomplete.

1.2 In practice the exchange rate mechanism does not imply absolute exchange rate rigidity. The existing margins of fluctuation, albeit narrow, provide a certain degree of flexibility. In addition, parities may be changed. Indeed, the EMS exchange rate mechanism was built and developed on the balance between adjustment and accommodation by the way of realignments. Nevertheless, in order to orientate the policies of member countries towards convergence around a low level of inflation, the size and frequency of realignments have been limited and linked as far as possible to fundamental divergences.

1.3 The dismantling of capital controls has potentially two opposite effects. On the one hand, taken by itself, it could be interpreted as evidence of the will to increase economic and financial coherence among member countries. This would have a favourable impact on expectations and help to maintain the existing degree of exchange rate stability. On the other hand, liberalisation will enlarge the scope for speculative capital flows and this should be seen against the risk that markets may exaggerate the exchange rate implications of temporary economic, financial or political disturbances arising inside or outside the EMS exchange rate mechanism.

The experts are not unanimous in their views on how to tackle such exchange rate crises. Some of them consider that in exceptionally adverse conditions greater flexibility of exchange rates should be accepted. They believe smaller but more frequent realignments are an appropriate answer to destabilising capital flows since they would limit the size of interventions which might otherwise be so heavy as to create liquidity shocks for domestic monetary conditions.

Other experts feel that tension occasioned by anything other than clear fundamental disequilibrium should be countered by a combination of wider use of the margins and greater use of intervention and interest rate policies. Interventions would have to be more substantial than before liberalisation of capital movements. They would be most effective if they took place simultaneously in the countries losing and in those receiving capital. The scope for joint intervention cannot, however, be determined in advance, since individual members' contributions will depend also on the nature and duration of the disturbances giving rise to temporary exchange rate pressures. Domestic interest rates would also have to be moved up or down earlier and more strongly. Intervention and interest rate policies should be linked more closely; intervention sales in defense of downward pressure on a currency have the added benefit of pushing domestic interest rates up and reducing liquidity and vice versa.

One may well ask what interest rate differentials would have been necessary to avoid parity adjustments in the weeks leading up to the "crisis" realignments that have been made since 1979. However in some circumstances, very sharp rises in money market rates have effectively discouraged speculation and, since they lasted only a short time, have had no destabilising effect on the economy. Anyway, the latter effect may, if necessary, be limited by variations in compulsory reserve requirements.

Certain countries with highly open economies which are already very exposed to external constraints fear the deflationary risk entailed by the necessity of raising domestic interest rates still further in order to stifle capital outflows. Conversely, those countries which have eliminated inflation and whose currencies are candidates for revaluation fear being unable to control their monetary aggregates.

1.4 These opposing fears show how important it is not to let oneself be forced into a crisis situation and, to this end, to make a constant effort towards a sufficient degree of convergence. Nevertheless, however vital it may be at this stage, convergence does not provide an absolute guarantee, as operators may consider that, over time, the risk is not constantly equal for all the currencies concerned.

## 2. Co-ordination of monetary policies

Convergence can only be the result of a protracted socio-economic process which includes close co-ordination of overall economic policies, especially fiscal and monetary policies. This is why co-ordination of economic policies and convergence of results constitute a central element of the texts establishing the EMS which is conceived as "a scheme for the creation of closer monetary co-operation leading to a zone of monetary stability in Europe".

### 2.1 How to conceive co-ordination of monetary policies

2.1.1 The countries participating in the exchange rate mechanism could align themselves - to comply with the constraint imposed by the exchange rate - with the policy of one of their number, whether because it is judged to be the best or because it is that of the dominant economy.

2.1.2 Alternatively, national inflation objectives could form part of a more explicitly co-ordinated strategy for the Community as a whole, aiming at convergence towards a low common inflation rate in the longer run. Such an approach would have to be backed up by overall economic policies, since monetary policy alone could not be expected to guarantee the best outcome for prices and growth. Even so, national inflation rates are unlikely to converge fully in the short run. In these conditions nominal interest rates



in participating countries would still differ, and from time to time exchange rate adjustments would have to take account of inflation differentials according to the current practice.

2.1.3 When a general reduction of the rate of inflation in the Community is called for the natural choice is the convergence of prices on the best performance. This does not exempt the best performer from making temporary concessions to external constraints to the extent that they do not lead to an irreversible departure from its inflation objectives and the corresponding long-term target path for monetary growth. In the present environment of reduced inflation it might appear that there is no longer a single country which provides a natural objective for convergence and thus the second alternative presents itself. However, countries which have already eliminated inflation would only find such an approach acceptable if the long-term Community objective were close to zero.

2.1.4 In EMS countries with small, open economies monetary stability largely depends on exchange rate stability, and thus an exchange rate target is set. This target can take the form of a link with the currency of the dominant economy but some of the countries concerned also consider it possible to set an exchange rate objective which fits into the Community strategy mentioned above.

## 2.2 How to reinforce co-ordination

2.2.1 Structural differences between the countries participating in the exchange rate mechanism rule out the use of a money or credit aggregate as a basis for a common European objective. It is not feasible to co-ordinate directly intermediate monetary objectives in different countries and a system involving an automatic response to deviations from a given norm is impractical.

2.2.2 The medium-term strategy suggested in paragraph 2.1.2, if adopted at a Community level, should be translated into annual national price norms. The technical question of the appropriate price measure would have to be resolved and common policy co-ordination procedures would have to be initiated at the governmental level in order to ensure that each participating country applies a policy mix which is compatible with its national inflation target.

2.2.3 At the same time efforts should be made to improve the understanding and availability of information concerning monetary aggregates, the demand for money and the movement of capital in a new, liberalised environment.

2.2.4 In the shorter-term perspective and possibly as a first step in the direction mentioned above, it is important to establish an early-warning system for disturbances in the markets. For this purpose, those responsible for monetary affairs might have regular discussions, on a monthly basis, on interest rate developments, focusing on the interplay of:

- interest rate differentials between countries;
- exchange rate movements within the EMS band;
- interventions on the foreign exchange markets, together with other official capital flows; and, in the light of the considerations above,
- economic fundamentals in individual countries (the Group's Report No. 29 considers the key variables relevant for the achievement of intra-EEC exchange rate stability, viz. nominal prices, monetary aggregates, the budget and current account balance, real GNP and unemployment);
- the impact of capital flows vis-à-vis countries outside the EMS (see section 3 below).

Such discussions should be supported by appropriate statistical material and a synopsis of salient developments (see Annex III). The existing published or confidential sources of information on interest rates should be utilised or adapted as far as possible, and similarly the existing meetings and channels of communication between officials should be used and improved if necessary.

2.2.5 It could be envisaged that any significant changes in money market conditions be communicated to partners without delay, possibly by supplementing the daily concertations currently carried out on developments in the foreign exchange markets.

### 3. Temporary tensions in the EMS exchange rate mechanism caused by external shocks

3.1 Capital flows between the countries participating in the EMS exchange rate mechanism and third countries involving sudden and sizable

changes in exchange rates destabilise the EMS exchange rate mechanism to the extent that they lead the markets to reassess the sustainability of the prevailing parity grid. This will be the case if:

- the economies of member countries are unevenly affected by the external shocks;
- some member countries are expected to be able to cope with the impact on their economies of currency appreciation or depreciation more easily than other member countries;
- markets perceive a lack of co-ordination of policies by member countries in response to these external shocks.

If such doubts on the sustainability of the parity grid in the face of external shocks arise, the result will be that initial inflows or outflows from or to third countries will concentrate on a few individual EMS currencies instead of all EMS currencies; in addition there will be speculative intra-EMS capital flows which will heighten the problem of the uneven distribution of the initial capital flows.

The implications of capital liberalisation in these circumstances do not differ in essence from those described in paragraphs III 1.3 and III 1.4 above.

#### CHAPTER IV THE SITUATION OF EEC COUNTRIES NOT PARTICIPATING IN THE EXCHANGE RATE MECHANISM

##### 1. Countries maintaining more or less severe exchange controls

The situation in Greece, Spain and Portugal is characterised by the fact that inflation is still above the EMS average and public sector borrowing requirements are relatively high. The degree of domestic difficulty, however, varies, as does the degree of restriction of capital movements; Spain seems to have moved relatively close to the average economic performance of EMS countries and some liberalisation measures have recently been taken. The Spanish authorities envisage joining the EMS exchange rate mechanism in the not too distant future, the exact time being dependent on further progress towards more domestic stability and the modernisation of financial structures.

Even more far-reaching measures will have to be taken in the two other countries. Under present circumstances liberalisation of capital movements would involve serious balance-of-payments problems. This would put additional strains on monetary policies in these countries with serious consequences both for public sector deficits and the private economy. At the same time financial markets will have to be developed further in order to allow flexible monetary policies.

2. Countries where no exchange control operates

The liberalisation of capital movements in partner countries is likely to have little impact on capital flows and monetary policy in the United Kingdom. Nor is it likely to affect the United Kingdom's attitude to membership of the exchange rate mechanism which remains influenced inter alia by the belief that exchange rate movements in response to changes in oil prices may be necessary to ensure a sustainable balance of payments position in the longer term.

CHAPTER V CONCLUSIONS

(i) The liberalisation of capital movements currently being pursued in the EEC is a vehicle of progress towards greater efficiency of the financial system and, hence, capital utilisation, in Europe.

However, this process of change has raised, in particular, the following issues:

- the assessment of domestic monetary conditions and the appropriate adjustment of instruments of monetary control;
- the co-ordination of monetary policies within the EMS with the dual aim of achieving domestic and external stability;
- the position of the countries not participating in the exchange rate mechanism.

(ii) The first of these issues is not new. It has already been raised as a result of the financial innovation which has been taking place in recent years and thus the effect of capital liberalisation will be one of degree

rather than nature. The problems posed are largely technical and call for work to improve understanding of the behaviour of monetary aggregates, the demand for money and the movement of capital in the new liberalised environment.

(iii) The second issue raises fundamental questions about the future conduct of the exchange rate mechanism. In theory, it is impossible to combine complete freedom of goods, services and capital movements with both fixed exchange rates and autonomous monetary policy. In order to consolidate the progress already made in the field of price and exchange rate stability, increased co-ordination of monetary policies is necessary. This might take the form of a medium or long-term common strategy aiming at national inflation rates converging at a low level, coupled with a co-ordinated monitoring system in the shorter-term perspective which would focus on the interplay between capital flows, interest rate differentials, exchange rate movements and interventions on the foreign exchange markets, in connection with economic fundamentals.

(iv) Outside the exchange rate mechanism, liberalisation in partner countries will not significantly change the situation in the United Kingdom. In the three remaining EEC countries on the other hand, liberalisation will be a challenge to adjust the real economy and to undertake the necessary reform of the financial systems.

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

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10th February 1987

MANDATE  
FOR THE GROUP OF EXPERTS  
UNDER THE CHAIRMANSHIP OF M. RAYMOND

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The group has been invited to examine:

- the implications of the liberalisation of capital movements for interest rates and monetary policy in the countries participating in the exchange rate mechanism, focusing on the increased need for co-ordination in the setting and pursuit of objectives;
- the implications of dollar movements and capital flows vis-à-vis outside areas for the conduct of monetary policy within the EMS;
- the monetary implications of capital liberalisation for the countries not participating in the exchange rate mechanism.

Since the Chairman of the Committee of Governors will present a preliminary report to the informal ECOFIN meeting at the beginning of next April, the group should aim at reaching some preliminary conclusions on the questions mentioned in the first indent in time for the next meeting of the Committee of Governors on 10th March 1987.

RECENT MEASURES  
TO REDUCE RESTRICTIONS ON CAPITAL MOVEMENTS  
AND THE CURRENT STATE OF RESTRICTIONS  
ON CAPITAL MOVEMENTS IN THE COMMUNITY

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I. RECENT MEASURES TO REDUCE CAPITAL RESTRICTIONS

Several countries have recently taken important measures to reduce restrictions on capital movements. In France the authorities have eased exchange controls on forward cover for firms' commercial and financial operations and on transfers abroad by residents; in Italy the rules governing the financing of external payments, the importation of Italian bank notes and the contracting of financial credits abroad have been relaxed and more recently, well in advance of the deadline established at Community level, the 15 per cent. compulsory deposit on the purchase of foreign assets was lifted and other liberalising measures taken; the Dutch authorities have lifted the last remaining restrictions on capital movements; Spain has adopted a series of liberalisation measures aimed notably at the acquisition of foreign securities by residents which goes beyond her obligations under the Treaty of Accession to the EEC; and in Greece the authorities have liberalised certain categories of capital movements relating to non-residents in accordance with the 1960 Directive as well as capital movements relating to direct investment from non-EEC countries, while, in April 1987, the conditions under which enterprises can borrow from abroad were significantly relaxed.

At the Community level, the Council has adopted the first stage of the programme for the liberalisation of capital movements which extends the obligation of unconditional liberalisation to three more categories of capital movements: capital movements resulting from: (a) long-term credits linked to commercial transactions or the provision of services, (b) acquisition of securities not quoted on a stock exchange and (c) the admission of securities issued by an enterprise in one member state on the capital market of another member state.

## II. CURRENT STATE OF RESTRICTIONS ON CAPITAL MOVEMENTS IN THE COMMUNITY

Capital movements mentioned in list A<sup>(1)</sup> of the 1960 Directive (unconditional liberalisation) are already largely liberalised. Safeguard measures of a more or less far-reaching scope under Article 108 § 3 of the Treaty exist in favour of Greece and Ireland. Spain and Portugal have been granted temporary derogations from Community obligations in the Treaty of Accession.

More restrictions exist with regard to capital movements mentioned in lists B<sup>(2)</sup> and C<sup>(3)</sup> of the 1960 Directive. With the exception of Belgium/Luxembourg (which, however, have a dual exchange market regulation), Germany, the Netherlands and the United Kingdom (where there are virtually no restrictions at all), member countries restrict especially national currency financial loans to non-residents and operations of a monetary nature involving an outflow of capital.

Detailed information on the current state of restrictions on capital movements in the Community is given in the Commission's document II/542/86 of 27th November 1986.

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- (1) Mainly direct investment, investment in real estate, credits related to commercial transactions (former list A), and acquisition of domestic securities by non-residents and of foreign securities by residents (former list B). The former lists A and B were merged into a new list A in November 1986.
  - (2) Former list C which mainly deals with granting and repayment of long-term credits not related to commercial transactions or the provision of service.
  - (3) Former list D which covers essentially all capital movements of a monetary nature.



S P E C I M E N\*

SHORT-TERM DEVELOPMENTS IN THE EMS EXCHANGE RATE MECHANISM

FEBRUARY AND THE FIRST FEW DAYS OF MARCH 1987

I. EXCHANGE MARKET DEVELOPMENTS

In the period under review exchange market developments were characterised by substantial capital movements within the EMS and the stabilisation of the US dollar rate vis-à-vis EMS currencies under the impact of some widening of the interest rate differential in favour of the US dollar and exchange rate expectations in connection with the Louvre accord (see Chart 1).

Short-term capital flows started to flow back from the Deutsche Mark into the French franc and the Belgian franc and there were further large inflows in favour of the Italian lira. Net capital outflows from Ireland continued while outflows from the Netherlands increased in size and put some downward pressure on the Dutch guilder.

Capital flows within the EMS were met mainly by interventions (see Table 1) which were relatively heavy; they consisted essentially of purchases of Deutsche Mark by the Banca d'Italia and to a lesser extent the Banque de France and the Banque Nationale de Belgique. The Dutch and the Irish central banks supported their currencies by foreign exchange sales; in the case of the Central Bank of Ireland, the volume of intervention sales shrank somewhat in comparison with the previous months but remained relatively substantial.

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\*Specimen of a note to be prepared in the framework of monitoring short-term developments in the EMS. It has been drafted on the basis of information available at the beginning of March 1987.

Bilateral spreads in the EMS band have changed only modestly (see Chart 2). They have remained well within the maximum of 2.25 per cent.; at times the EMS band narrowed to half its maximum spread. However, on average the EMS band has been exploited more extensively; this has been the result of a weakening of the Belgian franc, the Deutsche Mark and the Dutch guilder in the lower half of the EMS band. The Italian lira stabilised at a position around the upper limit of the narrow EMS band.

## II. DEVELOPMENT OF FUNDAMENTALS IN EMS COUNTRIES (see Tables 2 and 3)

With regard to the fundamentals in EMS countries one notes a certain acceleration of the increase in consumer prices in Denmark and France (in January) and Belgium (January and February). In Germany the inflation rate continued to become less negative in February. In contrast, in Italy the decline in consumer price inflation resumed in February after a short interruption in January. In the Netherlands prices fell by more than 1 per cent. over the last twelve months up to January 1987.

Partly in connection with substantial inflows from abroad, monetary growth in Germany (in terms of M3) accelerated in January after the previous month's temporary lull. In the last three months M3 grew at a seasonally adjusted annual rate of 11 per cent., while since the fourth quarter of 1986 the central bank money stock has grown at a seasonally adjusted annual rate of 7 1/2 per cent., considerably above the 3-6 per cent. target range for 1987. In the Netherlands the liquidity ratio increased slightly in the three months to end-November, with strong liquidity creation by the public sector and the banking system largely offset by outflows through the balance of payments. In Italy monetary growth continued to accelerate and private sector credit demand remained strong despite somewhat slower growth in January. In contrast, monetary growth continued to be negative in Ireland and slowed down further in Denmark and France; in the latter country the increase in M3 in the last quarter of 1986 over the last quarter of 1985 was 4.6 per cent., i.e. within the target range of 3-5 per cent. set for 1986.

The large current account surpluses in Germany and the Netherlands appear to be on a declining trend. In Germany both the trade and current

account surpluses decreased on a seasonally adjusted basis in January and the Netherlands even recorded a current account deficit in the fourth quarter. In France the trade account swung back into deficit in January, although the current account was in healthy surplus for 1986 as a whole.

Elsewhere external positions continued to improve. The trade balance in Italy was in significant surplus in December and there was a considerable reduction in both the trade and current account deficit for the whole year 1986. In Denmark and Ireland the trade account improved further.

### III. INTEREST RATE POLICY RESPONSES

Changes in short-term domestic interest rates (see Table 1) were motivated to a large extent by external factors. Short-term rates declined slightly in France (0.5 percentage point) and to an even lesser extent in Belgium in response to capital reflows and, in the case of Belgium, following the weakening of the Deutsche Mark in the EMS band. There was also a very slight decline in Italy which recorded large capital inflows. In Denmark interest rates continued to rise in the absence of significant capital reflows. In contrast, interest rates in Ireland and the Netherlands remained virtually unchanged over the period as a whole despite some foreign exchange outflows. Interest rates in Germany rather were stable throughout the month at a level of 4 per cent.

Domestic considerations gave no rise to interest rate changes but played a role in the sense that they sometimes constrained the authorities' interest rate policies. For instance, strong credit growth in Italy so far has limited the scope for more pronounced interest rate cuts designed to check the strong demand for the Italian lira on the exchange markets. In Ireland, the already high level of nominal and real interest rates constrained a more decisive response to exchange rate pressure.

Intra-EMS interest rate differentials (see Chart 2) have moved only modestly. The differential in favour of the French franc narrowed while that in favour of the Danish krone increased further.

IV. ISSUES RAISED

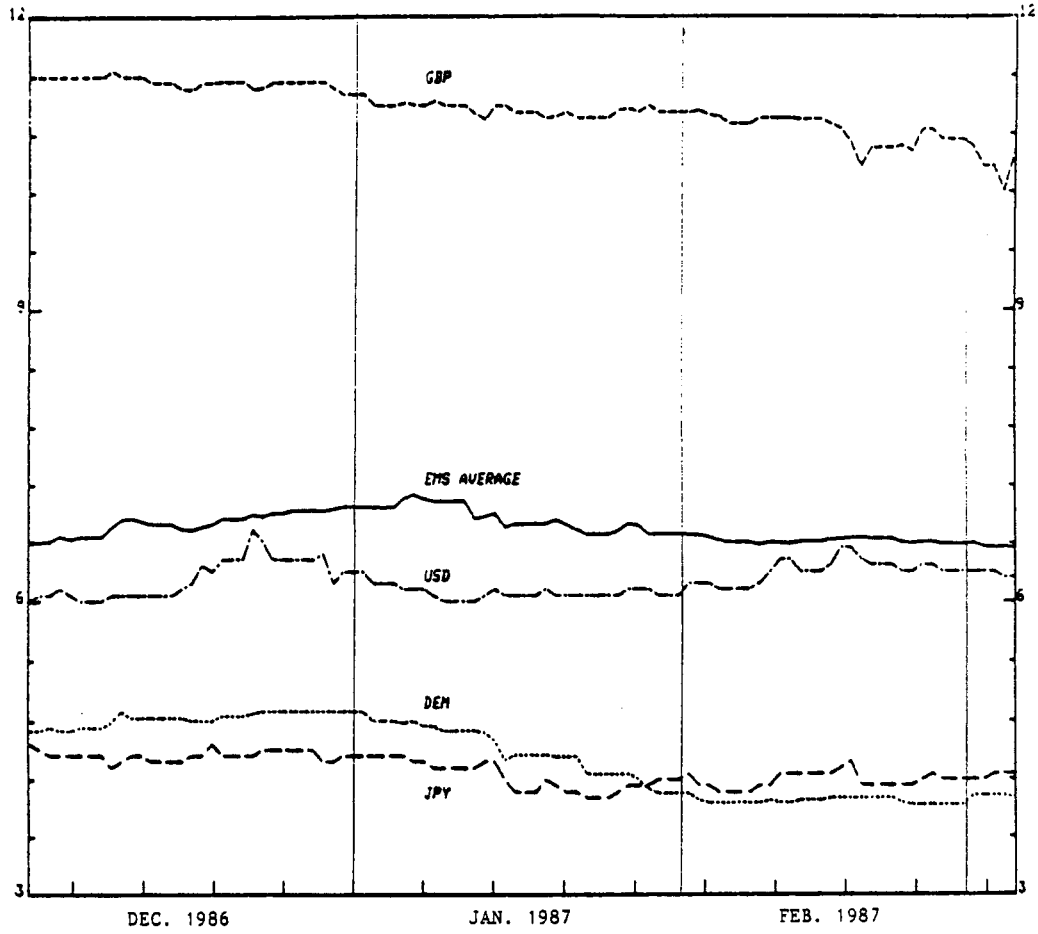
Developments in the EMS exchange rate mechanism in particular raise the question of whether interest rate differentials are appropriate. The maintenance of substantial interest rate differentials favours capital reflows and allows some of those EMS central banks which experienced considerable reserve losses to restore their currency holdings and/or to repay outstanding debt vis-à-vis the EMCF. With the exception of Italy, EMS central banks have not yet recouped reserve losses experienced before the realignment. There is the question to what extent interest rate differentials remain appropriate if and when reflows continued and increased in size.

In the case of Italy, heavy intervention does not reflect reflows but new capital inflows. They are related to the fact that on the one hand the interest rate differential in favour of the Italian lira is substantial and on the other hand strong growth of bank lending to the private sector is refinanced by Italian banks through loans raised abroad; the latter funds are not subject to compulsory reserve requirements which apply only to lira deposits.

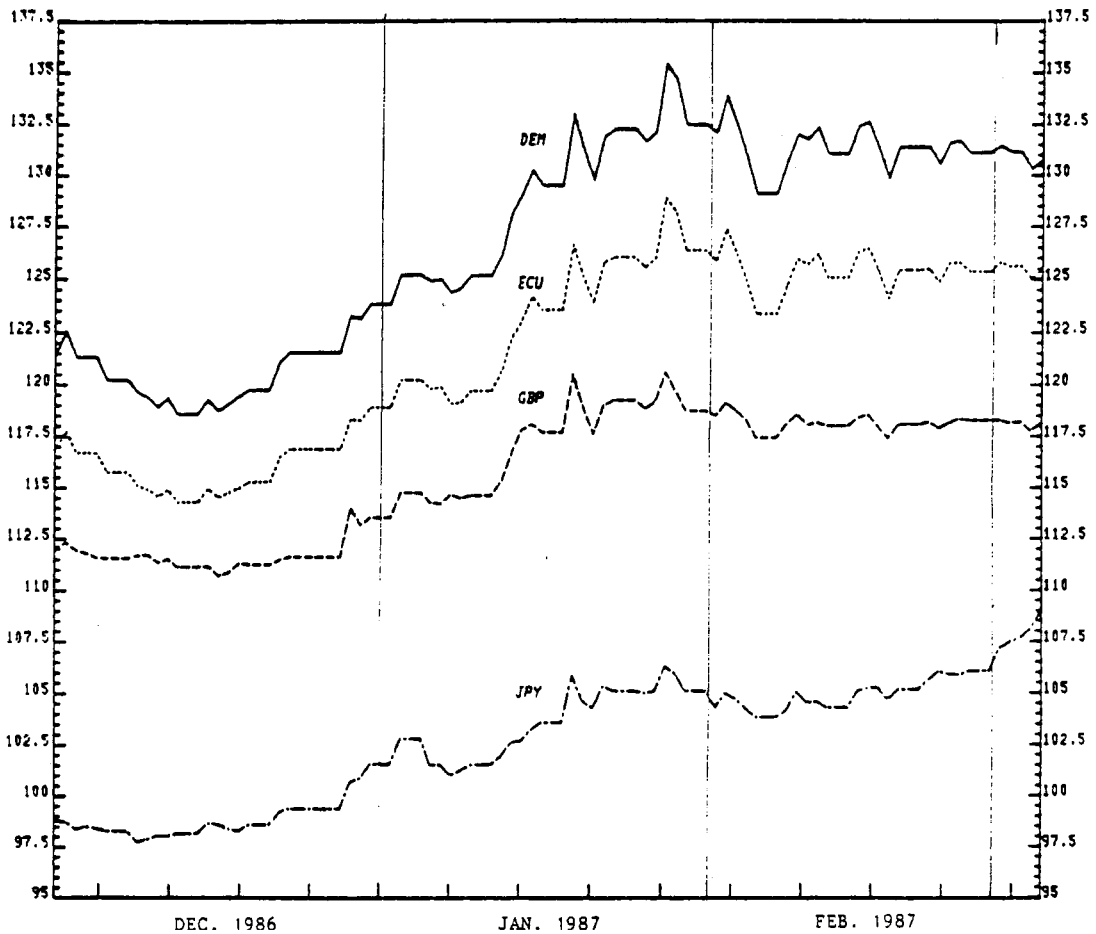
One should also note the relative weakness of the Irish pound (as evidenced by its position in the EMS band and the volume of interventions in its support) despite the very high interest rate differential in its favour.

SHORT TERM DOMESTIC INTEREST RATES  
 USD, EMS AVERAGE, DEM, GBP, JPY

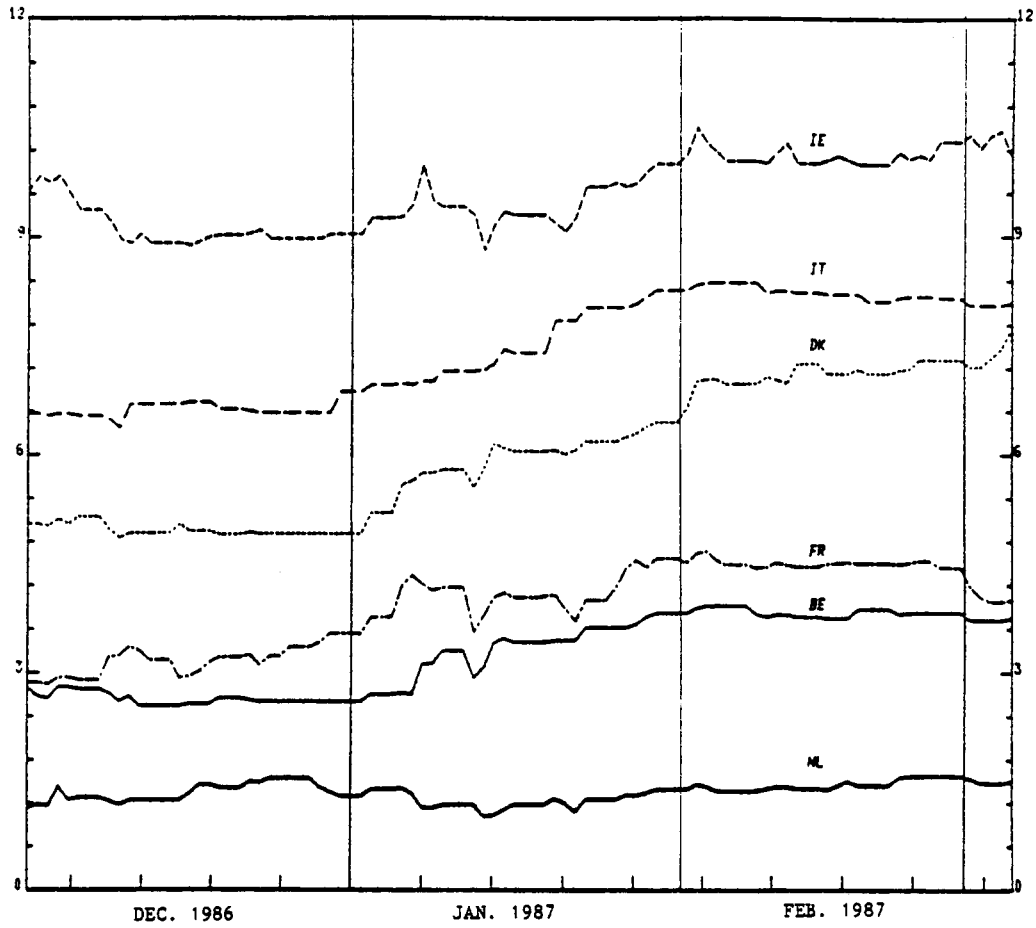
CHART 1



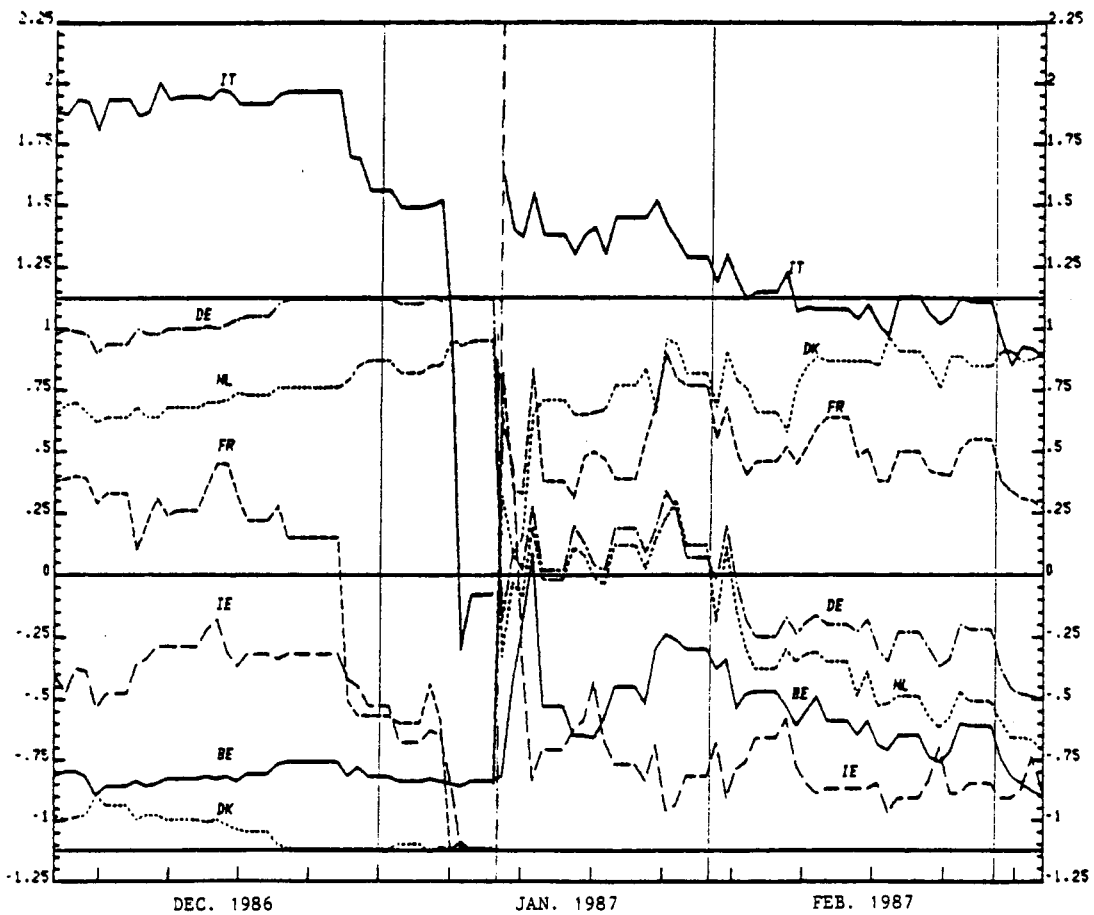
EXCHANGE RATES VIS-A-VIS THE USD (APRIL 1986 = 100)



SHORT TERM INTEREST RATE DIFFERENTIALS  
 INTRA-EMS DIFFERENTIALS VIS-A-VIS THE LOWEST



POSITIONS IN THE EMS EXCHANGE RATE MECHANISM



INTEREST RATES AND INTERVENTIONS

	BE	DK	DE	FR	IE	IT	NL	EMS
OFFICIAL INTEREST RATES(1)								
Last ob- servation	87.01.30 87.03.06	11.0 11.0	4.6 3.8	8.0 8.0	13.3 13.8	11.8 11.8	5.4 5.4	- -
DOMESTIC MONEY MARKET RATES(2)								
Monthly averages	86 Dec 87 Jan 87 Feb	9.8 10.5 11.1	4.8 4.5 4.0	8.1 8.6 8.5	14.0 13.9 14.1	11.6 12.1 12.1	6.1 5.7 5.4	6.9 6.9 6.7
Weekly averages	87.02.06 87.02.13 87.02.20 87.02.27 87.03.06	10.9 11.0 11.1 11.2 11.4	4.0 4.0 4.0 3.9 4.0	8.5 8.4 8.5 8.4 8.1	14.2 14.1 14.0 14.1 14.3	12.3 12.2 12.2 12.1 12.1	5.4 5.4 5.4 5.5 5.5	6.7 6.6 6.7 6.6 6.6
Last obs.	87.03.06	11.8	4.0	8.0	14.1	12.1	5.5	6.6
INTERVENTIONS ON EXCHANGE MARKETS(3)								
Monthly figures	86 Dec 87 Jan 87 Feb							
Weekly figures	87.02.06 87.02.13 87.02.20 87.02.27 87.03.06							

(1) Belgium: Yield at issue on 3-month Treasury bills; Denmark: Money market intervention rate; Germany: Open market rate; France: Intervention rate; Ireland: Short term facility rate; Italy: Rate on transactions under repurchase agreement; Netherlands: Rate on special advances.  
(2) Belgium, Denmark, Germany, France, Ireland, Netherlands: Three-month interbank rate; Italy: Interbank sight deposits. EMS: Weighted average of domestic interest rates, calculated on the basis of respective ECU weights.  
(3) In USD million. Net purchases(-)/net sales(+) of the currency of the country indicated above. Excluding purchases and sales of these currencies by central banks outside the EMS exchange rate mechanism. EMS: Sum of the absolute values of net positions, adjusted for double accounting of interventions in EMS currencies.

\* Given the confidential character of the data on interventions the latter are not shown in the present specimen.

	BE	DK	DE	GR	ES	FR	IE	IT	LU	NL	PT	GB	EC12	EMS	US
CONSUMER PRICE INCREASE (% change over one year)(2)															
(annual averages)															
1985	4.9	4.7	2.1	19.3	8.8	5.8	5.4	9.2	4.1	2.3	19.3	5.5	5.8	6.0	3.6
1986	1.3	3.6	-0.4	23.0	8.8	2.7	3.9	5.9	0.3	0.0	11.7	3.4	3.6	3.0	1.9
1987 f	1.5	4.0	1.0	14.0	5.4	2.5	3.0	4.3	1.4	-1.5	9.0	4.0	3.2	3.1	3.4
(quarterly averages)															
1986 Q2	1.3	4.0	-0.2	24.5	8.1	2.4	4.4	6.5	..	0.4	11.8	2.8	4.6	2.7	2.1
1986 Q3	0.8	4.2	-0.4	23.8	9.4	2.1	3.1	5.8	..	-0.6	11.5	2.6	4.3	2.1	1.6
1986 Q4	0.7	4.4	-1.0	19.5	8.6	2.1	3.2	4.7	..	-0.2	10.8	3.4	3.6	1.9	1.3
(monthly data)															
1986/12	0.6	4.3	-1.1	16.9	8.3	2.1	..	4.3	..	-0.1	10.6	3.7	3.1	1.9	1.1
1987/01	0.9	4.8	-0.8	15.5	6.0	3.0	..	4.5	..	-1.3	9.8	3.9	3.3	2.0	1.6
1987/02	1.0	4.8	-0.5	..	5.5	..	..	4.2	..	..	..	..	..	..	2.1
CURRENT ACCOUNT(3)															
(% of GDP)															
1985	0.2	-4.7	2.1	-10.0	1.7	0.0	-3.2	-0.8	28.1	4.3	1.8	0.8	0.5	0.5	-3.0
1986 pe	2.1	-5.2	4.0	-4.5	1.8	0.5	-1.8	0.8	29.0	2.9	4.6	-0.3	1.2	1.8	-3.5
1987 f	2.9	-3.0	3.0	-2.9	1.2	0.4	-1.2	0.5	30.0	1.4	1.8	-0.7	0.9	1.6	-3.3
(in billions of national currency units)															
1986	145.3	-34.5	77.8	-263	734.4	25.8	-329.0	..	..	..	..	..	..	..	..
lat. 12 m	145.3	-34.5	74.5	-263	734.4	21.6	-329.0	1,111	see	12.7	203.3	0.8	..	..	-139.1
lat. 3 m	34.3	-8.4	22.4	-58	52.9	4.8	..	4,448	BE	1.1	103.0	-1.1	..	..	-36.3
lat.mon.	6.4	..	4.9	-20	-77.5	..	..	790	..	0.4	26.7	..	..	..	..
up to:	86/12	86/12	87/01	86/12	87/01	86/12	86/10	86/10	86/11	86/10	86/10	86/09	..	..	86/09
REAL GDP GROWTH															
(% change on preceding year)															
1985	1.5	4.3	2.6	2.1	2.0	1.1	1.0	2.7	2.3	2.0	3.3	3.5	2.4	2.1	2.7
1986 pe	2.1	3.5	2.5	0.7	3.0	2.3	0.3	2.7	2.5	1.5	4.0	2.6	2.5	2.5	2.5
1987 f	0.9	-0.3	2.5	-0.5	..	..	1.5	3.0	2.0	1.9	4.0	3.0	2.3	2.1	2.3
(% change on preceding quarter)															
1986 Q1	..	..	-1.1	..	..	-0.2	..	-0.4	..	..	..	1.7	..	..	0.9
1986 Q2	..	..	3.4	..	..	1.1	..	2.7	..	..	..	0.2	..	..	0.2
1986 Q3	..	..	0.7	..	..	..	..	0.4	..	..	..	0.2	..	..	0.7
1986 Q4	..	..	-0.4	..	..	..	..	..	..	..	..	1.2	..	..	0.3

1) Source: country figures: data and forecasts by national authorities; aggregated figures for the Community: Eurostat and Commission; aggregated Eurostat and Commission figures may not always correspond to country figures.  
 2) Figures given by the Commission are the private consumption deflator. Figures for the United Kingdom are the percentage change between the fourth quarters of the preceding year and the current year. 3) On a transaction basis. Figures for Greece are only in part on a transaction basis. Figures for Spain are estimated. Figures shown in the column BE refer to the BLEU and are on a transaction basis up to the first quarter of 1986 and on a cash basis subsequently.



S P E C I M E N  
MONETARY POLICY VARIABLES (1)

Key variables (1)	Annual averages		Twelve-month % change			Three-month % changes (s.a.) (5)			Targets for 1987			
	1985	1986	Nov. 1986	Dec. 1986	Jan. 1987	Jul. 86 Sep. 86	Aug. 86 Oct. 86	Sep. 86 Nov. 86 Dec. 86 Jan. 87	assumption a objective forecast	assumption b beginning of the target period(2)	assumption c forecast	
BE	7.8	8.9	..	..	..	0.9	..	0.8	..	-	-	-
DK	13.5	14.3	10.0	8.3	4.8	-0.1	-0.3	0.7	-0.9	-	-	-
DE	4.6	6.4	7.7	8.3	7.5	2.3	2.6	2.4	1.8	3-6(3)b	3-6(3)b	7.5 February
M3	4.9	5.9	8.2	6.7	7.5	1.9	2.4	2.6	2.0	-	-	-
M2	7.7	8.3	5.1	3.8	3.7	1.2	0.4	0.3	1.1	4-6 (3)b	4-6 (3)b	..
M3	6.2	5.4	5.0	4.4	5.0	1.4	0.9	0.8	1.7	3-5 (3)b	3-5 (3)b	..
IE	7.7	-0.0	-2.7	-1.0	-3.9	..	..	..	-1.0	-	-	-
PSCE	3.6	7.5	7.7	7.4	7.0	..	..	..	3.1	-	-	-
IT	11.1	9.3	9.8	9.3	9.3	2.4	3.6	4.4	1.9	6-9 b	6-9 b	..
PSCE	12.9	11.4	13.1	11.4	14.0	3.4	3.7	4.4	3.9	5-9 b	5-9 b	..
NL	7.8	5.9	5.5	2.3	3.0	2.3	2.2	0.8	-2.7	2.5 f	2.5 f	..
DM2	3.6	7.0	11.3	8.9	8.3	4.0	3.3	2.9	-1.6	2.1 b	2.1 b	..
PSCE	19.9	15.4	15.7	15.4	14.0	2.7	3.0	3.0	2.4	11.0 b	11.0 b	..
M3	26.8	18.9	19.6	18.9	..	3.7	4.3	3.2	..	15.7 f	15.7 f	..
ES	13.2	11.4	11.2	11.4	11.2	0.9	1.9	2.7	2.5	6.5-9.5 b	6.5-9.5 b	8.0 January
PT	29.1	26.7	28.4	26.7	25.4	7.7	7.4	7.4	5.1	17.8 f	17.8 f	..
DCE	20.0	22.5	..	..	..	..	..	..	..	14.5 f	14.5 f	..
TCE	19.7	13.5	..	..	..	..	..	..	..	12.0 f	12.0 f	..
GB	13.4	18.0	18.6	18.0	17.6	4.4	3.6	4.6	2.6	-	-	18.9 February
M0	3.8	5.2	5.2	5.2	4.1	1.6	1.5	1.6	1.9	2-6 b	2-6 b	4.1 February
PSL2	12.6	14.3	14.9	14.3	13.2	2.8	2.5	2.9	1.9	-	-	13.1 February
EMS (4)	9.9	9.7	..	..	..	..	..	..	..	5.6	5.6	..
EC12(4)	7.7	6.9	..	..	..	..	..	..	..	7.4	7.4	..

(1) For explanations, see notes. (2) Up to latest month indicated at annual rate. (3) Change over the fourth quarter of the preceding year. (4) Commission figures. (5) Not annualized.

NOMINAL EFFECTIVE EXCHANGE RATES(1)

Period	EMS currencies(2)										Other EC currencies										Other currencies		
	BEC	DKK	DEM	FRF	IEP	ITL	NLG	GRD	ESP	PTE	GBP	EC12	USD	JPY	CHF								
AGAINST (THE REST OF) EMS COUNTRIES																							
1980	99.6	90.9	102.4	101.2	100.2	97.0	100.3	85.9	95.4	95.0	113.8		99.6	91.0	99.4								
1981	99.5	91.2	106.0	99.6	99.5	92.1	101.1	83.5	94.4	98.1	124.7		126.1	117.9	107.9								
1982	91.3	87.9	116.2	92.7	99.8	87.3	107.8	78.7	91.0	86.9	122.8		143.6	118.9	118.5								
1983	89.2	87.4	124.2	86.4	95.8	85.1	110.5	65.4	76.7	68.5	116.9		157.8	136.5	125.3								
1984	89.2	87.2	127.2	85.4	94.5	83.1	111.4	58.4	77.6	58.2	117.1		179.8	155.3	126.7								
1985	90.2	88.6	128.5	86.8	95.9	78.7	111.9	49.8	76.2	51.7	117.5		187.0	161.2	126.2								
1986	90.4	87.3	133.2	84.5	91.4	75.8	114.3	37.0	70.1	44.8	101.3		141.3	172.5	130.1								
86 Sep	90.7	86.7	135.0	82.7	87.0	76.1	115.2	36.3	69.6	43.3	96.5		134.1	177.7	134.1								
86 Oct	90.5	87.2	135.1	82.8	86.4	76.0	115.2	35.6	68.7	42.6	91.9		131.7	172.9	132.6								
86 Nov	90.4	87.0	135.4	82.9	86.4	75.9	115.2	35.0	68.1	42.3	92.7		133.2	167.6	130.4								
86 Dec	90.4	87.0	135.4	82.7	86.4	75.9	115.3	34.2	67.8	41.9	92.1		131.2	165.7	129.9								
87 Jan	91.2	87.2	136.8	81.9	85.4	74.6	116.3	33.5	66.2	40.9	90.7		123.1	163.2	130.4								
87 Feb	91.5	87.6	136.9	82.0	85.0	74.2	116.2	33.2	65.6	40.6	90.4		121.1	161.8	129.7								
AGAINST THE REST OF 20 INDUSTRIALIZED COUNTRIES																							
1980	98.9	89.9	101.2	100.4	96.7	96.9	99.3	85.5	95.3	93.8	114.7	103.8	99.9	90.0	99.2								
1981	93.3	83.2	95.7	91.6	88.5	85.0	95.1	76.5	86.1	90.3	117.9	87.6	112.9	102.1	99.2								
1982	84.7	79.6	100.4	84.0	87.4	79.1	99.9	70.4	80.9	78.8	109.4	81.6	126.5	97.0	106.8								
1983	82.4	79.3	104.6	78.1	84.2	76.2	102.1	57.5	67.0	62.2	101.7	74.9	134.2	107.8	111.5								
1984	80.4	76.1	102.7	74.3	80.2	71.7	100.3	49.7	65.5	51.3	97.4	65.9	143.9	113.6	108.7								
1985	81.1	77.1	103.1	75.1	81.1	68.0	100.6	42.1	64.0	45.4	97.3	64.7	149.9	117.2	107.8								
1986	86.3	82.8	114.7	79.2	85.1	71.2	108.8	33.3	63.7	42.3	90.7	73.0	122.1	151.0	119.7								
86 Sep	87.5	83.8	117.5	78.8	82.9	72.6	110.8	33.1	64.2	41.7	87.8	74.2	117.3	161.5	125.0								
86 Oct	88.3	85.3	119.2	79.9	83.7	73.3	111.9	32.8	64.1	41.4	84.2	74.9	117.1	159.3	125.0								
86 Nov	88.2	85.2	119.2	80.0	83.5	73.3	111.9	32.2	63.5	41.1	85.0	75.1	118.9	153.3	123.0								
86 Dec	88.5	85.7	120.1	80.2	84.0	73.6	112.4	31.6	63.5	40.9	84.9	75.8	117.8	152.8	123.2								
87 Jan	90.5	87.5	123.1	80.9	84.6	73.8	114.7	31.4	63.2	40.6	85.3	78.2	112.6	156.6	125.8								
87 Feb	91.0	88.3	123.6	81.4	84.6	73.9	114.9	31.2	62.8	40.4	85.5	78.8	111.1	156.5	125.7								

(1) Index figures March 1979 = 100. Annual and monthly averages of daily observations respectively. Source: Commission departments: double exporting weights variable from year to year until 1983.

(2) Currencies participating in the EMS exchange rate mechanism.

## NOTES

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Table 3: MONETARY POLICY VARIABLES

Aggregates shown in this table are defined as follows:

(a) Money stock and liquidity measures

- M1 = Money stock narrowly defined (mainly currency in circulation and sight deposits).
- M2 = M1 and quasi-money (mainly time deposits and foreign currency deposits held with domestic banks). In Belgium M2 includes monetary assets held abroad. In France until 1985 M2 included monetary assets held by non-residents. M2 in the United Kingdom is designed to be a measure of transactions balances; it covers currency in circulation plus the non-bank private sector's retail deposits in sterling at banks and building societies (generally defined as deposits with residual maturity up to one month and up to £100,000 in size) and deposits in National Savings Bank ordinary accounts.
- M2H = harmonised Community definition of broad money stock.
- M3 = in Germany: M2 and savings deposits at statutory notice (broadly comparable to M2H).  
= in France since redefinition of monetary aggregates: M2 and all non-marketable bills, time deposits and marketable short-term securities issued by banks (certificates of deposit among others). It also includes securities sold by banks to non-financial residents under repurchase agreements.
- ALP = in Spain: liquid assets held by the public (broadly comparable to M2H).
- L<sup>-</sup> = in Portugal: total liquidity held by non-financial residents (M<sup>2</sup> plus Treasury bills).
- L = in France: M3 plus marketable short-term securities issued by the Treasury and non-financial agents, as well as the contractual savings (mainly housing schemes).  
= in Portugal: L<sup>-</sup> plus liquid assets held by emigrants and non-monetary financial institutions.

- PSL2 = in the United Kingdom: private sector liquidity broadly defined (roughly comparable to M2H). Besides £M3 it includes deposits with building societies, money-market and other short-term instruments and certain liquid national savings accounts.
- £M3  
(LM3,  
STGM3) = in the United Kingdom: currency in circulation plus all sterling deposits held with the UK monetary sector by UK private sector.
- M0 = in the United Kingdom: wide monetary base (mainly currency in circulation).
- MZ = in Germany: central bank money (currency in circulation plus minimum reserve requirements on banks' domestic liabilities at constant reserve ratios).

(b) Credit measures

- DCE = domestic credit expansion (credit granted by domestic banks to residents, in Ireland including external borrowing by the Exchequer).
- DM2 = in the Netherlands: money supply (broadly defined) from domestic sources, i.e. excluding external counterparts. It corresponds to the expansion of bank credit (net of banks' own and long-term borrowed funds) to the domestic economy plus short-term non-bank credit to public authorities, expressed in per cent. of outstanding broad money stock M2.
- PSCE = private sector credit expansion (credit extended by banks and other financial intermediaries to private sector residents and non-State public entities).
- TDCE = total domestic credit expansion (credit extended by domestic banks and other financial intermediaries to non-financial residents).
- TCE = in Portugal: total credit expansion (domestic and external borrowing by domestic non-banks).

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

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GROUP OF EXPERTS ON MONETARY POLICY

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Banco de España	L. A. Rojo J. Ariztegui
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Secretariat of the Monetary Committee	R. Barthélémy
Bank for International Settlements**	J.T. Kneeshaw
Secretariat of the Committee of Governors	A. Bascoul H.K. Scheller N.K. Cook

The group held two meetings: on 30th and 31st March 1987;  
on 23rd and 24th April 1987.

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\*The composition of this delegation was not the same at each meeting.

\*\*The BIS representative attended the first meeting as observer.