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# Information and Notices

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**Council and Commission**

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# COUNCIL AND COMMISSION

## TWENTY-SECOND REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

### FOREWORD

The purpose of this report is to give a brief account of the activities of the Monetary Committee in 1980.

The Committee held eleven meetings in the course of the year while the Alternates and the Working Parties set up at its initiative met several times.

At its meeting on 23 January 1980 the Committee elected its officers. Mr. J.-Y. Haberer, Directeur du Trésor, Paris, was elected Chairman, and Sir Kenneth Couzens, HM Treasury, London, Mr L. Dini, Banca d'Italia, Rome and Mr M. Horgan, Department of Finance, Dublin were elected Vice-Chairmen. Mr W. Flandorffer, Bundesministerium für Wirtschaft, Bonn, was appointed Chairman of the Alternates. These officers will end their term of office on 31 December 1981. The list of members in office during 1980 is annexed.

Starting in November, Greek representatives attended the Committee's meetings as observers.

### I. INTRODUCTION

1. The world economy in 1980 was hit by the effects of the second oil shock. First, the expansion of economic activity slowed distinctly: world production and trade growth rates fell sharply. Second, the current account balance of payments disequilibria of the major country groupings worsened further: the OPEC (Organization of Petroleum Exporting Countries) surplus swelled considerably; this was matched by a more than twofold increase in the current payments deficit of all the OECD (Organization for Economic Cooperation and Development) countries and a sharp rise in the non-oil developing countries' deficit.

2. The Community's economy was hit head on by these developments. Growth slowed, unemployment spread, inflation increased and the current payments deficit almost tripled in comparison with 1979 – an unprecedented development. Not only did the rate of inflation rise in the Community, but inflation rate differentials between Community countries widened further, although towards the end of the year a marked reduction of the inflation rate in some countries with relatively high inflation took place. Unlike the situation during the first oil crisis, almost all the Community countries are running current payments deficits. Despite this unfavourable environment, the European Monetary System worked satisfactorily: no realignment took place in 1980, the participating currencies all remained within their fluctuation margins and the observed changes in relative positions did not threaten the overall stability of the system.

## II. COMMUNITY ACTION AND THE ACTIVITIES OF THE COMMITTEE

3. The Committee began the year by continuing the work it had started in 1979 on *the evolution of the European Monetary System after the transitional period.* In February, in enumerated the points which it felt needed detailed technical examination. The list of subjects for study is fairly extensive: they range from the characteristics of the ECU and the techniques for its creation, to the role of the future European Monetary Fund and the system's relationship with third currencies. The Alternates devoted much of the year to this technical work with the help of contributions from the Commission departments. Furthermore, on various occasions throughout the year, the Committee closely examined the functioning of the European Monetary System and found that it had been satisfactory.

4. However, it became apparent that there had been profound changes in the international economic and monetary situation since the devising of the European Monetary System. The repeated oil price rises, the emergence of serious current payments imbalances, the resurgence of inflation, the swelling of international liquidity – all these were developments altering the framework within which the Committee had to undertake its work: the problem of reserve assets gained priority and, in this context, the development of the role of the ECU acquired new importance. These issues were set out by the Chairman in a statement delivered to the Council meeting on 17 March 1980.

5. Subsequently, the European Council meeting on 27 and 28 April paid particular attention to these problems, 'to the growing deficit in the developing countries' external accounts, the extent of the petroleum-producing countries' surpluses, the volume of international liquidity and the effects which these factors in combination might have on the stability of the international economic and financial system and on trade.' Shortly afterwards, the President-in-Office of the Council invited the Monetary Committee to examine what initiatives the Community could take in the field of recycling, and their practical details.

6. In response to this request, the Committee, at its meeting on 4 June, adopted an opinion on the *issues raised by the recycling process* (Annex I) which it forwarded to the Council and the Commission. This opinion sets out the various aspects of the problem, examines the role of the Community in the recycling process and concludes by suggesting that, as a contribution to the smooth development of this process, various proposals could be considered, such as the adaptation of the Community loan mechanism and of other existing Community instruments.

7. After examining this opinion, the Council, at its meeting on 9 June, called upon the Committee to examine in greater depth certain points relating to *the Community's role in the recycling process.* The Committee therefore resumed its work, and, after devoting several meetings to this subject, on 10 October adopted a report on recycling (Annex II) which it forwarded to the Council and the Commission. The report deals mainly with the role which the Community can play in recycling in favour of member countries: it describes how the Community loan mechanism – set up in 1975 to aid Member States in balance of payments difficulties caused by the increase in prices of petroleum products – should be adapted to the requirements of the new structure of external payments disequilibria with the aim of improving its effectiveness. The report also examines aspects of possible measures in favour of individual third countries faced with grave balance of payments difficulties, and contains in annex an opinion on the use of the ECU as denominator for loans by the Community, a subject which is also relevant to recycling.

On the basis of this report the Commission in November presented the Council with a proposal for a Regulation adjusting the Community loan mechanism designed to support the balances of payments of Community Member States. The European Council at its meeting on 1 and 2 December asked that work on the subject be actively pursued.

8. The Committee concerned itself with other *international monetary problems* besides recycling. As it does every year, it prepared for the spring and autumn meetings of the Interim Committee of the International Monetary Fund and for the IMF and World Bank annual meeting: for each of these meetings, it examined the draft text of the statement to be made by the President of the Council on behalf of the Community. On 2 April, the Committee also delivered an opinion (Annex III) on the substitution account under examination at the IMF: this formed the basis of the joint position put forward by the Community countries at the April meeting of the IMF Interim Committee. Lastly, in November, it took the initiative of delivering an opinion on the monetary and financial items on the agenda of the United Nations global negotiations, in which it reaffirmed the guiding principles in the approach to these problems.

9. During its February meeting the Committee examined proposals presented by the Commission departments for improving *economic policy coordination.* The Committee recognized the paramount importance of improving coordination, both for the proper operation of the EMS and for cohesion within the Community. It stressed that it was preferable to use the

existing mechanisms more intensively and more effectively rather than introducing new procedures; but that consultations on monetary developments in the Community countries needed to be held as often as possible, so that sudden changes in one country did not take its partners by surprise. These views were brought to the knowledge of the Commission, which took them into account in its March communication to the Council on this subject. The Council recorded its general approval of the ideas put forward in this communication and invited the various specialised Committees to strengthen the coordination of their economic policies on the basis of this communication.

10. It is in this perspective of permanent consultation that the Committee continued its regular 'tour d'horizon' of *monetary policy developments:* on three occasions, in April, June and December it concentrated on interest rate developments in particular. During the year, it also held in-depth examinations of economic and monetary policy in the Netherlands and Belgium. The examinations were based on analytical documents prepared by the Commission departments, and were led by an examining member appointed for the occasion.

11. As it does every year and in accordance with its prerogatives, the Committee was several times consulted on *agri-monetary matters,* such as the alterations in the exchange rates of national currencies applicable in the agricultural sector, the codification of existing agri-monetary regulations, or the exchange rate to be applied in 1981 in the agricultural sector for Greece.

## III. WORKING PARTIES OF THE MONETARY COMMITTEE

12. The Working Party on the Harmonization of Monetary Policy Instruments, a joint group of the Monetary Committee and the Committee of Governors, was in May 1980 invited to study from a Community viewpoint, the proposals put forward in the United Kingdom's Green Paper on Monetary Control, and in particular their consistency with UK membership of the EMS exchange rate mechanism. It met three times for this purpose and in August presented a report (Annex IV) to its parent Committees. In this report the Working Party draws some conclusions and notes that they indicate certain difficulties which might arise once the United Kingdom participated fully in the EMS if the proposed control methods were adopted. In September the Monetary Committee examined the Working Party's report, endorsed its conclusions, and expressed the wish that the United Kingdom authorities take them into consideration.

13. The Working Party on Capital Markets (formerly Securities Markets) held four meetings in 1980. It continued to examine developments in the capital markets of the Member States and in the international bond markets, and reviewed the policies pursued with regard to these markets. It also completed its study on the variability of interest rates and the right to cancel contracts and continued its work on the development of savings in equities in Community countries.

## LIST OF MEMBERS AND ALTERNATES OF THE MONETARY COMMITTEE

*Chairman*

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| J.-Y. Haberer | Directeur du Trésor (Paris) |

*Vice-Chairmen*

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| Sir Kenneth Couzens | Second Permanent Secretary, HM Treasury (London) |
| Dott. L. Dini | Direttore Generale, Banca d'Italia (Rome) |
| M. Horgan | Second Secretary, Department of Finance (Dublin) |

*Members*

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| S. Andersen | Member of the Board of Governors, Danmarks Nationalbank (Copenhagen) |
| M. J. Balfour | Assistant Director, Bank of England (London) |
| F. Boyer de la Giroday | Director in the Directorate-General for Economic and Financial Affairs, Commission of the European Communities (Brussels) |
| J.-M. Camdessus | Chef du service des affaires internationales à la direction du Trésor, Ministère de l'économie (Paris) |
| Dr L. Gleske | Mitglied des Direktoriums der Deutschen Bundesbank (Frankfurt am Main) |
| P. Jaans | Commissaire au contrôle des banques (Luxembourg) |
| G. Janson | Directeur de la Banque nationale du Belgique (Brussels) |
| R. Kirsch | Conseiller de gouvernement, Ministère des finances (Luxembourg) |
| M. Lahnstein (until 1 December 1980) | Staatssekretär, Bundesministerium der Finanzen (Bonn) |
| Prof. G. Magnifico (until 18 January 1980) | Consigliere economico, Banca d'Italia (Rome) |
| T. O'Grady Walshe | Deputy General Manager, Central Bank of Ireland (Dublin) |
| T. Padoa Schioppa | Director-General for Economic and Financial Affairs, Commission of the European Communities (Brussels) |
| Dott. S. Palumbo (until 18 January 1980) | Consigliere del ministro del Tesoro (Rome) |
| A. Prate (since 2 December 1980) | Premier sous-gouverneur de la Banque de France (Paris) |
| Dott. F. Ruggiero (since 19 January 1980) | Direttore generale, Ministero del Tesoro (Rome) |
| Dr H. Schulmann (since 2 December 1980) | Staatssekretär, Bundesministerium der Finanzen (Bonn) |
| Drs A. Szasz | Executive Director, De Nederlandsche Bank NV (Amsterdam) |
| M. Théron (until 1 December 1980) | Premier sous-gouverneur de la Banque de France (Paris) |
| N. Ussing | Kommitteret, Det Økonomiske Sekretariat (Copenhagen) |
| J. van Ypersele de Strihou | Chef de Cabinet du Premier ministre (Brussels) |
| Dr A. H. E. M. Wellink | Thesaurier-generaal bij het Ministerie van Financiën (The Hague) |

*Chairman of the alternates of the Monetary Committee*

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| Dr W. Flandorffer | Bundesministerium für Wirtschaft (Bonn) |

*Alternates*

| | |
|---|---|
| Drs D. H. Boot | De Nederlandsche Bank NV (Amsterdam) |
| S. Boyer-Søgaard | Danmarks Nationalbank (Copenhagen) |
| P. J. Bull | Bank of England (London) |
| M. Emerson | Directorate-General for Economic and Financial Affairs, Commission of the European Communities (Brussels) |

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| Drs F. A. Engering | Ministerie van Financiën (The Hague) |
| Mrs M. Hedley-Miller | HM Treasury (London) |
| P. Jurgensen | Ministère de l'économie (Paris) |
| G. Lefort | Banque de France (Paris) |
| Dott. S. Masera | Banca d'Italia (Rome) |
| D. McCutcheon | Department of Finance (Dublin) |
| J.-J. Rey (since 22 February 1980) | Banque nationale de Belgique (Brussels) |
| G. Reynolds | Central Bank of Ireland (Dublin) |
| Dr W. Rieke | Deutsche Bundesbank (Frankfurt am Main) |
| J. Roelandts (until 21 February 1980) | Banque nationale du Belgique (Brussels) |
| M. Schmit | Ministère des finances (Luxembourg) |
| J. Thomsen | Det Økonomiske Sekretariat (Copenhagen) |
| J. Vanormelingen | Ministère des finances (Brussels) |
| P. Zimmer | Commissariat au contrôle des banques (Luxembourg) |
| Dott. A. Zodda | Ministero del Tesoro (Rome) |

*Secretariat*

| | |
|---|---|
| Dr A. Kees | Secretary of the Committee |
| H. Carré | |
| A. Leipold | |

*ANNEX I*

# OPINION TO THE COUNCIL AND THE COMMISSION ON ISSUES RAISED BY THE RECYCLING PROCESS

## 1. Introduction

1.1. The conclusions of the Presidency of the European Council of 27 and 28 April 1980 state that 'the Council paid particular attention to the growing deficit in the developing countries' external accounts, the extent of the petroleum-producing countries' surpluses, the volume of international liquidity and the effects which these factors in combination might have on the stability of the international economic and financial system and on trade. The Council took the view that to deal with these problems it would be necessary to step up cooperation in appropriate forms between States and with the relevant international institutions.' The President-in-Office of the Council subsequently invited the Monetary Committee to examine what initiatives the Community could take in the field of recycling, and their practical details. The Committee accordingly met on 20 May and 4 June 1980 and the present opinion sets out the results of its examination.

1.2. Following the 1973–74 oil price rise, the financing of the resulting payments imbalances was managed with greater ease than originally envisaged. In the first place, the import-absorbing capacity of OPEC revealed itself to be larger than forecast, while the relative price of oil declined fairly rapidly, so that the overall OPEC surplus – which had been predicted to persist for many years – declined to modest and manageable proportions by 1978, while a number of OPEC countries began to incur deficits. Secondly, the international financial markets and the commercial banks provided finance on a considerable scale, amounting to about two-thirds of the net external financing required by the non-oil developing countries.

1.3. The present situation seems to be more difficult. The large oil-induced payments imbalances (the OPEC surplus is projected to reach US $ 100–120 billion or even more in 1980 and the counter-part deficit some US $ 80 billion for the OECD area – of which US $ 33 billion for the Community – and US $ 60 billion for the non-oil developing countries) are likely to raise much more serious and lasting problems than in the period after 1973–74, and this for a variety of reasons:

— the OPEC surplus is expected to persist for a longer period, as the relative price of oil is likely to be maintained or even increased. Although the imports of goods and services by the oil-producing countries should again grow substantially, it remains to be seen to what extent the exceptionally marked increase which took place after the 1973–74 oil price rise can be repeated;

— though the role of the commercial banks will remain prominent, they may well be reluctant to continue net lending on as large a scale in real terms as in the past and to disproportionately increase their exposure, at least *vis-à-vis* certain individual developing country borrowers; private balance of payments financing could thus become both quantitatively tighter, with higher spreads and shorter maturities, and more selective, with the poorer countries and perhaps some of the major borrowers finding their borrowing capacity more circumscribed. These tendencies have already shown some signs of developing in the syndicated medium-term credit market;

— the debt burden of the non-oil LDC's is now considerably larger: their outstanding public and publicly guaranteed medium- and long-term external debt has increased threefold in nominal terms between end 1973 and end 1979 (from US $ 75 billion to about US $ 250 billion) and nearly doubled in real terms, and the debt-carrying capacity of certain countries may be approaching its limit.

1.4. The Committee feels that recycling will be effected without major difficulties in 1980, and possibly in 1981, given especially the build-up of reserve holdings by the majority of the developing countries in recent years and the volume of bank credits committed but not yet disbursed. It cannot however be assumed that recycling will be automatically smooth and problem-free in the years beyond, when access to the international markets is expected to become more restricted and debt servicing difficulties could arise for a number of individual countries.

## 2. Aspects of the recycling problem

2.1. Although credit systems and markets have played their role with effectiveness and flexibility, the whole range of domestic and international financial relationships has been deeply affected by the first oil shock. The stability of the international banking system has been subjected to unprecedented strains, flows through the international markets have increased very rapidly without control and exchange rate movements have been wide and sometimes erratic. Adjustment has been insufficient in a number of countries where inflation rates in 1978 were still well above pre-1973 levels. In recent years, the need to improve the supervision of the system has been recognized. It has led to internationally coordinated actions in prudential bank supervision, to new proposals to improve still further the surveillance of Eurocurrency markets and to various initiatives to render less disruptive the process of currency diversification. The launching of the European Monetary System has to be seen in the same context. The Committee expresses the view that after the second oil shock, reinforced international and Community action on these various fronts is even more necessary and that it will greatly contribute to a smooth process of recycling.

2.2. Recycling is a process by which the surpluses run by certain countries – in this case the oil-producing countries – are made available to countries in balance of payments deficit. This process is based to a large extent on international financial intermediation, both public and private, which ensures a certain transformation between the forms of investment offered to the surplus countries and the financing terms offered to the deficit countries.

2.3. This process involves a transformation of maturities, and sometimes a substitution of currencies, since the oil-producers generally wish to lend for a shorter period than that desired by the borrowers and sometimes in a currency other than the dollar. Costs and risks are associated with – though not specific to – recycling operation: transformation costs, possibly exchange risks, and default risks. These costs and risks can vary, depending on the extent of the transformation undergone by the financial assets in the intermediation process and on the financial situation of the funds' final recipient; they also vary with the procedures adopted for making the funds raised available to the recipient. If funds are lent on conditions more favourable than those on which they were raised, budgetary costs ensue. All these costs and risks must be shouldered in one way or another.

2.4. The Committee stresses that while financing payments imbalances due to the new oil price is necessary, adjustment to the new terms of trade through appropriate demand and supply policies is the fundamental way to restore a stable growth path in the importing economies. The achievement of the proper mix of financing and adjustment cannot be assured by markets alone. Indeed, it should be the major preoccupation of policies in the years to come. The right combination of adjustment and financing needs to be defined for each country, but the financing granted must not be the pretext for postponing the necessary adjustment either in the rapidly industrialising countries or in the industrialized countries; for the poorest countries, an increase in development aid seems a necessary element in any solution.

2.5. Financing can be granted either mainly through the international banking system, i.e. by the markets, or through official channels (Governments, international institutions). The Committee feels that in official interventions in favour of recycling the Bretton Woods institutions have an essential role to play, not only in view of the IBRD's particular vocation to the financing of developing countries, but above all because they constitute the fora in which all the main actors of the recycling process are present: the United States, whose exchange rate policy is a central element, as well as the OPEC countries, and the other international participants. The distinction between official and private forms of financing is very important for the distribution of risks and for setting the conditions of financing operations. It has, however, become increasingly clear that rigid separation would not be desirable and would entail the danger of official bodies being brought in only at a stage when the general economic conditions in the debtor countries were already seriously deteriorated. This is evidenced by the emergence and success of intermediate formulae in which international institutions cooperate with commercial banks (consortia, cofinancing). In addition, in the majority of cases, deficit countries make joint calls on the two forms of credit and often the banks grant financing only after the international institutions have themselves done so: for commercial banks, this is a way of taking account of the country risk since they are not themselves in a position to impose economic policy conditions on the recipient countries.

2.6. As regards the terms and the use of the funds, it is usual to make a distinction between grant aid and loans on the one hand; and between loans intended for the execution of projects and loans designed to finance the external payments deficit on the other. Different risks, techniques and conditions are associated with these different forms, and these must be taken into account in a recycling policy. In practice, however, when loans carry interest subsidies, a grace period or the granting of a guarantee, they contain a grant element. As regards the loans themselves, the structural adjustment loans towards which the World Bank is moving represent a category which straddles both project and balance of payments financing.

## 3. The role of the Community in strengthening the recycling process

3.1. Without substituting itself to the normal recycling process nor competing with them, the Community has a particular role to play in the context of the present payments imbalances. It has important trading relationships with OPEC, being the biggest oil importer and at the same time the main supplier of goods and services to the OPEC countries, accounting for 40 % of their imports. In addition, it maintains special relationships with certain groups of countries (Mediterranean, ACP) which are themselves trading partners of the oil-producing countries, and whose financial situation is, in some cases, precarious. Furthermore, because of its geographical proximity to the Mediterranean and oil-producing countries, the equilibrium and the economic and political stability of both of them are of vital importance for the Community. The Community aspect of the problem is also related to the need to shelter the intra-Community exchange relations from the pressures which would result from prolonged monetary disturbances and would concentrate on certain Community currencies, and to the opportunity to use the 'Community potential' if it is more effective and less costly than a mere juxtaposition of national actions, even if coordinated. The Community's collective borrowing capacity is large, its credit standing excellent and it constitutes a zone of monetary stability. Any action which the Community could undertake would have a new character with respect to the events following the first oil shock: it would be the action of a Community in which all members will be in a position of current account deficit. It would therefore have to be effected essentially by means of borrowed resources and not by means of the transfer of surpluses earned by its members. Furthermore, if a deterioration in international political and economic relations and a widening of the gulf between the richest and the poorest countries were to raise concern, the Community must make an active contribution to the solutions, on a world scale, to the serious problems posed by the existence of structural imbalances in current payments.

### 3.2. *Contribution to action at a world level*

3.2.1. The Committee agrees that the bulk of the recycling activity will continue to be carried out by *the international financial markets and the commercial banks.* In view of the important contribution of the international banking system in this respect, the Community should fully support efforts directed at safeguarding the soundness and the stability of the system, at strengthening regular and systematic monitoring of its activities and at maintaining sound banking standards in international lending. The press communique released by the Bank of International Settlements on behalf of the central bank Governors of the Group of Ten countries and Switzerland, on 15 April 1980, marks a positive step forward towards the achievement of these ends.

3.2.2. The Committee stresses that the important role of the international banking system will have to be increasingly supplemented by an expanded activity of the *international organizations,* and primarily of the International Monetary Fund, the World Bank and the regional development banks. These are the institutions suited to this end, all the main participants are adequately represented, the necessary funds are for the immediate future largely available and the mechanisms to incite borrowers to undertake the appropriate adjustment policies are present. The IMF still has substantial funds available. An adequate application of the Fund's principles is required, including a conditionality adapted to the requriements of an adjustment which, at times, is of a structural nature. The Fund's larger role in recycling and its possible recourse to direct borrowing from surplus countries, as recommended by the Interim Committee meeting in Hamburg on 25 April 1980, must also be supported and encouraged, and the efforts directed at implementing a properly designed and operational substitution account must be pursued. The World Bank also has an important contribution to make. Better coordination and close cooperation between the IMF, the World Bank and regional financial organizations should be sought and developed, while their resources could be directed in a larger measure to programme or structural adjustment lending. These institutions could also develop consortium type operations, joint examination of external indebtedness, etc. The Community should further examine these possibilities with a view to playing an active and unified role within these organizations and support new initiatives aimed at improving and expanding their role. The Committee is of the opinion that the Community should define common positions on these different points which would be communicated to the officials who represent the Member States in the IMF and the World Bank.

3.2.3. The *oil-exporting countries* have an essential part in the recycling process. A large part of the oil funds are at present directed towards short-term Eurocurrency deposits. Given the risks involved in this situation for international monetary stability, the Community should encourage the OPEC countries to place the oil surpluses at longer-term, either in the markets or outside them, in the forms of direct loans to the developing countries, to cooperate more actively with the international organizations and to participate in 'triangular' arrangements. The Community should, in any case, endeavour to establish closer contacts with the oil exporting countries.

3.3. *Direct Community interventions*

The member countries

3.3.1. The Community's primary responsibility is towards its members. In all the member countries, whose combined deficit in 1980 will exceed US $ 30 billion – over one quarter of the OPEC surplus – the adjustment process is envisaged or has begun. However, structural conditions and inflation rates were very diverse at the time of the second oil shock, and adjustment policies are not likely to achieve everywhere the same results. Seen in the light of long-standing difficulties, this represents not only a threat to monetary cohesion and economic convergence, but also a potential danger for the actual unity of the market. It is incumbent on the Community institutions to play their proper part in promoting the convergence of economic results and in helping organize such action as may prove necessary to combine adjustment and financing in the proper proportions to ward off this threat and this danger. The Community has various financing mechanisms and instruments: first, it has a specific mechanism for balance of payments financing based on external borrowing (Community loans), created in 1975, following the first oil shock; it also grants loans to finance investment projects – which often contain an aid element, interest subsidies – and sometimes programmes, through the EIB, and financial instruments for structural purposes (Euratom loans, ECSC loans, new Community instrument).

3.3.2. To support the efforts of its members, the Community should undertake action on two fronts: that of general economic coordination on the one hand, and that of financing instruments, if necessary, on the other.

— The Committee feels that the strengthening of the coordination of economic policies is essential so that the Community authorities can help promote adjustment before a country's balance of payments and exchange rate relationships are threatened, and so that the necessary adjustment is not unduly postponed by resorting to unconditional bank financing. One way in which the Community could help in this respect might be by more closely linking private financing operations with Community credits through a sort of 'early conditionality' which the Community is in a position to recommend for its members, but whose modalities remain to be studied by the Committee.

As to Community financing operations, the Committee is of the opinion that the Community must first and above all make the most of the existing instruments, adapting their size and their terms when necessary to improve their effectiveness. In this regard the following possibilities were mentioned in the Committee:

— increasing the volume of Community loans, set up in 1975, whose available margin is limited, and improving this mechanism, so that it can make a more effective and more complementary contribution both to the financing of acceptable deficits and to the macroeconomic adjustment of member countries;

— adjusting the Community's borrowing techniques in respect of all its instruments (Community, ECSC, Euratom, new Community instrument, EIB) (1) in the light of the need to raise from the surplus countries the maximum amount of funds required;

— strengthening the structural instruments – notably the new Community instrument – and giving their management rules the necessary flexibility.

Outside the Community

3.3.3. Beyond its own frontiers, the Community maintains special relations, which include an important financial aspect, with certain countries (applicant and Mediterranean countries, ACP countries). Thus the Community grants loans, usually with interest rate subsidies on the Community budget, or through the EDF for the ACP countries. The loans are granted by the EIB under special financial protocols or by the EDF under the Lomé convention; in each case they relate to the financing of specific projects. The Community is also involved in operations of a wider nature, in particular the guaranteeing of export earnings (Stabex) under the Lomé convention, which is a form of balance of payments support and the financial and food aid operations to the developing countries in general. In the context of recycling, immediate interest centres on the Community's lending activities to the countries with which it maintains special relations. The Lomé convention has just been renewed and involves an expansion of these activities. The Community is also engaged in preparing new financial protocols with the Mediterranean countries for the five-year period beginning in 1981. It is important to bear in mind the need for recycling to the benefit of these countries, in so far as this need can be satisfied by the type of investment financing to which the Community instruments are suited. The Committee also raised the question as to whether the Community could not resort to the technique of structural adjustment loans. Beyond this, the Community, within the framework of the IMF and the World Bank, will have to seek action which brings a positive response to these problems.

(1) The Committee has been informed of the work carried out on this point within the EIB.

Criteria and procedures

3.3.4. In the face of a problem of a financial nature such as recycling, which will extend over a period of several years, the Committee stresses that though the existence of the European Monetary System and the future transition to its institutional phase are factors of major importance for the Community, this issue should not be linked with the immediate problems of recycling. Whereas in a later stage the ECU could permit more effective measures by its contribution to the stability of the international monetary system, the Committee feels that the allocation to it of an external role in response to the immediate necessities of recycling would be liable to jeopardize its balanced and durable establishment. In the present phase it is preferable to limit its role to that of denominator of paper which could be offered by the Community institutions in order to, if necessary, have a greater and more direct access to the oil surpluses.

3.3.5. The Committee had a preliminary exchange of views on the implications for the Member States and for the Community of the recycling operations which the Community could undertake, whatever their destination. These implications would include the shouldering of part of the risks and costs mentioned above in paragraph 2.3. This would presumably be justified by recognition either of the reduction of the overall cost by means of a Community intervention, or by benefits of a general nature such as greater economic convergence and better monetary equilibrium. A recognition of the importance of these factors is a prerequisite for the further examination of the technical procedures of a Community initiative.

## 4. Final comments

At the end of this initial examination of the recycling problem, the Committee would like to stress that its remarks were preliminary in nature and require further consideration. Nevertheless, certain points can be made:

— recycling is likely to be generally manageable in 1980, and possibly in 1981, but difficulties are to be expected for the years beyond;

— the bulk of recycling activity should be effected through the markets, but the international institutions will have to support, supplement and strengthen private initiatives; for the poorest countries an increase in development aid seems a necessary element in any solution;

— in the face of a problem which is external in origin and international in scale the Community as an entity must support the efforts made in the wider international context.

Various proposals could be considered:

— the use of a variety of cofinancing formulae;

— the adaptation of the Community loan mechanism and of other existing Community instruments;

— the setting up of triangular financing schemes, with the participation of the Community, the OPEC countries and the developing countries (associated or ACP).

The Committee is ready to undertake any further studies on these points which the Council might deem appropriate.

*ANNEX II*

# REPORT TO THE COUNCIL AND THE COMMISSION ON RECYCLING

CONTENTS

## INTRODUCTION

The Committee's opinion on issues raised by the recycling process (doc. II/267/80 dated 4 June 1980) was referred to the Council meeting on 9 June 1980; the Council then called upon the Committee to examine the following points in greater depth:

1. the Community's role in the recycling process in the framework of the international organizations;
2. the Community loan mechanism and the other Community instruments for recycling in favour of the member countries of the Community;
3. the instruments for recycling in favour of third countries (e.g. the possibility of opening a window for third countries in the Community loan mechanism);
4. the link between adjustment and financing, problems of surveillance and 'early conditionality';
5. cofinancing and triangular operations;
6. costs and risks (guarantees, transformation, etc.), resources available and tentative quantification of possible actions.

Part I of this Report examines the Community's role in recycling in favour of member countries, through an adjustment of the Community loan mechanism, and the related questions of conditionality, surveillance and the mix between adjustment and financing; the other points of the Council's mandate, including the aspects of recycling to non-member countries, are examined in Part II. The Committee has furthermore delivered a separate opinion on another issue relevant to recycling, i.e. the use of the ECU as a denominator for loans floated by the Community institutions (doc. II/397/80 dated 8 September 1980 – in Annex).

The Committee would point out that the present Report should be seen as complementary to its opinion of 4 June 1980, in which the issues raised by the recycling process were examined in their general terms and in a broader context. In particular, the opinion defined recycling as 'a process by which the surpluses run by certain countries – in this case the oil-producing countries – are made available to countries in balance of payments deficit.

This process is based to a large extent on international financial intermediation, both public and private, which makes possible a certain transformation between the forms of investment offered to the surplus countries and the financing terms offered to the deficit countries'. Furthermore, the opinion stressed that 'the bulk of the recycling activity will continue to be carried out by the international financial markets and the commercial banks . . . supplemented by an expanded activity of the international organizations, and primarily of the International Monetary Fund, the World Bank and the regional development banks'. The Community as an entity must on the one hand support the efforts made in this wider international context, and on the other has a particular role of its own to play in the context of the present payments imbalances.

## I. ADJUSTING THE COMMUNITY LOAN MECHANISM

The Committee has devoted itself to examining how the Community loan mechanism set up in 1975 should be adapted to the requirements of the new structure of external payments disequilibria, the aim being to improve its effectiveness and enable the Community to contribute to the harmonious development of the recycling process. In this part of the Report the Committee studies the problems connected with the financing of the deficits of Member States.

### 1. **Aim, duration and ranking of the mechanism**

1.1. According to Article 1 of Regulation (EEC) No 397/75 which set up the mechanism, 'the Community may undertake a series of operations to raise funds, either directly from third countries and financial institutions, or on the capital markets, with the sole aim of re-lending those funds to one or more Member States in balance of payments difficulties caused by the increase in prices of petroleum products'.

The Committee feels that the wording of this Article should be clarified. It accepts the notion of 'sole aim' if it is understood that its intention is merely that of ensuring that the Community borrows solely in order to re-lend to one or more Member States. As regards the cause of the balance of payments difficulties, the Committee is of the opinion that the relevant phrase should read as follows: 'balance of payments difficulties directly or indirectly related to an increase in prices of petroleum products'.

1.2. As regards the duration of the mechanism, which was not specified in the 1975 Regulation, the Committee feels that the Council should in five years' time, on the basis of a report from the Commission, examine whether the Community loan in its principle, its arrangements and its ceiling still meets the needs which led to its creation.

1.3. Since it does not directly involve the commitment of member countries' foreign exchange reserves, this instrument is still, as far as its general design is concerned, well suited to the requirements of recycling. There is however, the question of whether any order of priorities should be assigned to the way in which calls are made on the various resources available to the national authorities to finance an external payments deficit (international capital markets, Community assistance, IMF facilities). The Committee discussed this question and concluded that no *a priori* position should be taken on the matter, so as to be able to react to circumstances in the best way possible.

The Council Decision of 8 May 1964 on cooperation between Member States in the field of international monetary relations (64/301/EEC) provides that 'consultations shall take place within the Monetary Committee in respect of any important decision or position taken by Member States in the field of international monetary relations and concerning in particular: . . . recourse by a Member State to resources which can be mobilized within the framework of international agreements'. It is in the framework of these consultations that the ranking of calls on the various sources of financing could be examined.

Similarly, the Committee did not consider it useful to attempt to establish priorities in the recourse to the medium-term financial assistance and the Community loans. Cases are possible in which only one of the two could be used, and others in which both could be used simultaneously. In the present situation, with all the Member States running current payments deficits, financing by Community borrowing, in accordance with the needs of recycling, may be the form of Community support which could most easily be mobilized in practice.

2. **Techniques**

Experience of the past lending operations has shown that the procedure for implementing the mechanism is at times excessively rigid:

2.1. Raising the loan (Article 2 of Regulation (EEC) No 397/75), after a loan application by a Member State, requires the Council, after consulting the Monetary Committee, to authorize the Commission to negotiate with the lenders; the Monetary Committee must again be consulted after the negotiations, and finally, a further Council decision is required to authorize the borrowing and lending operations involved. Experience has shown this procedure to be lengthy – in the first implementation of the mechanism, approximately one year intervened between the initial request and the funds' disbursement – and too cumbersome, in that it does not always permit the Community to adapt easily to market conditions.

The Committee considers that this procedure should be simplified so as to, if possible, reduce the references to Council to only one: the Council's role could consist in authorizing the lending of a specified amount for a specified country (and the corresponding borrowing), and in simultaneously setting the economic policy conditions before the conclusion of the negotiations with the lenders; the ensuing operations would be carried out by the Commission in consultation with the Monetary Committee.

2.2. Experience with loans that have been made under the mechanism has revealed one unsatisfactory feature, namely that a country that had borrowed through the mechanism and was in a position to repay its borrowings ahead of their due date was not able to do so because there was no means whereby the Community itself could prematurely redeem the funds which it had borrowed and on-lent. There is not much sense in setting economic policy conditions for a Member State whose position has already recovered and is ready to repay a loan granted to it. Therefore, whenever a borrowing member so wished and agreed to the terms of the borrowing this would involve, explicit provision should be made for the possibility of early repayment. Allowing advance repayment clearly implies having recourse to the usual borrowing formulae prevalent on the market, which would expressly contain an early redemption clause.

2.3. Instead of giving preference to the issue of bonds as has been the case hitherto, the Commission should dispose of the necessary flexibility in its borrowing operations, both to facilitate the possibility of early repayments discussed above and to make the best of market conditions. It should thus be able to have recourse to the other instruments available on the markets and to new instruments such as ECU-denominated loans, and it should explore and develop the possibilities of borrowing directly from surplus countries. In practice, however, variable rate loans should not be given preference over fixed rate borrowing; they should in particular be avoided as far as possible when borrowing directly from surplus countries. At all events, loans denominated or payable in the currency of a Member State should be issued only after the agreement of the competent national authorities. In this context, the provision under Article 2 of Regulation (EEC) No 397/75, whereby the average period of loans may not be less than five years, should be made more flexible, it being understood that the Community should not engage in maturity transformation. It is therefore suggested that the period of loans should be subject to mutual agreement between borrowing Member States and the Commission, in consultation with the Monetary Committee.

## 3. Conditionality

3.1. As requested by the Council, the Committee proceded to define the modalities which might govern the concept of early conditionality mentioned in its opinion of 4 June 1980. In practice this means that a country may have recourse to the Community loan before serious balance of payments difficulties have arisen, rather than after a situation of manifest crisis. This implies an appropriate concept of conditionality. It is in fact in the Community's interest to promote adjustment in a member country, through the contribution of even a modest financing, before this country reaches a situation of manifest crisis. On the other hand, a country may have an interest in relying on Community conditionality to promote the adoption of an adjustment programme *vis-à-vis* its own public opinion.

3.2. *Graduation of conditionality.* Conditionality should aim at restoring a sustainable balance of payments situation and should concern not only the demand side but place greater emphasis on the structural adaptations required in the medium term, particularly as regards energy. This concept of conditionality should at the same time contribute to increased convergence in the Community. Conditionality itself will have to be adapted to the situation of the country seeking a loan, particularly to the sustainability of the forecast deficits having regard to the country's external indebtedness and to the possibilities of financing these deficits. The more serious the Member State's economic situation, the more specific endeavours on the supply side, particularly in the energy field, will have to be supplemented by general adjustment measures on the demand side. This may imply setting monetary or fiscal targets. These targets would be set at regular intervals by the Council, acting on a proposal by the Commission and after consulting the Monetary Committee; compliance would be monitored, at regular intervals, jointly by the Commission and the Committee. It may be desirable for the loan to be disbursed in successive instalments, the release of each instalment being subject to compliance with the programme's objectives.

3.3. *Council procedures.* In practice the situation of a country facing balance of payments difficulties and intending to adopt an adjustment programme and to have recourse to a Community loan would be assessed by the Council on a proposal by the Commission, after the Monetary Committee had been consulted and had made its examination. The Council could grant a Community loan against the country's undertaking to conform to an adjustment programme, whose nature and validity would be the subject of a Monetary Committee opinion. Furthermore, according to the seriousness of the situation, or its development, the country could be asked to respect specific quantified targets.

3.4. *Procedures in the Monetary Committee.* The Committee feels that a mutual information and monitoring procedure on the balance of payments and external indebtedness positions of all member countries and on the policies pursued in these areas should be established. Essentially this would mean reinforcing and making more systematic the exchange of information which already takes place. Such a procedure falls within the Committee's competence, and the Committee has agreed to establish it as soon as possible.

## 4. Guarantee

4.1. In the event of default by the final borrower, the guarantee arrangements for the Community's creditors consist in participation by the Member States in accordance with a procedure laid down in Article 6 of Regulation (EEC) No 397/75 and in Articles 1 to 9 of Regulation (EEC) No 398/75, and in a token entry of the liabilities in the Community Budget to ensure that the creditors are paid without delay.

4.2. The Committee stressed that – as the experience of past decades has shown – the likelihood of default by any Community Member State is practically nil and it is in this light that it examined whether the present dual-guarantee system ought to be maintained. It is clear that the present system will remain in force with respect to the Community's loan operations carried out under Regulations (EEC) No 397/75 and (EEC) No 398/75.

Several members felt that the entry in the Community's Budget constitutes in itself a commitment by the Community – i. e. by the Member States – which is sufficient to satisfy lenders and that there is consequently no need for a special or adjacent guarantee. Abolition of the system of guarantees by the Member States would correspond to the Community nature of the instrument and make it simpler to implement. Payments in the event of default would be made according to normal budgetary procedures. Other members felt the maintenance of the present dual-guarantee system would be preferable, either because they felt that every effort should be made to avoid exhausting at some date the Community budget's financing capacity, or because they questioned the interpretation the markets could give to the scrapping of the counter-guarantees by the Member States.

4.3. It should be noted that, were the counter-guarantee system by Member States to be maintained, certain member countries would submit an increase in the amount of the Community loan authorized by the Council to a parliamentary procedure, which would result in a further delay, as happened in 1975 when the system was set up. Between the Council's political decision and the termination of the procedure in the last country, the delay could thus be long enough for a modification of the international financial environment to intervene.

5. **Ceiling**

The Committee feels it advisable to recommend the following adjustments. It points out in this respect that, if these modifications are adopted, they will require a decision in the form of a Council Regulation and, particularly if the Member States' counter-guarantee system is maintained, certain member countries might find themselves bound to the precedent of 1975 to make their agreement subject to parliamentary procedure.

5.1. *Denomination.* In conformity with other decisions taken within the Community, the ceiling should be denominated in ECU and not in US dollars.

5.2. *Calculation of the ceiling.* Interst on borrowing operations should henceforth be excluded from the ceiling, in line with normal international practice in the matter: the ceiling fixed by the Council would therefore relate only to the principal. As an example, applying this new method to the nominal figure authorized at present would – in the present market conditions – entail an increase of about one half in the borrowing capacity.

5.3. *Definition of the ceiling.* The ceiling should be considered as a limit on all outstanding amounts, i. e. the borrowing and lending resources would be reconstituted as and when repayments were made. If a margin can be reconstituted, there is no need to return to the Council each time the ceiling is exhausted, it being nevertheless understood that each activation of the mechanism is subject to prior authorisation by the Council.

5.4. *Increase in the ceiling.* The general feeling of the Committee is that the ceiling should be increased from that decided in 1975 (three billion US dollars in principal and interest payments). The modifications described above would by themselves, if adopted, entail a significant increase.

5.4.1. Certain arguments may be put forth in support of a more substantial increase:

— the erosion in the ceiling's real value since 1975;

— the need to reverse the decline in the present ceiling in relation to the size of the international capital market, whose annual volume of operations has tripled since 1975;

— the Community's current deficit is at present larger in proportion to trade and output than was the case following the last oil shock and is expected to persist for longer; a higher ceiling is thus necessary for the mechanism to contribute significantly to recycling;

— while after the first oil shock there were still a number of surplus countries within the Community, now all Community countries are in current deficit;

— the desire for coherence with the increase in the size of the credit mechanisms decided when the European Monetary System was set up, in order to have the same credibility and positive announcement effects on the exchange markets: it must be observed in this regard that in spite of their significant resources the two mechanisms have not been used, which confirms their psychological effect;

— the need to allow a number of large borrowers to have recourse to the mechanism simultaneously without exhausting its facilities, in contrast to the present situation (over 80 % of the funds available were promptly taken up by loans to two member countries).

5.4.2. Other arguments may be put forth in support of a more modest increase:

— the higher level of reserves, not least the result of the gold valuation within the EMS, and the relatively high credit worthiness of all Community countries create a better basis for the financing of deficits which is now becoming necessary;

— when the EMS was set up, short-term monetary support and medium-term financial assistance were more than doubled, in order to give a credible guarantee of the stability of exchange rates as regards the foreign exchange markets; neither of the two instruments has been used so far, which therefore leaves a borrowing margin available;

— in order to maintain the high credit standing with regard to its various borrowing instruments, the Community must give an example of a disciplined, not a permissive policy;

— it must be demonstrated both internally and internationally that the first priority is the most rapid adjustment possible to the changed conditions of the world economy;

— the Community should not compete too hard for OPEC funds with other methods of recycling of special importance throughout the world, e.g. direct channelling to the developing countries, making funds available for the IMF and the World Bank, etc.

5.4.3. The members of the Committee who support the first set of arguments (5.4.1.) consider that it would justify a ceiling of between 10 and 15 billion ECU. The members of the Committee who support the second set of arguments (5.4.2.) consider that it would justify a ceiling of between four and five billion ECU. Some members however could sympathise with some of the arguments presented in 5.4.1. and some of the arguments presented in 5.4.2. They therefore felt that a compromise should be found between the two ranges indicated above.

In all cases, the Committee members based their assessments on the assumption that the proposals advanced in paragraphs 5.1, 5.2 and 5.3 are adopted.

5.4.4. Several members pointed out that fixing a ceiling is essential only if it were decided to maintain the counter-guarantee system subscribed by Member States. In fact, the Council is called upon to decide, in each particular case, the amount of the borrowing operations authorized and therefore remains master of the overall volume of such loans. One could therefore refrain from preventively fixing the ceiling for such operations and assess the size of the envisaged loans each time the activation of the mechanism is requested.

5.4.5. As a formation of independent experts, the Committee has the general feeling that a compromise around seven billion ECU would have some chance of being a point of equilibrium and would not pose particular financial or technical problems (1).

(1) The alternate members of two countries preferred not to take a position on this point.

## II. OTHER ASPECTS OF RECYCLING

These other aspects cover points 1 (international organizations), 3 (recycling for the benefit of non-member countries), 5 (cofinancing) and 6 (costs and risks) on the list drawn up by the Council. The Committee's work on these points is a follow-up to the opinion of 4 June: it continues the analysis and defines certains solutions.

### 6. Costs and risks

The Committee started by drawing a distinction between the 'recycling' aspect and the 'aid' aspect of the problem of assistance to the developing countries, in order to deal only with recycling proper: it is nevertheless aware not only of the need to increase development aid so as to enable the poorest countries to overcome their difficulties, but also of the fact that intervention by public bodies in the recycling process would entail shouldering part of the risks and costs – transformation costs, possibly exchange risks and default risks.

### 7. The Community and the international institutions

In its Opinion of 4 June, the Committee considered that the Bretton Woods institutions have an essential role to play and called on the Community to play an active and unified role within these institutions, and to support new initiatives aimed at improving and expanding that role. The Community should in particular support the proposals for the IMF to borrow directly from surplus countries, for better coordination between the IMF, the IBRD and regional financial organizations, and for the development of consortium-type operations and structural adjustment loans. The Community should endeavour to coordinate its interventions in the fora in which international monetary questions are discussed, not only in the Bretton Woods institutions but also – in the present context of global negotiations – in organizations such as the United Nations. This means defining a common position in advance, or, at the very least, coordinating more closely the positions upheld by the Member States' representatives in these institutions. The Monetary Committee could be invited to intensify its action in this field.

### 8. Third country financing

8.1. For geographic and political reasons, non-member countries have different relations with the Community according to whether they are candidates for accession (or potential candidates), associated countries, ACP countries or other countries. The Committee is aware of the fact that the assessment of the problem can be modulated according to membership to one or other of these groups.

8.2. The general feeling of the Committee is that the formal opening in the Community loan mechanism of a special window for non-member countries is not appropriate at this time. The Community cannot take the place of the IMF, which is equipped to deal with international payments imbalances, has the mechanisms to induce borrowers to adopt the appropriate adjustment policies and where, lastly, the main parties to the recycling process are represented. The Community's role must be to support the efforts of the Fund, and even to supplement its action in certain specific cases by making its own or its members' contribution to solving a particular problem.

8.3. Although it felt that a window in favour of non-member countries should not be opened when the Community loan mechanism is adjusted, the Committee nevertheless considers that for certain countries and in certain circumstances, the Member States and the Community could take part in joint measures for the benefit of countries in serious payments difficulties. This has happened in the past and it should not be ruled out that it might happen in the future. By way of example, these measures have taken various forms in the past: rescheduling of the external debt, granting of guarantees, action on export credits, accelerating the implementation of financial protocols, etc. The countries particularly concerned are those which, because of their geographical proximity or their political and commercial links, maintain close relations with the Community. The Committee considers that when such actions are undertaken, it would be advisable for the member countries to confer together at Community level and even, if necessary, for the Community as such to participate. It also felt that, despite the special nature of these measures, their design and implementation must follow a number of guiding principles. Thought must be given to these guiding principles within the Community – a task which the Committee could assume. Thus, not only could these *ad hoc* measures be made more effective, but also the functioning of the normal financing instruments need not to be distorted by the pressure of events.

## 9. Cofinancing and triangular operations

9.1. The Community can make a third contribution to strengthening the recycling for the benefit of both its members and non-member countries by continuing and expanding the cofinancing and triangular financing operations in which certain Community institutions are already involved.

9.2. The EIB is already carrying out loan operations for the benefit of non-member countries and its borrowing operations on markets outside the Community draw partly on the savings of the oil-producing countries. It also contributes to the recycling process, as does the EDF, by associating oil capital in co-financing operations. Thus, under the first Lomé Convention, the EDF and the EIB contributed 17 % and Arab funds 19 % to financing a group of cofinanced projects totalling 3·2 billion EUA. Cofinancing operations have also been carried out under association agreements, with the Mediterranean countries and in connection with aid to non-associated developing countries.

9.3. In the future, these operations are likely to develop and multiply, both under the new Lomé Convention (five articles of which are exclusively devoted to cofinancing arrangements) and under the new financial protocols in preparation. The past and future development of these operations is largely due to the attraction for the holders of large funds of the Community's activity in the field of project financing, because of the experience it has acquired, the tested procedures at its command, and the administrative technical and financial aid it can grant. The Committee is aware of the importance of the Community institutions' efforts to develop this type of operations. It feels that in this area it is desirable for cooperation with the surplus oil countries and their institutions to be increased in the most appropriate forms by the authorities responsbile for the various financial instruments.

## 10. Characteristics of financial assets

An essential aspect of the problem is that of defining the characteristics of the financial assets which best meet the requirements of recycling: on the one hand, every effort should be made, in the interest of deficit countries, to obtain as favourable conditions as possible; on the other, attention must be given to offering surplus countries assets which are sufficiently attractive. The examination and testing of the appropriate formulae in this area is being actively pursued in numerous national and international quarters, both official and private. The Monetary Committee considers that, given both the trade links between oil producers and member countries and the relations uniting the latter within the European Monetary System, the Community should actively participate in this research and seize on the occasions which arise to adopt a common attitude and to promote the most effective financial innovations possible. The examination of the characteristics of the financial assets which best meet the requirements of recycling should continue and involve a detailed discussion on subjects such as the choice of the duration of the securities, formulae for borrowing at variable rates, the distribution of exchange risk. As to the utilization of the ECU, the Committee recently adopted an opinion which is annexed to the present report.

*APPENDIX 1*

## OPINION ON THE USE OF THE ECU AS DENOMINATOR FOR LOANS BY THE COMMUNITY

The way in which the ECU is used and develops is of great importance for the future of the European Monetary System and its institutions, which the Committee is now studying at the request of the Council. The use of the ECU could also be relevant to recycling, which is the subject of a further remit by the Council to the Committee.

As suggestions have been put forward in various Community bodies that the ECU be used as denominator for loans floated by the Community institutions, the Committee would point out that in its opinion the following considerations should be taken into account:

1. In order to acquire sufficient experience with ECU-denominated issues, their continuity must be ensured. For market reasons, it is therefore necessary that such issues be repeated. An experimental isolated issue is of no interest in itself.

2. For reasons of consistency, care must be taken to see that the solutions devised for the technical problems arising in defining the characteristics of an issue are closely coordinated and are homogenous between the various Community issuers.

3. The Community's excellent credit standing and the quality of the ECU in relation to other numeraires offer the prospect of ECU-denominated issues being made on good terms. When a reasonably broad market in such issues had developed they might, if conditions are right, be made at a somewhat more favourable interest rate than the weighted average of the interest rates attaching to loans denominated in the currencies of Member States. In the initial stages however the narrowness of the market may prevent this.

*APPENDIX 2*

## LEGAL IMPLICATIONS OF ADJUSTING THE COMMUNITY LOAN MECHANISM

1. While it does not consider itself qualified to decide on the questions of legislative, budgetary and accounting procedures implied by adjustments to the Community loan mechanism, the Monetary Committee draws attention to certain consequences of the changes it proposes.

2. It is understood that it is for the Council, acting unanimously, to determine the adjustments to the mechanism at present in force by a regulation adopted on the basis of Article 235 of the Treaty; however, the question of whether the Member States should make their agreement subject to a national parliamentary procedure has not been settled. Three arguments have been put forward:

— Several members felt that a national parliamentary procedure is not required when the Council adopts a decision under Article 235. The regulation adjusting the loan mechanism would therefore be immediately applicable even if the present dual-guarantee system were maintained, and all the more so if it were abolished.

— Other members felt that if the Member States maintained the counter-guarantee system, any change made to the Community loan mechanism would be subject to a national parliamentary procedure. This requirement would disappear if the dual guarantee were abolished.

— Some members felt that a national parliamentary procedure was necessary in order to adopt the changes made to the existing mechanism even if the system of counter-guarantees by the Member States were abolished.

3. The Committee feels that, whatever the guarantee system adopted, the contractual obligation for servicing the debt devolves on the Community, as the institution issuing the loans.

Under the present dual-guarantee mechanism, the Community budget must, in the event of the debtor Member State finding it impossible to meet its commitments, assure the payments attaching to the loans out of its cash funds, until the refinancing mechanism is activated. The other Member States acquire a claim on the Community, and this claim is extinguished at the latest when the borrowing Member State has returned to solvency and can repay the instalments due.

If the counter-guarantee mechanism were abolished, the Community – still in the event of impossibility for the debtor Member State to meet its commitment – would take responsibility for servicing the debt in accordance with normal budgetary procedures (eg. supplementary or amending budget).

Irrespective of the guarantee system adopted, since the guarantee is represented by a token entry, the corresponding liabilities are not taken into account in fixing the volume of expenditure of the Community budget and in applying the own resources ceiling imposed by the limit of 1 % of the VAT rate.

*ANNEX III*

# OPINION ON THE SUBSTITUTION ACCOUNT

## I. INTRODUCTION

1. A substitution account is a mechanism whereby a country holding dollar claims may cede a part of them, and receive claims denominated in SDR in return, while the body which receives their deposits subsequently becomes the creditor of the US, but longer-term.

2. At the IMF Interim Committee in October last in Belgrade the President-in-Office of the Council, speaking on behalf of the Community, stated that 'in principle the Community was open to the idea of the setting up on a voluntary basis of a substitution account and supported the proposal that the Executive Board continue its study into the detailed provisions required for its operation.' Since then, there has been a change in the conditions under which the debate on, and setting up of, the substitution account has to be seen, because of the following new facts:

— the increase in oil prices;

— prospective increases in OPEC surpluses;

— large fluctuations in the dollar, sometimes up, sometimes down;

— the emergence in most Community countries of current account deficits which will have to be financed;

— increased need for recycling, both the industrialized and developing countries;

— big jumps in inflation rates, not without consequences on interest rates.

Whatever the importance of these factors, it is indispensable for the future of the International Monetary System to organize a better distribution of reserve asset functions, and it is in this light that the idea of creating a substitution account should be examined.

3. The Committee stresses the importance of four basic principles which should govern the setting up of the account:

— participation must be voluntary, but as wide as possible;

— if the account is to perform a positive role in the International Monetary System then it will have to be on a sufficiently large scale;

— the claims on the account must be both attractive and easily negotiable

— the financial balance of the account must be fundamentally assured.

## II. ASSESSMENT

4. The Committee has examined a number of advantages which would attach to the creation of the substitution account, but it points out that it will also raise a number of problems. Any final overall assessment will depend on the solutions, some technical, some political, which are found to the separate issues relating to the characteristics of the asset and the viability of the account.

5. **The substitution account:**

(a) would help to channel the diversification of official reserves in a non-disruptive way, i.e. outside the exchange markets. It would contribute to the partial funding of dollar reserves and also help to divert pressures on EEC currencies to play a reserve role. However, the liquidity of the SDR claims would have to be properly ensured in order that the liquidity of participating central banks would not be unduly impaired;

(b) would be a step towards the better management of international liquidity; on condition that this does not expand excessively;

(c) could constitute a step towards making the SDR the principal reserve asset in the system; however, to this end, competition between the SDR proper and the SDR claims would have to be avoided;

(d) could provide large reserve holders with an attractive investment opportunity not subject to national regulation offering a market-orientated yield, and a reduced exchange risk, as long as satisfactory solutions are found to the problems of possible capital loss of the account, and of a possible differential in interest received and interest paid by the account.

6. The lasting pursuit of prudent economic policies under the firm surveillance of the IMF, by all members and in particular those having an essential role to play in

the functioning of the system, is an important precondition for the satisfactory working of the substitution account and for a possible reopening of the account in future.

7. The Committee is of the opinion that a properly-functioning substitution account would contribute towards a greater degree of international stability which should provide for the smoother functioning of the EMS. Furthermore, the existence of a substitution account is not likely to impede the eventual development of the ECU, nor reduce its usefulness.

## III. UNRESOLVED PROBLEMS

8. The Committee draws attention to four main problems on which negotiations may centre:

— the need to make the claims sufficiently attractive;

— the principle according to which guarantees of the financial balance of the account should be shared between the US and other participants;

— the use of IMF gold;

— the distribution of voting rights and other institutional questions.

### A. *Attractiveness*

Liquidity of the proposed SDR-denominated asset is of primary importance. The availability of the asset to private holders should not be excluded, but this question should be dealt with in the context of the further development of SDR claims.

Rules will have to be devised for ensuring the maintenance of the financial balance of the account.

To this end, the capital value should be calculated at regular intervals, and appropriate solutions for meeting any shortfall worked out. The financial balance of the account could be ensured by appropriate recourse to the range of potential assets of the account, including previously accumulated surpluses, IMF gold, and by guarantees provided by the United States and depositors.

A disequilibrium could also arise from interest shortfalls; the Committee is of the opinion that while, as a general principle, these shortfalls, unless covered by previous surpluses in the account, should be covered by the United States, this issue will have to be negotiated.

### B. *Sharing of guarantees between the US and depositiors*

Any guarantee would have to be fairly shared. The main issues are:

— the size of and the priority to be accorded to the US share;

— the distribution of shares among the depositors, which should be related to the size of their deposits without special treatment for particular groups of countries.

### C. *IMF gold*

There is widespread agreement that IMF gold will play an important role in supporting the account. The method by which the gold is to be made available (direct transfer, restitution or earmarking) and the precise methods by which the gold would in practice support the account are issues still to be decided.

Moreover, a majority of 85 % of the voting power within the IMF is required for a decision to make gold available. Thus the agreement of the developing countries will be necessary. In this connection, it should be borne in mind that the account should provide for a better functioning of the International Monetary System and that therefore recourse to gold in support of the account would benefit all members of the IMF.

### D. *Distribution of voting rights*

This question is related to decisions on the legal structure of the account. The Committee would expect that voting rights of depositors would be related to the size of their deposits. In any case, the distribution should grant an appropriate position to the US.

*ANNEX IV*

## THE UK GREEN PAPER ON MONETARY CONTROL [1]

### Report of the Working Party

### 'Harmonization of the monetary policy instruments'

1. In May 1980 the Monetary Committee and the Committee of Governors invited the Working Party on Harmonization of Monetary Policy Instruments to study the United Kingdom's Green Paper on Monetary Control.

2. The Working Party has confined itself to considering the monetary control methods detailed in chapters 4 and 5 of the Green Paper. These are briefly outlined in Chapter I of this report. The effectiveness, costs and benefits of these methods from a domestic viewpoint are studied on the basis of EEC member countries' experience in this area (see chapter II). The compatibility of the monetary control methods with the objective of harmonizing monetary policy instruments and their significance for the working of the EMS and for future membership of the exchange rate mechanism by the United Kingdom are considered in chapter III.

(1) Monetary control, Command 7858, presented to Parliament by the Chancellor of the Exchequer by Command of Her Majesty, March 1980.

### I. THE GREEN PAPER ON MONETARY CONTROL

3. The Green Paper on monetary control was announced by the Chancellor of the Exchequer in November 1979 and published on 20 March 1980. It is part of a gradual strengthening of the monetary authorities' control over monetary aggregates dating back to 1976 when quantified monetary targets were formulated for the first time. It also forms part of a broader policy reassessment aiming at a reduction of the rate of inflation and creation of conditions for a sustainable growth of output and employment. Excessive reliance on interest rates to achieve the monetary expansion target has been ruled out, the government viewing a substantial reduction over the medium-term in the public sector borrowing requirement as a percentage of nominal GDP as of major importance, together with an appropriate funding policy.

4. Certain crucial propositions, fundamental to current thinking on monetary policy by the British monetary authorities, are made in the Green Paper and so are not open to discussion here:

— first, although no single statistical measure of money supply can be expected fully to encapsulate monetary conditions, the present practice of setting just one target (for sterling M3) [1] is endorsed. Even so the need for the monetary authorities to assess monetary conditions having regard to a range of monetary indicators is stressed;

— secondly, the British authorities are satisfied that the main instruments of monetary control – fiscal policy and interest rates – remain sufficient to achieve monetary objectives applied to periods of about one year.

5. Three firm proposals for change are made in the Green Paper. First, the direct control on banks' eligible liabilities – the Supplementary Special Deposit Scheme or 'corset' – should be abandoned; this was done in June 1980. Secondly, the Reserve Assets Ratio (RAR) should no longer be retained although the associated power to call for Special Deposits will remain in order to guard against possible adverse effects of excess liquidity in the banking system as a whole. Thirdly, the present cash requirement, which acts as a fulcrum for the Bank when it wishes to generate interest rate changes, should be extended to all banks rather than applying just to the London clearing banks as at present. (Concurrently with the Green Paper, the Bank of England also issued a separate consultative document on the need for banks to hold liquid assets for prudential purposes.)

6. In addition, the Green Paper welcomes views on two further proposals which would mainly serve the

(1) Sterling M3 is defined as notes and coin in circulation with the public, together with all sterling deposits (including certificates of deposit) held by UK residents in both the public and private sectors.

more limited purpose of seeking to improve monetary control in the short term, at least from quarter to quarter. This would be especially desirable if it led to ensure calmer conditions in financial markets which are at times very sensitive to unexpected short-term deviations of monetary indicators. It might also reduce any bias towards delay by monetary authorities reacting to short-term deviations from target and strengthen confidence in the authorities' resolve to achieve their medium-term monetary objectives. The Green Paper specifically avoids consideration of change to the range of debt instruments offered by the Government or of changes in their methods of operation in debt markets, as these subjects were opened to debate last year.

7. The first proposed new method of monetary control – a monetary base control system – seeks to control the amount of base money (1) in existence and so the total growth of the money supply. It assumes that there is a stable relationship between monetary base and the banks' balance sheets either because bankers maintain such a relationship in the normal conduct of their business or as a result of a mandatory reserve requirement.

8. The second monetary control scheme is an indicator system. Under the indicator approach, divergences from the desired path of the base or, even more directly given the present target aggregate, of sterling M3 itself, would trigger a predetermined adjustment of the Bank's lending rate to the discount market until such time as the target aggregate came back into line.

(1) Base money includes bankers deposits at the central bank and may also include notes and coin held by either or both the banks and the public.

9. The Green Paper sets two preconditions in considering the various possible forms of monetary control which would assist in bringing the growth path of monetary aggregates in the short term under closer control by the monetary authorities than at present:

— the authorities consider that any new technique must avoid providing a significant incentive to disintermediation (it was precisely for this reason that the UK authorities abandoned the 'corset' in June 1980);

— unless there was a high probability of assuring improved monetary control in the short term there is a presumption against changes in methods of monetary control that would require fundamental institutional changes and/or which could be so inconsistent with subsequent membership of the exchange rate mechanism of the European Monetary System that they would have to be changed again if the Government decided that the conditions for joining were appropriate.

## II. ASSESSMENT OF THE COSTS, BENEFITS AND EFFECTIVENESS FOR THE UNITED KINGDOM OF THE PROPOSED MONETARY CONTROL METHODS

10. The Green Paper suggests that there would be advantage in shortening the period within which it was possible to exercise monetary control, if there were practicable ways of doing this, since excessive short-term fluctuations may cause uncertainty about the Government's resolve and its ability to control monetary growth.

11. The group noted that preliminary econometric studies submitted to it pointed to the conclusion that the money stock in the United Kingdom might be no more volatile in the short run than elsewhere. In the United Kingdom's case, however, it has been argued that even greater short-run monetary growth stability is needed to improve the functioning of the long-term government bond market by encouraging a steady reduction of inflationary expectations which are a major determinant of demand in this market. This is explained by the fact that the financial markets have on occasions been nervous of any hint that the monetary authorities might for any reason be losing sight of a desirable monetary objective. With the expectation that the monetary authorities might have to raise interest rates considerably because of the upward deviation from target, there has usually been a sharp fall in market demand for government debt, especially from institutional investors, reducing the bank of England's ability to offset excessive monetary growth through gilt sales to the non-bank sector and so intensifying expectations of higher interest rates. As a result such a self-fulfilling prophecy of higher interest rates stemming from a short-term deviation from the official monetary growth path has required the authorities to react sharply in order to convince the market that interest rates were at their new peak.

### 1. Monetary base control

12. Provided there is a stable relationship between the development of the monetary base and that of the target variable, the authorities, by fixing the desired amount of base money, are in theory able to obtain the desired monetary growth rate, leaving the structure and the level of interest rates to be determined by market forces. Without considering the effectiveness of a monetary base control system in the longer run and the usefulness of monetary base as an indicator, the group felt that its implementation as a short-term control instrument involved sizable costs.

13. The nature of these costs can be seen when one looks at the operational details of the various possible schemes. The Green Paper rules out schemes without mandatory reserve requirements, as in the British case the banking system currently holds a variety of assets that the authorities are prepared to convert into cash or against which the authorities will lend cash. Consequently, without major institutional changes, there would be no prospect of a stable relationship between the monetary base and the money stock. As far as schemes with mandatory reserve requirements are concerned, the group noted that with lagged accounting (where current base requirements are fixed by reference to deposits in a previous period) the demand for base money will reflect monetary developments which have already materialized. If the money stock has been rising above the target (market determined demand exceeds the central bank's desired supply) the central bank has three choices. It can let the banks go below the reserve requirement, or it can allow interest rates to rise, possibly very sharply, leading to disorderly markets, or it can provide the base demanded. To the extent that the central bank is known to be unwilling to intervene, the banks will tend to hold greater excess reserves and the problem of imballance is likely to arise less frequently. However, if the banks are willing to vary their level of excess reserves, then the short run link between monetary base and money stock is weaker. The group noted that lagged accounting is the common practice of most EEC central banks. However, reserve requirements on a lagged accounting basis are not used as an instrument for controlling monetary growth over short periods but as a lever to bring about the desired money market and lending rate changes.

14. A mandatory relationship between the monetary base and deposits with lead accounting (where the holding of base assets would put a limit on deposits at some future date), together with penalties for both under- and over-predicting, would be better suited for monetary control over short periods. On the other hand, such a scheme may present some serious difficulties, in particular the risk of banks disintermediating or reintermediating in order to ensure that banks' forecasts of their future balance sheets were correct. Indeed, the working party noted that in an overdraft system and with considerable unused credit lines balance sheets projections were extremely unreliable, suggesting that the risk of artificial adjustments of balance sheets by banks would be considerable.

15. The group observed that the more rigidly monetary authorities operate a monetary base control system to control money stock in the short term, (i.e. the more severe the penalties on individual banks or the banking system as a whole) the stronger the incentive for disintermediation or reintermediation. Nevertheless, disintermediation could be less pronounced than under a system of quantitative controls such as the 'corset' and credit ceilings. Indeed, whereas credit ceilings are highly selective in their application, allowing greater scope for near substitution, the more generalized application of a monetary base control system could ensure that banks compete to secure base assets to match excess growth in deposits rather than resorting to more complicated disintermediation. The consequent increase in interest rates will help to curb the excessive growth of the money stock. The effect may, however, be limited since banks may become aware of the high costs of this process and would do their utmost to avoid aggressively bidding up the interest rate on base assets and would disintermediate further.

16. It may be argued that the attainment of the official monetary objective is of paramount importance and that disintermediation is an acceptable part of the process by which the monetary objective may be met without placing undue strains on the banking system. On the other hand, there are two major drawbacks. First of all, to the extent that the financial markets are aware of the existence of disintermediation, the confidence effect sought by the authorities by smoothing out short-term fluctuations in monetary growth will not come about. Secondly, the effectiveness of monetary policy will be weakened. Indeed, the final purpose of monetary policy is not hitting a given target, but contributing to the attainment of the final economic objectives. When setting a given monetary target, the authorities assume that attainment of this target will produce the desired effects on the economy. These effects would not come about if the authorities adhered to a target variable which no longer accurately reflected monetary conditions.

17. Some EEC central banks nevertheless operate schemes which give an incentive to disintermediation; this is, however, not for domestic manipulation of the monetary aggregates but in order to meet a specific economic objective. For example the ceiling on lira denominated bank lending to Italian residents has the effect of generating desired capital inflows. Elsewhere the authorities benefit from the fact that credit markets are relatively isolated from each other so that disintermediation cannot easily take place.

18. Consideration was given to whether the problem of disintermediation or reintermediation could be overcome by changing the definition of the target variable so as to cover 'distintermediated' assets. This could, however, give an incentive to develop new credit channels which might be even less identifiable and tolerable. An example, now that exchange controls have been abolished in the United Kingdom, is the potential permanent loss of bank business to the euro-markets.

19. The working party also discussed whether disintermediation could be avoided or restricted by making mandatory reserve requirements interest bearing. It concluded that this would avoid discrimination against conventional banking operations and so reduce the incentive for banks to permanently switch their lending operations into a non-controlled parallel market. However, it would not avoid disintermediation whenever the monetary authorities sought in the short-term to smooth out undesired movements in the money stock by means of monetary base control.

20. The group noted that besides these fundamental problems the operation of a monetary base control system is also made difficult by unpredictable swings in cash flows. It pointed out that most EEC central banks express the cash requirements in terms of an average over a period. This would not, however, entirely resolve the problem of unpredictable movements in cash flows, but only concentrate the problem on some critical days at the end of the reference period. These problems are, of course, of minor importance in these EEC countries because no attempt is made to control the level of the monetary base over short periods.

## 2. Indicator system

21. The attractiveness of an indicator system with a predetermined scale for interest rate changes is seen by its proponents as an attempt do devise a system in which the authorities would respond more quickly to changes in the underlying trend of sterling M3 rather than reduce directly its month-to-month variability. Therefore, unless the authorities avail themselves very frequently of the power to override automatic interest rate changes, any bias towards delay of action by the monetary authorities would no longer exist. This would prevent extensive periods of monetary growth in excess of the target range without corrective action being taken. The proponents of such a scheme further claim that the necessary interest rate changes could be smaller and this could also reduce the volatility in the growth of the money stock.

22. However, the group doubted whether all these desired effects would actually come about. Firstly, the indicator system would not alter the fact that changes in bank lending rates will only affect borrowing, and hence the money supply, with a lag. The size and timing of borrowers' reactions to changes in loan rates in the United Kingdom is unclear and some uncertainty therefore attaches to the use of indicator systems to control the money supply. In this regard an indicator system might not contribute to greater control over the short-term growth path of the money stock.

23. Secondly, while it is claimed that an indicator system would make sales of government debt easier, there are some doubts whether the interest rate adjustments taken according to a predetermined scale could convince the financial markets that interest rates have reached their peak or trough. If the markets were not convinced, they would remain in a state of tension and the deviations of monetary growth from the desired growth path might even be accentuated. In order to avoid such a perverse effect it would be essential that the authorities maintain the power to react, if necessary by drastic measures, in order to correct the situation. This, in fact, is the present system by which a refusal by the market to buy gilts at the prevailing price is usually met by a sharp rise in official interest rates followed by clear signs from the monetary authorities that a new peak has been reached and rates would then stabilize or even fall.

24. In consequence, there is no assurance that an indicator system would lead to less volatility in interest rates and monetary growth. In addition, frequent interest rate changes might have an effect on monetary growth not only in the short-term but also over longer periods. Thus, despite the monetary authorities' declared satisfaction with medium-term monetary control, more

frequent short-term interventions might interfere with medium-term control.

25. Some members of the group felt that nevertheless it might be worthwhile considering to what extent the present discretionary scheme could be adjusted so as to reduce any bias toward delay in taking monetary action. In the case of the United Kingdom this might take the form of liquidity facilities of the central bank becoming less easily accessible to the banking system (via the discount houses). This would allow a more aggressive money market policy to bring interest rates to the desired level before formal measures such as discount rate changes are taken. It would involve, however, major institutional changes whereas the indicator system claims the advantage of involving very limited institutional changes.

## III. THE POSSIBLE CHANGES IN MONETARY CONTROL METHODS FROM A COMMUNITY VIEWPOINT

26. The Working Party examined from two angles and from a Community point of view the possible changes in the techniques of monetary control presented in the Green Paper:

— the harmonization of monetary policy instruments within the Community;

— the consistency with the functioning of the EMS and with participation in the exchange rate mechanism.

### 1. **Harmonization of monetary policy instruments**

27. The Working Party's mandate requests it to study the instruments which are required by each Member State for its monetary policy and to examine their possible degree of harmonization with reference to Article 9 of Council Directive 74/121/EEC of 18 February 1974 on stability, growth and full employment in the Community. In this respect, the proposed or possible changes in the present system of monetary control, as presented in the consultation paper, would not seem to run counter to this Community provision. In fact, the Green Paper's concern with ensuring a rapid response of the authorities to apparent deviations from target appears to be in agreement with the Article's requirement that Member States be able 'to take prompt action on the various elements covered by the policy of the monetary authorities'.

28. The relevance of the Directive, with its approach of favouring 'fine-tuning' and short-term efficiency criteria, could however be questioned, since the emphasis of monetary policy, as mentioned in the group's last report (Report on certain questions relating to monetary policy instruments, dated 29 May 1979), has progressively become oriented to ensure more moderate and steadier growth in money supply over longer periods. In the United Kingdom this has been carried to the point of the publication by the Government of a quantified medium-term financial strategy which has as its main objective a progressive reduction in the annual rate of money supply growth to about 6 % in the financial year to April 1984.

29. Nevertheless, the ideas in the Green Paper would seem to accord with a general trend apparent in the Community over recent years, particularly in the major countries. The adherence to norms for a steady and moderate expansion of the monetary aggregates, designed to stabilize expectations and reduce the rate of inflation, has been accompanied by a less accommodating or a more aggressive stance in the management of monetary policy while the authorities have accepted relatively sharp movements in short-term interest rates.

30. However, there would appear to be important differences with regard to the specific aims and methods outlined in the Green Paper. In the first place, few EEC countries pursue their monetary intermediate objectives by exclusive reliance on the control of money market conditions; most employ a mix of direct and indirect instruments, i.e. of instruments which act through administrative measures and those acting through price and market mechanisms, and in many countries the former have often prevailed over the latter. For several countries, the control of money market conditions is dictated essentially by external considerations and cannot be relied upon to achieve the intermediate monetary objective (money stock or credit target). The need to keep a free hand with respect to interest rate policy has induced some smaller open economies to reject monetary targetting as impracticable.

31. Furthermore, it should be observed that even those larger countries which can afford to gear their day-to-day monetary management almost exclusively to the attainment of their monetary target apply methods which are more flexible than those described in Chapters 4 and 5 of the Green Paper. There is in particular no aim to achieve smooth trajectories consistent with the authorities' annual projections for the target variable: a process of strict adherence to the target path is seen to require such large and erratic variations in market interest rates as to have insettling and undesirable effects on the real economy and on the public's price and exchange rate expectations. In sum, the authorities have generally maintained a certain degree of operational flexibility and have accepted short-run or random departures from the target path to take account of shifts in money demand and/or the desire to smooth out exchange rate movements.

32. While in certain respects the formulae presented in the Green Paper might be seen as being part of a general trend within the Community, in other respects they depart from current practices. The Working Party is nevertheless of the opinion that this is not in itself of major significance as the harmonization of monetary policy instruments is not a central issue in the present phase of Community integration. In this regard it recalls the conclusion of its second report (Doc. II/458/78), which claims that harmonization of monetary policy instruments or even intermediate objectives is difficult to attain in present circumstances and is a longer term goal that might be harmful to economies if implemented at present. Pending further progress towards economic and monetary union, it recommends coordination as an essential element to improve understanding and to prepare for final harmonization. From this point of view, the question of the consistency of the possible changes in the methods of monetary control with the functioning and the future membership of the EMS exchange rate mechanism acquires particular relevance.

## 2. Consistency of the possible changes in monetary control methods with the functioning of the EMS and participation in the exchange rate mechanism

33. The consistency with the EMS of the monetary control methods outlined in the Green Paper may be examined from two perspectives:

— whether the monetary control methods pursued to bring down the rate of inflation while the UK is not a full member of the system could raise problems for its smooth functioning; and

— whether they are compatible with and take sufficient account of possible future membership.

34. Exchange rate expectations and interest rate levels are the joint determinants of external capital flows. If exchange rate expectations, are particularly sensitive to any deviation in the money stock from the authorities' target, the successful smoothing of the money stock growth rate within the target range would stabilize exchange rate expectations and so lessen the risk of erratic capital flows.

35. The group noted, however, that in certain circumstances there are still other factors than the monetary authorities' success in keeping money stock growth on target which determine exchange rate expectations and so overshooting of the money stock target in the short term might not necessarily undermine exchange rate confidence. In such circumstances the interest rate effects of the monetary base control and indicator systems might lead to undesired, erratic capital flows.

36. It may be argued that in a *monetary base control system* only very short term and largely technical interest rates are affected. Fluctuations in these very short-term interest rates might not be sufficient to generate sizable capital flows. Interest rates for longer-term periods (for example the three-month rate) might become even less volatile than at present if confidence in the monetary authorities' short-term smoothing operation is great or if as a result of the policies adopted smoother monetary growth is in fact secured with less sharp changes in interest rates. However, the group was not sure whether the effects would necessarily be confined to fluctuations in very short and largely technical interest rates. Even if they were, there might be situations on the exchange markets in which even fluctuations in these very short and technical interest rates might generate sizable capital flows. All these conclusions are, however, largely speculative given the lack of empirical experience in the whole field of short-term monetary base control.

37. The likely effect on the exchange rate and capital flows of disintermediation/reintermediation caused by a monetary base control system could be broadly neutral over time, although in the very short-run there might be

problems of timing which could cause exchange rate instability. The most likely form would be for banks situated in the United Kingdom and subject to the control to divert sterling deposits to offshore branches not subject to control. But since these offshore deposits would then probably be on-lent in sterling for use in the United Kingdom there would be exactly offsetting capital outflows and inflows with no net change in the demand for sterling. Schemes which present a strong incentive for disintermediation/reintermediation would thus create no major external problem but are not acceptable to the United Kingdom authorities for domestic reasons.

38. In an *indicator system* where the Bank of England's official rates were changed automatically much would depend on whether the size of interest rate changes which were necessary to control monetary growth would be smaller or greater than at present.

39. As long as the United Kingdom is not a full member of the EMS, the implementation of one or other of the control methods described in the Green Paper need not raise major problems for the smooth functioning of the EMS. However, greater exchange rate variability between the EMS currencies and the pound sterling would have harmful economic consequences for some smaller EMS countries with close economic and financial links with the United Kingdom. Further problems could arise if induced capital flows had an uneven impact on members of the EMS exchange rate mechanism. On the other hand, if the various control methods helped the British authorities to improve monetary control and this helped to bring down the rate of inflation – the latter being one of the major obstacles to UK membership of the exchange rate meachnism –, this would facilitate the United Kingdom's participation in this mechanism.

40. Considering whether the approach outlined in the Green Paper is compatible with and takes sufficient account of possible participation in the exchange rate mechanism of the EMS, the working party observed that since the EMS is a fixed but adjustable exchange rate system it is generally possible – as the policies of some of the larger members of the EMS indicate – to maintain the money supply as an intermediate objective and also to adopt an exchange rate commitment; but the temporal horizons of the two normally differ. Since the exchange rate commitment is absolutely binding in the short term – too frequent realignments being ruled out as inconsistent with the concept of the EMS – all participants have faced the necessity – at least for a short period – of accepting some deviation of their money stock growth rates from target because of external capital flows, including inflows from non-participants. Even so, over longer periods the money stock target may still be broadly attained once the generally short-lived exchange rate pressures have eased, or the parity is adjusted.

41. In consequence, the group noted that, depending on circumstances, the potential conflict between exchange rate commitments and money supply objectives could become more acute if the authorities attempt – as the Green Paper suggests – to control even short-term fluctuations in monetary growth. The fact that both an exchange rate and a monetary target involve staying within a range, rather than achieving a precise figure, would mitigate the risk of conflict only to a minor extent. Faced with pressures in the foreign exchange markets, central banks have had some success in sterilizing capital inflows through the banking system but sterilization of inflows through the non-bank sector is much more difficult.

42. In the case of actual participation of the United Kingdom in the EMS, the possible interest rate volatility of the monetary base control and indicator systems could seriously disturb the equilibrium within the exchange rate mechanism even if monetary intermediate objectives were consistent with each other in the longer run. On the other hand, as long as the methods are applied to a monetary rather than a domestic credit aggregate, it would be difficult to adapt only marginally the formulae to take account of the requirements of the exchange rate mechanism. For example, if in an indicator system the authorities used their power to override automatic interest rate changes because of the position of their currency within the EMS margins or in a monetary base control system they entirely or partly made allowance for that part of monetary base which is created or destroyed by foreign exchange purchases or sales by the central bank, this would run counter to the basic theoretical approach of the proponents of monetary control over short periods.

43. A final consideration is the cost of reversing some of the possible changes in the methods of monetary control if they were seen to be inconsistent with membership of the EMS exchange rate mechanism at the moment of joining. From this point of view, an indicator system based on the money supply would not necessarily involve significant changes in the financial system, so that it could probably be reversed at little cost if this were deemed necessary; this is clearly an important advantage of such a system.

## CONCLUSIONS

44. The Green Paper discusses two methods for improving short-term monetary control in the United Kingdom, i.e. a monetary base control system and an indicator system. The two proposals are briefly described in paragraphs 7 and 8 above.

45. There are some indications that from a domestic point of view monetary base control aimed at very short-term control of the money stock could either put severe strains on the British banking system or, if it created an incentive for disintermediation, impair the authorities' ability to set and achieve appropriate monetary targets in the medium run.

46. Although the group had some doubts whether an indicator system would actually have the desired effects claimed by its proponents, and felt that it might even have undesirable effects in certain circumstances, it acknowledged that such a system – unlike a monetary base control system – could be implemented without involving major institutional changes.

47. The group felt that it might be possible to reassure financial markets that the present system of discretionary adjustments of official rates need not necessarily imply a bias towards delay of action by the monetary authorities. The reassurance of financial markets could be enhanced if the monetary authorities also found better ways of communicating to the markets their resolve and ability to meet their medium-term monetary objectives, convincing the markets that short-term fluctuations in monetary growth are acceptable or even inevitable. In this connection the working group noted that according to preliminary econometric studies the money stock in the United Kingdom appears to be no more volatile in the short run than elsewhere. Consequently markets may gradually become less sensitive to short-term deviations of monetary growth as they progressively gain confidence in a rapid return to the desired path. There is some evidence for this in the experience of both the United Kingdom and other EEC countries. Furthermore, it noted that the scope for changes to the range of debt instruments offered by the Government or to their methods of operation in debt markets was already opened to debate in the United Kingdom last year.

48. From a Community point of view the group noted in particular some possible drawbacks for the functioning of the EMS but felt that there would be no major impediment to the smooth functioning of the system if any of the various control methods were applied while the United Kingdom still was not a member of the exchange rate mechanism.

49. Once the United Kingdom became a member of the mechanism the potential conflict in the system between exchange rate commitments and monetary objectives would be accentuated in particular by the monetary base control method if it is used to attempt short-term control of the money stock and if such short-term control does not have a positive effect on expectations. Indeed, in a fixed but adjustable exchange rate mechanism, the monetary authorities of a country can only be sure of achieving their monetary targets over longer periods (i.e. periods of a year or more), and short-term deviations from the target path have to be accepted on occasions. The aim by a major country to smooth short-term fluctuations in monetary growth could, in the extreme, imply the need for more frequent and erratic central rate alignments than would be desirable for the smooth functioning of the EMS exchange rate mechanism.

50. The group concluded that there remained considerable doubts as to whether the monetary control methods outlined in Chapters 4 and 5 of the Green Paper would, on balance, be advantageous either for the United Kingdom or for the Community as a whole.