EUROPEAN COMMUNITIES

MONETARY COMMITTEE

TWENTY-THIRD REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

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Summary

Foreword 5

I. Introduction 5

II. Community action and the activities of the Committee 6

III. Working parties of the Monetary Committee 8

List of members and alternates of the Monetary Committee 9

Annex I : Opinion to the Council and the Commission on indexation mechanisms (16 November 1981) 13

Annex II : Opinion on dollar interest rate and exchange rate developments (25 June 1981) 17

Annex III : Opinion on the financial aspects of North-South relations (15 June1981) 21

Annex IV : Report by the Working Party on Harmonization of Monetary Policy Instruments on 'The technical problems stemming from the co-existence of monetary and exchange rate objectives within the EMS' (22 October 1981) 25

FOREWORD

In 1981, the Committee held nine sessions; the Committee's working parties and the Alternates met on several occasions. The list of members in office during 1981 is annexed.

I. INTRODUCTION

1. World economic trends in 1981 were subject to a number of unfavourable influences: the aftermath of the second oil shock of 1980; the worsening of domestically generated imbalances (in particular budgetary imbalances); wide and sometimes erratic swings in interest rates and exchange rate relationships with the United States dollar. The effects of these factors on the economies of the major country groupings varied, but on balance activity may have picked up slightly in the course of 1981. The volume of world trade remained at the same level as in 1980, since the volume of imports by members of the Organization of Petroleum Exporting Countries continued to offset to some extent the low level of other countries' imports, which was accounted for by a marked slowdown in consumption and importation of oil. The imports of the non-oil developing countries, which have large external deficits to finance, increased at a slower rate in 1981. The oil-producing countries' surpluses on current account decreased in 1981, after almost doubling from 1979 to 1980. The industrialized countries recorded an aggregate deficit, although the overall picture masks sharp individual differences.

2. In the Community, the recession that began in 1980 continued into 1981. The rate of inflation remained generally high, and unemployment continued to rise. On the other hand, the slowdown in imports combined with an improved export performance led to a reduction in the current deficit in spite of a deterioration in the terms of trade over much of 1981. These aggregates, of course, mask differences between the countries, particularly between inflation rates.

The European Monetary System (EMS) continued to function satisfactorily, despite conditions that were generally unfavourable to the convergence of economies, and in the face of the destabilizing effects of wide variations in the exchange rates and interest rates of third currencies. Fluctuations in exchange rates between participant currencies were much smaller than during the 10 years prior to the inception of the system. There were however two EMS parity adjustments in 1981: the first, on 22 March, involved only one currency; the second, on 4 October, was the first general realignment since that of 23 September 1979. These two adjustments, though different in character, confirmed that the EMS can cope in an orderly fashion with realignments based on fundamental economic criteria.

II. COMMUNITY ACTION AND THE ACTIVITIES OF THE COMMITTEE

3. Against this general economic and monetary background, marked by strong pressures and turbulence, the Committee felt it was more than ever necessary to strive for cohesion and monetary stability in the Community: it concentrated on the operation of the European Monetary System and its possible development, on improving convergence of the economies of the participating countries, and on international monetary relations.

4. The Committee kept a close watch on economic and monetary trends and on the resulting policies, both at Community level and in the individual Member States. On several occasions, in the course of 1981, it examined in detail particular aspects of the Community's economic situation. An in-depth discussion on balance of payments and exchange rates in the European Monetary System allowed, for example, an examination of the fundamental trends affecting the exchange rates of participant currencies. Furthermore, at its October meeting, the Committee studied the stance of monetary policy in Member States in connection with the setting of monetary objectives for 1982, about to be decided by the monetary authorities of most Member States.

5. At a time of persistent disequilibria, aggravated by unstable exchange rate relations with non-member countries and volatile interest rates outside the Community, it was increasingly necessary to ensure the smooth functioning of the EMS, and to monitor its evolution. Both the realignment decisions taken in 1981 — and in particular the general realignment of 4 October — were preceded by discussions in the Committee; the decisions taken by the Ministers were based on the Committee's conclusions. Furthermore, important work was carried out by the Alternates on the technical aspects of the system's future development. This work culminated in a comrehensive inventory of the problems raised by the system's development and in proposals for adequate solutions. The findings were examined and discussed by the Committee, which identified a number of possible developments. The European Council meeting in London on 26 and 27 November 1981 asked that this preparatory work lead to concrete proposals for reinforcing the system.

6. The Committee, aware that the reinforcement of the European Monetary System depends on considerably greater convergence of the economies of the participant countries, stepped up its work in this field.

First, it examined the effects of certain rigid systems of indexation on economic trends in the Member States, and studied the possible monetary consequences, taking into account the proposals put forward by the Commission in its communication to the Council of 23 July 1981. In particular, the Committee felt that indexation presented serious drawbacks in the face of present adjustment requirements. No indexation system should be operated in such a way that it offsets for certain categories of income the consequences of economic policy changes or of variations in the terms of trade. The Committee's position on this question is stated in the Opinion of 16 November 1981 to the Council and the Commission (see Annex I).

Secondly, the Committee made thorough studies of the economic and monetary situation in two countries with special difficulties, Italy and Belgium. It examined the conditions which had led the Italian authorities to take emergency measures on foreign currency purchases, and put forward proposals for their gradual abolition. The Committee

emphasized that the policy to be pursued must attack the fundamental problems of the Italian economy; its position and recommendations were the subject of two oral statements by the Chairman to the Council. As regards Belgium, the Committee noted the Commission's recommendation to the Government under Article 11 of the 1974 Decision on convergence. It fully approved the Commission's initiative, in particular as the smooth functioning of the European Monetary System requires stronger Community discipline; it discussed the economic and monetary situation in Belgium on several occasions, together with the corrective measures envisaged, and repeatedly confirmed its intention of closely monitoring the implementation of principles expressed in the Commission's recommendation.

Thirdly, the Committee continued its regular examinations of the economies of the Member States, independently from its discussions on exceptional situations or significant changes in economic policy.

7. The trends of dollar interest rates and exchange rates had a decisive impact throughout the world, including the Community. The Committee analysed the consequences of these trends on several occasions, in the light both of the objectives of the US authorities and of the possibilities open to the European authorities to guard against the effects of US policy. In an opinion to the Council and the Commission (see Annex II), the Committee, while firmly supporting the general anti-inflationary thrust of US policy, expressed reservations on the effects of high and volatile US interest rates, provoking strong fluctuations in the dollar exchange rate. In particular, the Committee stressed the overriding importance, in an increasingly interdependent world, of close international coordination and cooperation: no country should frame its domestic policies without due regard to their international consequences, and large economies and leading reserve currency centres have a special responsibility in this respect.

8. The Committee continued its work pursuant to the Council Decision of 8 May 1964, which provides that consultations shall take place within the Monetary Committee in respect of any important decision in the field of international monetary relations. The Committee discussed the main points on the agenda of the Bretton Woods institutions; as it does every year, it prepared the statement of the Council Presidency on behalf of the Community to the IMF Interim Committee and the Annual Meeting of the IMF and the World Bank.

With a view to the deliberations concerning North-South relations, the Committee considered the monetary and financial aspects of the Commission's communication to the Council of 7 May 1981 on Community policy for the North-South dialogue and, reaffirming the approach laid out in its 1980 opinions and reports on recycling and on global negotiations, stated its position on the various aspects of international financial cooperation and the responsibility of the Bretton Woods institutions (see Annex III). The Committee believes that international financial cooperation should be developed with a view, in particular, to associating the oil-exporting countries and industrialized countries in the financing and exploitation of the energy resources of the non-oil developing countries. It furthermore considers that the World Bank's activities in the energy field should be extended.

III. WORKING PARTIES OF THE MONETARY COMMITTEE

9. The Working Party on the Harmonization of Monetary Policy Instruments, a joint group of the Monetary Committee and the Committee of Governors of the Central Banks, submitted in October its report on the technical problems stemming from the coexistence of monetary and exchange rate objectives within the EMS. This report compares potential conflicts and empirical evidence of conflicts between the two, given the requirement for convergence towards stability, and analyses the techniques used to mitigate temporary conflicts. According to the report, it is unlikely that the potential for conflict will disappear; only active coordination between monetary authorities in the EMS countries can prevent the actual emergence of conflict situations.

10. The Working Party on Capital Markets completed its work on the development of savings in equities in the Community countries, and continued to monitor trends in the capital markets of the Member States and in the international capital market, and reviewed policies on these markets.

LIST OF MEMBERS AND ALTERNATES OF THE MONETARY COMMITTEE

Chairman

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

Vice-Chairmen

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

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)
D. Chalikias (since 16 November 1981)	Vice-governor, Bank of Greece (Athens)
G. Drakos (until 15 November 1981)	Vice-governor, Bank of Greece (Athens)
Dr. L. Gleske	Mitglied des Direktoriums der Deutschen Bundesbank (Frankfurt-am-Main)
Prof. L. Izzo (since 9 June 1981)	Consigliere, Ministero del Tesoro (Rome)
P. Jaans	Commissaire au contrôle des banques (Luxembourg)
G. Janson	Directeur de la Banque nationale de Belgique (Brussels)
R. Kirsch	Conseiller de gouvernement, Ministère des finances (Luxembourg)
C. Mavraganis	Deputy director general, Ministry of Coordination (Athens)
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)
A. Prate	Premier sous-gouverneur de la Banque de France (Paris)
Dott. F. Ruggiero (until 8 June 1981)	Direttore generale, Ministero del Tesoro (Rome)

Dr H. Schulmann	Staatssekretär, Bundesministerium der Finanzen (Bonn)
Drs A. Szasz	Executive Director, De Nederlandsche Bank NV (Amsterdam)
N. Ussing	Kommitteret, Det Økonomiske Sekretariat (Copenhagen)
J. van Ypersle 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

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)
A. Chalkiadis	Ministry of Coordination (Athens)
M. Emerson	Directorate-General for Economic and Financial Affairs, Commission of the European Communities (Brussels)
Drs F.A. Engering	Ministerie van Financiën (The Hague)
R. Floc'h (since 15 January 1981)	Banque de France (Paris)
C. Georgoutsakos (until 15 November 1981)	Bank of Greece (Athens)
Mrs M. Hedley-Miller	H. M. Treasury (London)
P. Jurgensen	Ministère de l'économie (Paris)
G. Lefort (until 14 January 1981)	Banque de France (Paris)
Dott. S. Masera (until 7 June 1981)	Banca d'Italia (Rome)
D. McCutcheon (until 8 November 1981)	Department of Finance (Dublin)
M. Papageorgiou (since 16 November 1981)	Bank of Greece (Athens)
D. Quigley (since 9 November 1981)	Department of Finance (Dublin)
J.-J. Rey	Banque nationale de Belgique (Brussels)
G. Reynolds	Central Bank of Ireland (Dublin)
Dr W. Rieke	Deutsche Bundesbank (Frankfurt-am-Main)
Dott. F. Saccomanni (since 8 June 1981)	Banca d'Italia (Rome)
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
R. Barthélemy (since 1 May 1981)	
H. Carré (until 30 April 1981)	
A. Leipold	

ANNEX I

OPINION TO THE COUNCIL AND THE COMMISSION ON INDEXATION MECHANISMS

(16 November 1981)

At its meeting in Maastricht on 23 and 24 March 1981 the European Council took the view that 'high and divergent inflation rates are a threat both to the prospects of growth and to the economic and monetary cohesion of the Community. In this context the European Council also discussed the effects caused by rigid systems of indexation of incomes and expressed the opinion that an adjustment of such mechanisms should be considered'. On 23 July 1981, the Commission issued a Communication to the Council on the principles of indexation in the Community (COM (81) 457 final). Lastly, on 17 September, the Council called upon the Coordinating Group and the Monetary Committee to examine this Communication and to report on it at a future meeting.

In response to these initiatives, and with a view to contributing to greater convergence of economic trends within the EMS, the Monetary Committee has looked at this question; it stresses however that since the implications of indexation are not solely monetary, the Committee's Opinion does not claim to cover all aspects of the problem, regarding which other Community bodies might feel concerned. Furthermore, it notes that the question of indexation, especially as regards its effects on competitiveness, cannot be examined in isolation from the other elements affecting labour costs and other production costs. Structural adaptation and the re-establishment of European competitiveness require a global approach affecting the totality of production costs.

I. General observations

1. Indexation is predominantly used as a means of offsetting the social consequences of economic disequilibria. Yet indexation is by no means the only method to shield certain sectors or groups in the economy from the detrimental effects of these disequilibria and from inflation in particular. When such protection is effective, the result is clearly that the economic agents enjoying it — and only they — become to some extent insensitive to inflation. The return to a more balanced economic situation, in which the purchasing power of money is stabilized, requires a conscientious effort of rigour and determination, difficult to realise in a rigidly indexed environment.

2. In conformity with the Council's request, the Committee has examined the Commission Communication on the principles of indexation in the Community. It observes great

convergence between the content of this document and most of the views expressed within the Committee. In particular it notes close similarity in the analysis of the effects of indexation, which leads the Commission, as the Committee, to consider that an essential objective should be to adjust existing mechanisms so as to remedy their main disadvantages.

The Committee considers that the adjustment of indexation systems according to the principles outlined below would constitute an important step towards achieving greater convergence of economic performance within the Community and the maintenance of stable exchange rate relationships within the EMS.

II. Indexation of incomes

3. The indexation systems applied in the Member States vary widely. Three Member States (Germany, the United Kingdom and Greece) have no system for indexing incomes, wages and salaries in particular. The situation in the others is very varied, ranging from indexation solely of the minimum wage (France) or the occasional introduction, in wage agreements, of cost-of-living adjustments (Ireland), to general indexation (Italy, the Benelux countries and Denmark).

The indexation of retirement pensions and transfer incomes is fairly general. Lastly, the adjustment of income tax allowances and thresholds, to prevent inflation from distorting the progressive nature of taxation, must also be considered a form of indexation affecting the formation of incomes.

4. The Committee recognises that, during certain periods of relative price stability and moderate adjustments of nominal incomes, indexation mechanisms may have settled pay issues in a helpful way and encouraged the conclusion of agreements lasting more than one year, avoiding overfrequent wage negotiations and thus lessening social conflict. Further, wage determination is a complex process, in which indexation is only one of many elements. The Committee stresses, however, that in a period with large changes in relative prices and the ensuing problems of structural adaptation of output and demand, the rigidity in economic adjustments introduced by automatic or semi-automatic compensation for price increases may constitute a considerable drawback. In practice indexation is often based on a concept of maintenance not only of purchasing power but also on a specific basket of expenditure which is irreconcilable with the need for income adaptation, substitution and structural change.

5. In particular, the Committee emphasizes that if external economic relationships are suddenly altered (deterioration in the terms of trade due to an inflationary shock or to a change in exchange rate relationships), indexation impedes the necessary adjustments and therefore tends to perpetuate the external disequilibrium. The same is true of price increases due to internal forces — either demand or cost induced — which will tend to be perpetuated. Then again, if indirect taxation is increased in order to obtain certain adjustment effects (e.g. on the structure of consumption), the effects may be neutralized by the action of indexation; furthermore, higher taxation will, through indexation, push up wage costs and help to damage competitiveness. The room for manœuvre of the authorities, in terms of monetary and taxation policy, is constrained by the existence of such mechanisms.

6. It is true that the rigidities and distortions caused by — *de jure* or *de facto* — indexation arrangements do not necessarily take the form of more rapid inflation. Through a non-accommodating monetary policy, the authorities may, in certain countries, indeed

succeed in moderating the wage-price spiral and inflationary expectations. However, the costs of taking monetary measures strong enough to offset the inflationary pressures of indexation will emerge elsewhere, e.g. in terms of growth and employment, and such costs are likely to be higher than would be the case under a smooth income adjustment to changes in external conditions or to fiscal policy measures.

7. In view of these considerations, the Committee feels that the recourse to indexation presents drawbacks for the conduct of economic policy faced with the need for adjustment, and makes it more difficult to defend the value of money. It is therefore of the opinion that no additional indexation procedures should be introduced and that the scope of the present systems should not be extended. Where such systems exist, it would be desirable that, by a combined action of the public authorities and the two sides of industry, their scope be reduced so that they no longer undermine the effectiveness of certain economic policy instruments.

To this end, no indexation system should be operated in such a way that it passes on from prices into incomes the consequences of factors that are exogenous to the labour-business relationship, such as economic policy changes or variations in the terms of trade. This could be allowed for in the definition of the index, or in the degree and frequency of compensation, including, possibly, *ad hoc* agreements to forego indexation portions in circumstances clearly characterized by imperative needs for economic adjustment.

The effort to reduce the scope of indexation should extend to all its forms, including property income and professional fees.

III. Financial indexation

8. The Commission Communication to the Council does not deal explicitly with financial indexation. However, the Commission has already had occasion to express its position on the question of the protection of savings in times of inflation, [1] and the Committee itself has several times examined this specific question. Such examination highlighted in particular the two major problems confronting an economy using indexation of financial assets: first, the risk of an extension in the application of indexation measures and of an accentuated distortion in monetary functions, and second, the risk of disrupting financial circuits, entailed in the introduction of measures discriminating in favour of certain transactions.

9. For these reasons amongst others, the Committee requested that the inclusion of indexation clauses in a foreign loan by a Member State be subject to prior consultation within the Committee and that, as far as possible, there should be a similar consultation on internal loans. The Committee has furthermore on several occasions [2] warned against the opening of discussions on techniques which would endeavour to safeguard automatically the real value of monetary or financial assets, whether they are held by developing or by other countries. In the context of the adjustment of the Community loan mechanism, it also indicated that for borrowings under this heading variable rate loans should not be given preference over fixed rate borrowing and should in particular be avoided when borrowing directly from surplus countries. [3]

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[1] Commission Communication to the European Parliament — 'The protection of savings in times of inflation and the question of indexation' (COM (77) 549 final — November 1977).
[2] See in particular the Opinion on the financial aspects of North-South relations (Annex III).
[3] Report to the Council and the Commission on recycling (See Annex II of the 22nd Report on the activities of the Monetary Committee).

10. The Committee has not this time reconsidered the question of the indexation of financial assets in detail. It is however of the opinion that generalizd financial indexation should be opposed as it would be regarded as a capitulation to inflation and a demonstration of the inability to eliminate the mechanisms that perpetuate inflationary pressures in our economies, thus entrenching inflationary expectations. Financial assets and the returns they provide must be encouraged to adapt to overall economic conditions (not only to rates of inflation). This presupposes increased competition between financial intermediaries, less segregation of financial channels and greater contractual freedom between debtors and creditors.

The Committee acknowledges that a high rate of inflation is likely to have undesirable effects on the distribution of income and wealth between debtors and creditors. In such a situation, marked by great uncertainties about future interest rates and about the time-scale for the easing of inflation, certain limited forms of inflation-proofing may temporarily help to meet the needs of lenders and borrowers alike, bringing them together on terms which both fird acceptable; such forms give financial markets the necessary flexibility to adapt to rapidly changing circumstances and thus protect the existence of a long-term market. However also cetain other techniques for long term lending (such as variable rates) may in some cases reduce the effectiveness of interest rate management for monetary authorities, aligning financial market conditions automatically on those of the money markets, which are influenced by a different order of considerations.

ANNEX II

OPINION ON DOLLAR INTEREST RATE AND EXCHANGE RATE DEVELOPMENTS

(25 June 1981)

1. As requested by the Council on 15 June 1981, in full awareness that the difficulties experienced by Community countries are of both internal and external origin, the Monetary Committee has examined the consequences of dollar interest rate and exchange rate developments for the Community economy. The present Opinion, adopted at its session of 25 June, sets out the main results of its discussion.

2. In the 20 months since the change in techniques of monetary control announced by the Federal Reserve Board on 6 October 1979, US interest rates throughout the maturity spectrum have fluctuated over a very wide range, both in nominal and in real terms, thus attracting unprecedented attention to their variations and their level. European interest rates were broadly compelled to follow the upward movement of US rates, but did so on a generally steadier course. Both short and long term nominal interest rates within the Community are now either at or close to record levels, and in the lower inflation countries real interest rates are also extremely high.

3. Many factors affect exchange rates but, among these, high and variable US interest rates in 1980-81 have powerfully contributed to a marked fluctuation in the dollar exchange rate around a strongly rising trend against EMS participating currencies, which have however remained remarkably stable *vis-à-vis* each other. In the twelve months to mid-June 1981, the dollar has appreciated by between 35% and 42% against EMS currencies.

4. It is in the interest of the world economy that US inflation should come down as rapidly as possible: the Community should thus firmly support the general anti-inflationary thrust of US policy. At the same time it is important that the United States take into account the international consequences of the choices in the framing and executing of monetary, budgetary and public debt management policies, all the more so at the present time when the prospects for improved growth and employment are so tenuous.

5. The Committee considered the main problems raised by the above developments, taking in turn the variability of interest rates, the level of interest rates and exchange rate developments. It draws attention on the following aspects of these three problems:

(a) variability of interest rates

- changes in interest rates affect relative costs, resource allocation and economic behaviour;
- large and erratic variations in interest rates, and particularly large switch-back movements over a considerable period, entail — on the one hand — a climate of uncertainty and wait and see attitudes which upset investment decisions and — on the other — destabilize markets, especially at the long end;
- high interest rate volatility entails an increased recourse to variable rate financing and to short-term market instruments to finance longer term investments: although firms and banks can then benefit more rapidly from a fall in inflation, they become more vulnerable to adverse financial developments;
- techniques of monetary control play an especially important role in determining interest rate volatility; in the Committee's view these techniques should pay attention to the trend movement in the target aggregate rather than to short-term deviations;
- consequently, measures such as a staggering and a 'de-dramatization' of the publication of money supply figures, with an emphasis on the medium-term trend, have been suggested as means to reducing interest rate volatility. The recourse to more diversified instruments for controlling the growth of the monetary aggregates would go in the same direction.

(b) level of interest rates

- high interest rates are a consequence of high rates of inflation and, at the same time, an essential part of a determined fight against inflation through a strict monetary policy;
- in general the level of interest rates can be reduced, whilst not relaxing anti-inflationary policy, by substantially reducing the government deficit. This is not only valid for the US, taking into account the savings rate, but also for Community member countries, where the policy mix is far from adequate and where relatively restrictive monetary policies exist alongside large and persistent public sector deficits;
- as fiscal treatment of interest rate payments by households in the US allows relatively considerable deductions, interest rates have to be really very high to have an effect on personal borrowers;
- while in most Community countries there are domestically-generated reasons for relatively high interest rates, peaks in US rates may have led, in a number of member countries, to higher interest rates than generally warranted by purely domestic considerations;
- excessively high real interest rates, if long continued, penalize productive investment at a time when structural adjustment requires, for both internal and external reasons, and in particular to reabsorb unemployment, an increase in the share of investments in aggregate demand;
- high interest rates weigh heavily on the service of the public debt of many industrialized countries;
- high real interest rates add to the debt servicing burden of non-oil developing countries which have had recourse to variable interest rate loans. This debt service is absorbing a rising share of their export revenues, at a time when slow world growth restricts their export markets.

(c) exchange rates

- the fluctuations of US short-term interest rates have been an important, although not exclusive, cause of the marked variability of exchange rates and may have strengthened 'overshooting';
- a strong divergence of exchange rate trends from relative price and cost developments could store up further currency unrest in the future, because inflation differentials might eventually predominate among the factors, including the current account positions, which affect exchange rates;
- because of the depreciation of its currencies, Europe is now experiencing a new, strong wave of import price increases, analogous to that caused by an oil shock;
- developments since the transition to generalized floating in 1973 indicate that there is a need for some degree of foreign exchange intervention to deal with disorderly market conditions and erratic movements, in line with IMF guidelines and articles. The US policy on exchange rate intervention as recently outlined to Congress seems to go too far in limiting its use in disorderly market conditions. In a world in which reserve holders tend to currency diversification, it is, in particular, essential that the reactions of the authorities of the various reserve centres be mutually consistent and complementary.

6. On this occasion, the Committee wishes to stress that, although high and volatile US interest rates and strongly fluctuating exchange rates undoubtedly contribute to the difficulties experienced by Community member countries, these difficulties are to a large degree domestically-generated and that, as a general principle, responsibility for combating inflation by all appropriate means begins at home.

In conclusion, the Committee stresses the over-riding importance, in an increasingly interdependent world, of close international coordination and cooperation: no country should frame its domestic policies without due regard to their international consequences, and large economies and leading reserve currency centres have a special reponsibility in this respect.

ANNEX III

OPINION ON THE FINANCIAL ASPECTS OF NORTH-SOUTH RELATIONS

(15 June 1981)

1. Having received the Commission communication to the Council on Community policy for the North-South dialogue (COM (81) 68 of 7 May 1981), the Monetary Committee discussed the financial aspects of this communication at its meeting on 10 June 1981. Since these problems come within its sphere of responsibility, the Committee has taken the initiative of drafting the present Opinion.

General principles

2. The Committee first of all notes a certain tendency to a dispersion of the discussions and the definition of positions on the monetary and financial aspects of international relations; in this regard, the Committee considers it expedient to point out that:

(i) at Community level, the Council decision of 8 May 1964 states that the most appropriate method of ensuring a close coordination of the policies of the Member States in this field is for the necessary consultations to be held within the Monetary Committee;

(ii) at world level, the Bretton Woods institutions are responsible for dealing with these problems. They have access to the means of raising the necessary funds and the procedures to encourage borrowers to adopt the appropriate adjustment policies. Furthermore, the main parties involved are suitably represented in these institutions. The Community countries have a duty and an interest, in view of their weight in these institutions, to maintain their role, to reinforce their action and to encourage coordination between them.

3. The Committee considers that the entirety and specificity of the responsibilities of the Bretton Woods institutions must be maintained, which does not exclude that the activities of these institutions might be developed by the means which the Committee has already indicated in earlier Opinions, and in accordance with the conclusions of the last meetings of the IMF Interim Committee and the Development Committee. This general principle must underlie the approach to international monetary problems and the search for solutions: it is thus in the framework of the Bretton Woods institutions that the financial aspects of North-South relations ought to be examined.

Financial aspects of North-South relations

4. The Committee examined the 'financial aspects' section of the Commission communication, without however going into the details of the various proposals put forth therein, and intends returning to them as and when required.

5. Firstly, the Committee would re-affirm the view which it has already expressed in its Opinions and Reports of 4 June, 10 October (on recycling) and 14 November 1980 (on global negotiations). It is of the opinion that the bulk of the recycling activity will have to continue to be carried out through the international financial markets and the commercial banks; that this important role played by the international banking system will have to be supplemented by an expanded activity of the international organizations, primarily the International Monetary Fund, the World Bank and the regional development banks; and finally that the oil-exporting countries have a special responsibility in the financing of international payments imbalances.

6. Given the important role played by the international banking system in recycling, firm support must be given to efforts directed at safeguarding the soundness and stability of this system. In addition to this support, the Committee feels that the most stable forms of private resource transfers, particularly direct investments, ought to be encouraged and developed.

7. The role played by the markets will however have to be supplemented and supported by action on the part of the international institutions. As regards the development institutions, they have a vital role to play, both as regards the transfer of resources and the formulation of development principles. The Committee believes that these institutions are capable of adapting to the requirements of a new situation, as they have proved in the past; they should however be provided with the means to this end and the instruments at their disposal should be used to the best effect. An improved cooperation and a close coordination between the international financing institutions must be sought and organized, and co-financing or consortium operations enouraged. The Committee considers that, in the search for financing formulae, account should be taken of the varied situations of the developing countries, and feels that an increase in public development aid to the poorest countries is necessary to help them overcome the serious difficulties they face. The multilateral channels, which have so far shown their worth, must be given the financial resources appropriate to their functions, along with a continuing flow of bilateral aid.

The Committee believes that international financial cooperation might be developed with a view to, in particular, associating the oil-exporting countries and industrialized countries in the financing and exploitation of the energy resources of the non-oil developing countries. The Committee considers that firm support should be given to the proposal for extending the activities of the World Bank in the energy field and for studying appropriate measures to this end, including the possible setting up of a specialized affiliate. More generally, the Committee calls for the development and reinforcement of international financial cooperation in order to improve the stability of the financial system, but reiterates its warnings about proposals which would lead to the opening of discussions on ways of protecting the real value of the oil surpluses.

8. With regard to the International Monetary Fund, it must be stressed that quotas must remain its main source of finance, while recognizing the need — in current circumstances — for the Fund to borrow.

The OPEC surplus countries should furthermore play their full part in financing international payments imbalances. Saudi Arabia has demonstrated its willingness to commit itself in this direction, by concluding lending arrangements to the IMF. The Committee notes that these loans have been made on the basis of market conditions and parallel to loans made by various industrialized countries. It feels that other surplus countries should also contribute to increasing the resources available to the IMF.

9. In conclusion, the Committee emphasizes that an atmosphere of permanent negotiation over international monetary relations might well create uncertainty which would be prejudicial to the stability of currencies and to the monetary system as a whole. The Committee will continue to examine the various aspects of international finance and will state its views thereon as and when required.

ANNEX IV

TECHNICAL PROBLEMS STEMMING FROM THE CO-EXISTENCE OF MONETARY AND EXCHANGE RATE OBJECTIVES WITHIN THE EMS

Report by the Working Party on the Harmonization of monetary policy instruments

(22 October 1981)

Introduction

In February 1981 the Committee of EEC Central Bank Governors and the Monetary Committee expressed the wish that the Working Party on harmonization of monetary policy instruments should produce a report on the second of the three indents of a new mandate [1].

This report, under the title of 'Technical problems stemming from the co-existence of monetary and exchange rate objectives within the EMS' is divided into five chapters:

— Monetary and exchange rate objectives in EEC countries;
— Potential conflicts between monetary and exchange rate objectives due to EMS membership;
— Empirical evidence of conflicts between exchange rate and monetary objectives in the EMS;
— Mitigation of temporary conflicts between domestic monetary policy objectives and EMS exchange rate commitments;
— Conclusions.

I. Monetary and exchange rate objectives in EEC countries

A. Monetary objectives

In all EEC countries the principal objective of monetary policy is to set the appropriate monetary framework for the attainment of final economic objectives.[2] To achieve these ultimate aims, monetary policy is defined in terms of specific intermediate objectives for the financial variables (money or credit aggregates, interest rates, etc.) which may be affected

[1] The full mandate is annexed to this report.
[2] Final economic objectives in general concern inflation, growth, unemployment and the balance of payments (in particular the current account).

by the instruments available to the authorities. As shown below, there are, however, substantial differences between EEC countries with regard to the kind of intermediate objectives chosen by the authorities and the degree of commitment to their achievement. These differences are due to a variety of reasons and reflect differences in the instrumental role of monetary policy in achieving final economic objectives.

Three large EEC countries (Germany, France, United Kingdom) all gear their monetary policies predominantly to domestic objectives and especially to controlling inflation through publicly-announced money supply targets. The publication of targets is seen as a way of providing the expectational framework for a reduction in inflation and influencing exchange rate expectations. In addition, by representing a forward commitment of the authorities, it constitutes an element of self-discipline in the conduct of policy, requiring the authorities to take action to ensure the target is respected. The United Kingdom (where targets are furthermore formulated in the framework of a medium-term approach for a gradual deceleration in money supply growth) has published target ranges for money supply growth over a number of years in the belief that clearly stated medium-term objectives will create a more favourable expectational framework. In France and Germany the authorities consider committing themselves in advance to a fixed path over several years as unrealistic in view of the uncertainties with regard to the emergence of exogenous disturbances and possible changes in behaviour in the real and monetary sectors.

External considerations are particularly valid for smaller EEC countries with open economies, as, for example, Belgium, Denmark, Ireland and the Netherlands. In these countries publicly announced exchange rate commitments within the EMS largely play the role of published monetary targets. In some of them the exchange rate commitment is supported by the setting of an internal monetary objective. However, given the importance of the exchange rate for final economic objectives, especially price stability, intermediate monetary objectives may be less binding or even only an indicator for the authorities, and the setting of a medium-term objective is generally ruled out by the emphasis of monetary policy on external considerations. Furthermore, in certain cases the choice between an overall money supply approach and one based on monetary creation from domestic sources is dictated by the particular external position of the non-monetary sector (overall deficit or surplus).

In Italy almost continuous concern with an external deficit has favoured the choice of total domestic credit as the most appropriate target variable. However, when the external account is in surplus, the authorities place greater emphasis on the behaviour of monetary aggregates to keep monetary conditions in line with the aim of a progressive reduction of inflation. The high degree of substitutability between money and other financial assets has favoured the choice of broader aggregates such as M3 or total financial assets.

In all countries, whether they operate on a money supply or credit objective, a certain degree of operational flexibility is generally maintained; the authorities accept departures from the target path to take account of short-run fluctuations in money demand and/or to counter exchange rate developments which are seen to jeopardize domestic final objectives. In cases of institutional or other permanent changes in demand for money, even the targets may be adjusted.

B. Exchange rate objectives

The explicit exchange rate objective of all countries participating in the EMS exchange rate mechanism is to maintain their currencies in the EMS. At least in the short run this implies adherence to a fixed exchange rate system with limited margins of fluctuation. In the

longer run it is accepted that as the need arises — and in particular as indicated by the relative development of economic fundamentals in participating countries — realignments will take place.

The economic motives of adherence to the EMS vary from country to country but all countries recognize the value of a stable exchange rate system, with clearly defined bilateral exchange rates, backed up with substantial credit facilities. In several countries EMS participation means achieving short-run stabilization of their currencies against most of their principal trading partners, allowing them to trade in a stable exchange rate area. In a number of countries adherence to the system is seen as facilitating the control of inflation by placing constraints on domestic sources of inflation and in some countries as choosing a 'strong currency option'. An additional economic advantage, relevant in particular for the larger member countries, is that, providing that there is convergence of economic policies and final economic results, the EMS exchange rate mechanism allows the 'communitarization' of external shocks by moderating what might have been extreme fluctuations in their bilateral exchange rates *vis-à-vis* the US dollar whenever there are major movements between reserve currencies.

Greece and the United Kingdom have so far chosen not to participate in the exchange rate mechanism, though not for the same reasons. For Greece, this has been due to the particularly high level of inflation when compared with that in other EMS countries, which would have made participation extremely difficult. The United Kingdom authorities have argued that it has been differently placed from most other member countries in two important respects: first, sterling has been affected by the United Kingdom's new status as a major oil producer; secondly, the UK economy is undergoing a period of adjustment, with fundamental changes in economic policy aimed at substantially reducing the rate of inflation by controlling the rate of monetary growth. Both of these developments are likely to have substantial temporary and permanent effects on the exchange rate, which are, however, difficult to quantify.

Most member countries' primary and explicit exchange rate aim is thus the observance of EMS margins. In addition to this general commitment, however, several countries note the particular operational benefits of a more clearly defined position in the EMS band. Most countries are of the opinion that it is preferable or easier to maintain a more precise position in the EMS band than accept the full margin of fluctuation. In Denmark and Italy experience indicates that the amounts of intervention needed to stabilize their currencies in the EMS are normally lower when these currencies are in the upper part or around the middle of the band, whereas pressure tends to become self-reinforcing if the lower limit is approached. Thus a short-term policy of maintaining their currencies in 'defensible' positions within the EMS is followed. In the Netherlands the prime benefit of participation in the EMS exchange rate mechanism has been to maintain a stable DM-guilder exchange rate whenever the Deutsche Mark is strong in the EMS band, accepting the consequent disciplining effects and making it easier to avoid changing the DM-guilder central rate in the event of an EMS realignment. In contrast, the German opinion is that it would be neither practical nor meaningful for Germany to aim to maintain the Deutsche Mark in a given area of the EMS band.

Finally, no participating country is indifferent to movements of third currencies, in particular of the US dollar, as these movements affect their effective exchange rates, albeit unevenly, and thus may have an unfavourable effect on domestic inflation and the balance of payments. It should be noted, however, that while smaller countries can hardly affect their dollar rates given bilateral EMS margins, policy decisions in the monetary field in

larger countries (especially Germany, given the DM's role as an alternative reserve currency) carry more weight in influencing their dollar exchange rate or the position of the EMS band as a whole against third currencies.

II. Potential conflicts between monetary and exchange rate objectives due to EMS membership

A. Definition of conflict within the EMS exchange rate mechanism

Within the EMS, conflict between the exchange rate and monetary policy objectives of a single country will arise when exchange rate commitments dictate a shift in policy [1] which, if maintained, will undermine the chances of achieving the nation's intermediate monetary objectives and the final economic objectives. Furthermore, insofar as participation in the EMS exchange rate system results in an undesired movement against third currencies, the resultant effective exchange rate movement may lead to deviations from the final economic objectives, indirectly reflecting conflict between EMS membership and monetary policy objectives.

B. Examples of potential conflict

A number of instances of potential conflict between EMS countries' exchange rate and monetary policy objectives could arise. In some cases such conflicts can be assumed to be of a temporary nature such as for instance when one country finds its cyclical position temporarily out of phase with that of its EMS partners; when market exchange rate expectations move excessively in favour of or against a currency; or during the gestation period of a domestic stabilization programme, when the benefits have still to be seen and performance of key economic variables remains disappointing. In all these cases where the conflicts are not related to differences in fundamental economic performance, a solution through realignment is clearly unwarranted and the burden of countering tensions in the EMS will fall primarily on monetary policy, although this may imply that certain domestic objectives of monetary policy will have to be temporarily sacrificed.

In other cases where the conflict is of a *more durable nature* because of fundamental differences in economic performance, two scenarios can be envisaged. First, a country with a consistently better record on fundamentals than its partners may well find itself at the top of a fully stretched EMS band. Intervention in the foreign exchange markets and a resulting easing of monetary conditions, whilst called for in order to comply with EMS commitments, may endanger not only the intermediate monetary objective but also the final economic objectives. If the authorities choose instead to fend off inflows by easing monetary policy, this might also conflict with domestic objectives. This scenario has most frequently been illustrated by Germany.

The second scenario applies to a country with weak economic growth and high unemployment whose currency is at the bottom of the EMS band. The appropriate monetary measures or foreign exchange market intervention would depress economic activity further,

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[1] Such a policy shift may occur either when the effective stance of monetary policy has to be altered in order to maintain the currency within the given EMS margins, or in response to the presumption to act when the divergence threshold has been crossed, or to hold the currency at a preferred position in the EMS band. The shift in effective stance can result from:
— intervention in the foreign exchange markets, with expansionary or contractionary effects on domestic monetay conditions;
— and/or the implementation of appropriate monetary measures to eliminate the need for inteventions or at least contain their size.

reducing the prospect of achieving the final economic objectives, although any risk of overshooting the intermediate monetary objective would be reduced. Since the EMS was established this type of conflict has been characterized at certain times by Belgium.

In these scenarios where the conflict is of a more fundamental nature and the symptoms those respectively of an undervalued or an overvalued currency the appropriate solution should in principle include a realignment of central rates. In general this has been accepted, as illustrated by the history of both the snake arrangement and the EMS.

In many cases however, the situation may well be less clear-cut. For instance a revaluation may not be appropriate if the authorities are in doubt about the durability of external demand. Similarly a devaluation may be inappropriate if a nominal devaluation cannot be made effective, for instance because of widespread wage indexation. There may also be other reasons (either political or associated with developments in third currencies) why a realignment is delayed although justified on strictly economic grounds; and last, but not least, a realignment of course means that a difference in economic performance becomes embodied in the exchange rate structure and that the hope of 'rolling back' the discrepancy through the disciplinary effect of a fixed exchange rate system is given up.

For all these reasons the burden of countering tensions in the EMS may fall on monetary policy for shorter or longer periods also in those cases where the conflict has the symptoms of being of a more durable nature. Given that a more balanced policy response would be desirable in such circumstances, this would have to include economic and fiscal measures in addition to monetary policy action in cases of conflict arising from fundamental incompatibilities in the economy.

The movement of the EMS band against third currencies may in some cases offset and in others reinforce conflict. For example, if a fully-stretched EMS band were appreciating against third currencies as conflict emerged under the first scenario, then in the short run an increase in the effective exchange rate which could not be achieved through realignment might be brought about by an appreciation against third currencies, reducing the risk of higher inflation resulting fom the monetary action necessary to respect the EMS limits. On the other hand, under the second scenario, where weak domestic economic activity was the main preoccupation and not inflation control as in most other EMS countries, the situation would not be helped by the appreciation of the band against third currencies and might even be made worse, at least in the short run. Not only will the currency's appreciation against third currencies tend to depress export demand and strengthen import penetration, further weakening economic activity, but its effective exchange rate will become increasingly unrealistic, requiring a further tightening of monetary policy to check further exchange rate weakness in the EMS bnd. An additional consideration, disregarded in this analysis but important to note, is that EMS currencies are normally affected to a different extent by movements in third currencies. If third currencies weaken against the EMS band and the currency already at the top, being a 'substitute reserve currency' tends to come under stronger upward pressure than its EMS partners, tension in the EMS will be intensified.

In contrast, the effect of a downward movement of the EMS band against third currencies would be the opposite, intensifying the inflationary risk for the currency at the top of the EMS and easing the effect on economic activity of the weakest EMS currency, although in this case imported inflation would be greater.

For a number of general reasons *potential conflicts may not be felt or observed.* One main reason is that a response lag exists between monetary policy actions and final economic variables, while an immediate effect can often be seen in the nominal exchange rate

following monetary policy action. This lack of coincidence implies that exchange rate considerations may be given priority for some time without impinging materially on the attainment of final economic objectives provided the breathing-space offered by the response lag allows the monetary authorities to return to their earlier stance without renewed exchange rate pressures.

Another reason why anticipated conflict may not be felt in practice is that authorities may, pragmatically, be prepared to accept a certain amount of slippage from some or all of their initial intermediate monetary and/or final economic objectives as they see that the assumptions and expectations on which they were based are no longer valid or that changing economic conditions require a different policy mix.

III. Empirical evidence of conflict between exchange rate and monetary objectives in the EMS

A. Summary of events within the EMS

Although the EMS exchange rate mechanism has occasionally experienced some tensions since its start in March 1979 (see the attached chart No 2) and interventions have been sizable, [1] there have been very few major conflicts between monetary policy objectives and EMS exchange rate commitments. Monetary targets were met with relative accuracy in the past two years (see the attached Table II), and the EMS exchange rate mechanism has been maintained with stabilization of exchange rates. Although this required four realignments, only two were general. Those monetary policy measures that were necessary could be reversed after a while or proved to be necessary also for domestic reasons. In the EMS, which covers a more varied group of countries than in the 'snake', economic performance was however more divergent.

Speculative capital movements based on expectations of a realignment of EMS central rates occurred only during limited periods. *In the summer of 1979 the Deutsche Mark* came under upward pressure as a result of the continuing uncertainty surrounding the exchange rate of the US dollar and rumours of a parity realignment in connection with the review of some provisions of the EMS six months after its start. These flows may have been accentuated by interest rate rises in Germany intended to avoid any excessive expansion of monetary aggregates which would have accommodated the inflationary impact of the energy price increase. Whereas Germany succeeded in reducing the monetary impact of these flows through sterilization measures, other countries, especially Belgium and Denmark, had to tighten their monetary policies in order to defend their currencies. After the realignment in September 1979 the tensions eased and the higher level of interest rates in Germany's partner countries was considered necessary also for domestic reasons or was considered unavoidable in view of the rise in US interest rates.

The weakness of the DM within the EMS exchange rate mechanism during *the autumn of 1980 and the beginning of 1981* reflected several domestic and external developments. Domestically, the Bundesbank did not allow monetary conditions to tighten in response to interventions on foreign exchange markets since it regarded the interest-rate related

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[1] Interventions in EEC currencies from the beginning of the EMS until August 1981 amounted to the equivalent of more than USD 30 thousand million whereas interventions in USD (which also in part assist cohesion of EMS currencies) totalld over USD 20 thousand million (purchases) and almost USD 60 thousand million (sales).

strengthening of the US dollar as a temporary phenomenon. Moreover, by early autumn the domestic inflation rate had been brought down to a more acceptable level while the real economy was somewhat weaker than expected.

The Bundesbank only changed its policy of offsetting all outflows of funds at unchanged interest rates when, in February, the Deutsche Mark suffered a new bout of weakness and it became clear that a number of factors, including the persistant weakness of the German current account — also reflecting a loss of international market share and increasing import penetration of the domestic market — the lack of progress in energy policy and the Federal Republic's exposed political situation, had led to changes in market assessment of the DM/US dollar exchange rate. In addition, the rise in import prices since mid-1980 had begun to raise inflationary expectations at home, while recognition of re-accelerating German inflation as well as the deterioration in the current account due to J-curve effects contributed to the unfavourable shift in exchange market expectations against the Deutsche Mark. The particular weakness of the Deutsche Mark, not only against the US dollar but also against most other EMS currencies, meant that the period was marked by a fully stretched EMS band, with the French franc generally at the top and by periodic intervention.

Speculative downward pressures on the French franc in May 1981 caused some conflicts not only in France, which had to take drastic measures to stop speculation, but also in some other EMS countries. The sale of Deutsche Mark in support of the French franc did not directly threaten the stance of German monetary policy. Nevertheless, at a time of particularly high and rising US interest rates, it contributed to a further weakening of the DM/US dollar exchange rate and the EMS band underwent a further depreciation *vis-à-vis* the US dollar, which was already at a higher level than thought desirable by some EMS countries. The conflict was, however, only temporary because the French policy measures had a rapid effect on the exchange markets.

Tension because of pronounced expectations of EMS central rate realignments was thus confined to fairly limited periods although divergence in economic performance persisted. In other periods, however, it could be held that the very stability of exchange rate expectations led to undesirable capital movements, necessitating exchange market intervention, the reason being that nominal interest rate differentials were not offset by expectations of central rate realignments. In other words market participants thought they could take advantage of prevailing high interest rates in high inflation countries without — at least in the short run — running a risk of losing on the exchange rate.

In the event there were only a few occasions — *affecting Denmark and Italy in 1979 and France and Ireland in 1980* — when domestically determined interest rate levels caused disturbing capital inflows, and then solutions were generally rapidly found. In Denmark a temporary ban on the sale of government bonds to non-residents was introduced and after a while foreign demand for mortgage bonds also dwindled. France and Ireland had recourse to measures sterilizing the expansionary effect on money market conditions of foreign exchange inflows and discouraging further capital imports. In Italy, on the other hand, the authorities accepted the easing of domestic monetary conditions in order not to strengthen the upward pressure on the lira, but the main motivation may have been the desire to favour the pick up of economic activity after a protracted period of low output and high unemployment.

Similarly, the fact that intra-EMS capital flows have in some periods been guided mainly by nominal interest rate differentials has only rarely caused conflicts in those countries where low inflation rates might be expected to warrant relatively low interest rates. Throughout the life of the EMS, Belgium has had to maintain interest rates at high levels relative to

other EEC countries after allowance for inflation differentials, but most of this dilemma could be attributed to more fundamental problems of the Belgian economy.

B. Analysis of factors causing, limiting or preventing conflicts

As described above, there was only limited conflict between adherence to the EMS and monetary policy aims from March 1979 onwards. The principal unsettling influence has *come from developments outside the EMS.* Several factors however combined to minimize the effect of this unsettling influence. First, a favourable position at the start of the EMS (newcomers with above average inflation rates entering the EMS with competitive exchange rates — see Table III) provided a margin of tolerance and saved the EMS from immediate exchange rate difficulties. Secondly, traditionally strong currencies, including the Deutsche Mark, were hit by a weakening of their current account, partly because of the oil price increase, thereby reducing expectations of realignments. Both factors may explain the absence of speculative intra-EMS capital flows for more than relatively short periods. Thirdly, tensions between monetary and exchange rate objectives were also reduced by a clear shift in monetary authorities' attitudes, placing more weight on the long-term advantages of price stability than on the short-term losses in output. This was reflected in the fact that some countries accepted as less harmful a tightening of monetary policy in response to exchange rate developments within the EMS since inflation resurged during the early period of the EMS while real growth was relatively strong.

Another contributory factor to the avoidance of tension and conflicts has been the way that the authorities have been prepared to use their *monetary instruments* more promptly and flexibly in support of their exchange rate. It should also be noted that EMS countries have followed broadly similar monetary approaches. All countries refrain fom very short-term control of monetary and credit variables, thus avoiding unnecessary volatility of interest rates which can be a cause of erratic capital movements. [1] However, this is not the practice in other countries (e.g. the United States) and erratic capital movements affecting the US dollar during the life of the EMS have also affected EMS currencies, though not always to the same extent. The result has been imported instability in the EMS for brief periods.

The short-term room for manœuvre of monetary policy in order to avoid conflict emerging between exchange rate and monetary policy objectives has been also maintained through the use of three techniques. *Official foreign financing* to cover the oil-related current account deficits in some cases has contributed to easing the strains on monetary policy imposed by EMS membership, while other countries have been encouraging private sector foreign borrowing in order to maintain adequate levels of foreign exchange reserves, despite foreign exchange market intervention. *Outward foreign exchange controls* have been extended in some countries and at the same time the Netherlands and Germany have suspended — in view of their changed balance of payments position — restrictions on capital inflows, in so far as retained to protect their currencies from capital inflows. A third technique, evidenced by French and Dutch experience, has been to *directly regulate a credit monetary variable* which is a major element of their intermediate monetary objective. Interest rate adjustments when a currency reaches its EMS intervention point, it is believed, can then be made without affecting the main element of the intermediate monetary objective since, in these countries, the application of a net credit ceiling can direct the bank financing of strong credit demand to the capital market, and not the money market. Accordingly, action on

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[1] A more detailed presentation of this aspect can be found in the group's last report, dated 13 August 1980, on the UK 'Green Paper' on monetary control (see Annex IV of the 22nd Report on the activities of the Monetary Committee).

the interest rates to influence the exchange rate in the short run will not affect the credit monetary variable, and the quantitative controls on credit in the short-run will only influence the cost of credit and not the exchange rate.

IV. Mitigation of temporary conflicts between domestic monetary policy objectives and EMS exchange rate commitments

Although conflicts in the past were limited and infrequent, in future conflicts between monetary policy objectives and EMS exchange rate commitments may become harder to avoid. In compliance with its mandate, the group has therefore studied whether there is some scope for adapting the methods of monetary management to the requirements of the EMS.

Before discussing the techniques it is recalled that a distinction was made in Chapter II between conflicts — generally of a temporary nature — when the full burden of adjustment falls on monetary policy and conflicts that are related to fundamental differences in economic performance and which eventually may have to be resolved through a realignment of central rates because more general stabilization measures have proved insufficient or inappropriate. The following discussion refers to conflicts that have to be resolved within a given set of central rates either because the conflict is thought to be of a temporary nature or because the conditions for a successful realignment are not met.

The monetary authorities have shown considerable flexibility in their resort to techniques to avoid or minimize the effect of conflicts between their exchange rate and monetary policy objectives. Measures used in the past two and a half years have been:
— officially induced foreign borrowing,
— foreign exchange controls,
— direct regulation of a monetary variable,
— measures offsetting the impact of foreign exchange flows on bank liquidity,
— flexibility in choice and formulation of the monetary target.

Resort to *officially induced foreign borrowing* is appropriate to cover the oil-related current account deficit. This applies, however, only as long as the oil-exporting countries run a substantial surplus, exerting pressure on economic activity and the balance of payments in oil-importing countries, and as long as such financing does not impede stabilization and adjustment policies in the deficit countries.

Foreign-exchange controls may at least temporarily allow authorities some freedom to direct monetary policy to domestic objectives while reducing the risk of disturbing capital flows. However, the introduction of certain capital controls runs against the spirit of the Community's commitment to free capital movements within the EEC. It is to be noted that in the area of exchange controls Germany and the Netherlands have been able to suspend certain controls on inward capital movement.

Direct regulation of a monetary variable may either involve direct control over the variable representing the intermediate objective of monetary policy (credit expansion in Belgium in certain periods) or control over an important determinant of money supply (gross credit ceilings in Italy and net ceilings in France and the Netherlands). In all these cases some room for manœuvre is achieved in the short-run for using interest rate policy to affect capital movements and foreign exchange markets. This possibility was more fully discussed in the group's Third Report on certains questions relating to monetary policy

instruments dated 29 May 1979 where it was observed that such an approach may also induce capital flows — which in certain circumstances may be undesired — albeit through different channels and with different time lags.

In the short run *measures offsetting the impact of foreign exchange flows* on bank liquidity can insulate national monetary policies from external developments. Such measures have been actively used by a number of EMS countries in the past two and a half years, but all recognize that the margin for manœuvre is limited. Even if the liquidity effects could be fully neutralized without prolonging periods of tension within the EMS, this protects the stance of monetary policy only in those cases where the exchange rate pressure is of a short-term nature and is not related to a fundamental deterioration in a country's economic position in comparison with that of its EMS partners.

The negative confidence effects from deviation from the announced target might be mitigated through *flexibility in choosing and formulating such targets*. Opinions diverge as to the methods of expressing the monetary target. Some experts consider that the setting of a target range could allow a margin of tolerance for absorbing unexpected capital flows as well as random shocks emanating from the real and monetary sectors of the domestic economy; on the other hand, they consider that strict adherence to a single numerical target might force the authorities concerned to take unwarranted measures which could have undesirable repercussions on EMS exchange rate relationships. Other experts consider that, on the contrary, selection of a single target enables conflicts to be more readily discerned and that setting a target range may give national and international opinion the impression that the monetary authorities are less determined or even that they would be prepared to accept in advance deviations from their central objective.

Furthermore, if initial assumptions about the external balance fail to materialize, a money supply aggregate may be difficult to keep on track. It might therefore be advisable especially for smaller open economies, to set a different constraint, for example a DCE ceiling. Nevertheless, it is necessary to monitor closely the development of the money supply because a DCE ceiling alone may accommodate unwarranted liquidity creation when the balance of payments moves into surplus. A DCE ceiling is more appropriate in deficit countries where monetary policy is primarily geared to balance of payments financing than in surplus countries where price stability is the principal concern.

V. Conclusions

The Working Party has listed and briefly discussed in the previous chapter a number of techniques and procedures that have been followed to overcome the problems stemming from the co-existence of monetary and exchange rate objectives. It has not, however, been able to indicate methods that have not already been used and tested by member countries in the past two and a half years. Moreover, it has pointed out that the margin of manœuvre available at the technical level is limited. Nevertheless, these techniques have helped the EMS to withstand severe shocks — most notably the successive oil price rises and the sharp fluctuations of the US dollar. Not only have conflicts between exchange rate and monetary policy objectives been relatively mild, but realignments have taken place only on a few occasions.

The constellation of exchange rates and current balances at the start of the EMS and the fact that the oil price increase also weakened the external position of the traditionally strong countries tended to ease the pressure on exchange rates for some time.

Without giving a judgement on the prospects for strains in the EMS, it is unlikely that the potential for conflict will disappear. It does not, however, seem to be possible to establish predetemined rules for resolving or mitigating such conflicts, given the differences in their origin, type and intensity.

In order to avoid conflicting policy actions, active coordination between monetary authorities in EMS countries is needed. These arrangements should allow an assessment of the causes of conflict for particular countries and of whether other EMS countries may be able to help by taking appropriate measures, without, however, jeopardizing the attainment of their own monetary policy objectives. Such coordination, even if it were to involve monetary objectives, could not, however, by itself guarantee convergence towards stability within the EMS. This essential requirement calls for a determined effort covering all spheres of economic policy.

TABLE I

Risk of deviation (overshooting/undershooting) from intermediate monetary policy objectives [1]

		Time horizon	Money supply objective controlled by		Domestic credit expansion controlled by	
			manipulation of money market conditions	credit ceilings [2]	manipulation of money market conditions	credit ceilings [2]
At top of EMS exchange rate mechanism	capital inflows through banking system	immediate	none	none	none	none
		delayed	overshooting via stronger DCE and protfolio effects as a result of lower interest rates and abundant bank liquidity	overshooting via portfolio effects as a result of lower interest rates	overshooting via stronger DCE as a result of lower interest rates and abundant bank liquidity	none
		in the longer run		disintermediation effects equivalent to overshooting of the target		disintermediation effects equivalent to overshooting of the target
	capital inflows through non-bank residents	immediate	overshooting if these inflows show up in an increase of banks' monetary liabilities		none	none
		delayed	further overshooting via stronger DCE and portfolio effects as a result of lower interest rates and abundant bank liquidity	further overshooting via portfolio effects as a result of lower interest rates	overshooting via stronger DCE as a result of lower interest rates and abundant bank liquidity	none
		in the longer run		disintermediation effects equivalent to overshooting of the target		disintermediation effects equivalent to overshooting of the target
At bottom of EMS exchange rate mechanism	capital outflows through banking system	immediate	none	none	none	none
		delayed	undershooting via weaker DCE and portfolio effects as a result of higher interest rates and reduced bank liquidity	undershooting via weaker DCE and portfolio effects as a result of higher interest rates	undershooting via weaker DCE as a result of higher interest rates and reduced bank liquidity	undershooting via weaker DCE as a result of higher interest rates
		in the longer run				
	capital outflows through non-bank residents	immediate	undershooting if these outflows show up in a decrease of banking monetary liabilities		none	none
		delayed	further undershooting via weaker DCE and portfolio effects as a result of higher interest rates and reduced bank liquidity	further undershooting via weaker DCE and portfolio effects as a result of higher interest rates	undershooting via weaker DCE as a result of higher interest rates and reduced bank liquidity	undershooting via weaker DCE as a result of higher interest rates
		in the longer run				

[1] It is assumed that the authorities do not take any measures to offset the liquidity impact of capital flows.
[2] While disintermediation may be significant with a gross credit ceiling, it is unlikely to occur with a net credit ceiling.

TABLE II

Monetary policy variables

Objectives or forecasts (a) and results (b)
(Figures in italics are published targets or commitments)

	Key Variable*	1976 a	1976 b	1977 a	1977 b	1978 a	1978 b	1979 a	1979 b	1980 a	1980 b
Belgium	TDCE	15	14.5	13	13	13	11.8	12	12.4	11	10.0
Denmark	M2	12	11	11	9.8	9-10	6.7	9	9.9	6	10.9
	DCE	17	19	15	12.4	10-11	8.0	9	12.9	9.5	17.3
Germany	MZ	*8* [1]	9.2 [1]	*8* [1]	9.0 [1]	*8* [1]	11.4 [1]	*6-9* [2]	6.3 [2]	*5-8* [2]	4.9 [2]
France	M2	16.5	12.8	*12.5*	13.9	*12*	12.2	*11*	14.4	*11*	9.8
Ireland	M3	22	14	18	16.3	16-18	28.7	15	19.0	17	17.0
	PSCE				26.4	20	33.0	18	19.3	13	13.0
Italy	TDCE	*17.8*	19.8	*15*	17.8	*19.4*	20.8	*18.5*	18.6	*17.5*	18.0
Netherlands	M2	12.5	20.5	9	7.6	7.0	5.5	—	6.9	—	3.8
	DM2	9.5	19.5	8	8.8	—	10.3	8.5	10.8	7.5-8	7.7
United Kingdom [7]	DCE	*£ 9.2 bn*	£ 5.0 bn	*£ 7.7 bn*	£ 3.6 bn	—	—	—	—	—	—
	£M3	*9-13*	7.5	*9-13*	16.3	*8-12*	10.5	*8-12* [3]	13.5 [3]	*7-11* [5]	16.9 [5]
								7-11 [4]	10.8 [4]	*7-11* [6]	18.5 [6]
Greece	MO						21.1		14.2	15	15.7
	PSCE						24.4		18.9	16	20.4

[1] Annual average. [2] Increase between final quarters of the preceding and current year. [3] October 1978/October 1979. [4] June 1979/April 1980 [5] June 1979/October 1980 at an annual rate. [6] February 1980/April 1981 at an annual rate. [7] Financial year ending in March of the following year, unless otherwise stated.

* DCE = Domestic credit expansion. TDCE = Total domestic credit expansion (expansion of credits granted by domestic banks and other financial intermediaries). PSCE = Domestic credit expansion to private sector. M2/3 = Money supply broadly defined. MZ = Central bank money. £M3 = £ money supply broadly defined. DM2 = Money creation from domestic sources. MO = Currency in circulation.

TABLE III

Cost/price competitiveness of EMS countries [1]

	BELGIUM		DENMARK		GERMANY		FRANCE		IRELAND		ITALY		NETHERLANDS	
1. Index of competitiveness, 17 partner countries	a	b	a	b	a	b	a	b	a	b	a	b	a	b
— 1978	97.7	109.9	114.1	120.1	112.9	108.2	96.0	97.0	97.2	97.1	93.7	82.1	111.3	123.5
— 1979	94.8	106.7	110.3	113.3	113.7	108.0	98.8	98.8	98.7	97.4	96.8	84.3	106.8	120.3
— 1980	88.2	101.1	100.7	104.9	107.2	103.8	102.7	101.3	93.0	95.0	101.1	89.9	102.9	116.9
— 1981 f	79.3	96.2	94.5	96.6	95.4	96.1	97.0	100.0	91.7	90.2	96.2	88.5	96.5	111.4
2. Index of intra-EMS competitiveness	c	b	c	b	c	b	c	b	c	b	c	b	c	b
— 1978	117.8	105.6	102.7	110.2	99.1	104.0	92.6	92.9	77.6	82.6	82.7	77.6	112.9	119.1
— 1979	116.0	102.9	101.0	107.9	97.4	103.6	95.2	95.2	84.8	87.1	83.8	79.7	112.6	116.8
— 1980	114.0	99.6	95.0	100.6	94.2	100.1	99.3	99.0	94.4	93.5	89.3	86.0	109.6	115.5
— 1981 f	113.4	97.3	96.3	101.1	91.2	97.5	103.8	102.8	97.9	99.0	94.4	89.3	105.1	113.9

[1] Commission sources. Index greater than 100 indicates increase in relative prices, loss of competitiveness. 1970 = 100
a Based on wholesale prices of manufactures, annual averages, weights of 1974.
b Based on GDP prices, annual averages, exports weights changed from year to year, 1970-79.
c Based on unit labour costs for the whole economy, annual averages, export weights changed from year to year, 1970-79.
f *For b and c:* Forecasts based on the Commission's Economic Budgets of May 1981; exchange rate estimate made in August 1981 and compatible with central rates established on 23 March 1981. This estimate does not take account of the realignment of 5 October 1981. Its effect, which applies only to three months of 1981 and depends on market rates adjusting to the new central rates, would in any case have been small.
For a: Figures relate to 3rd quarter.

CHART 1

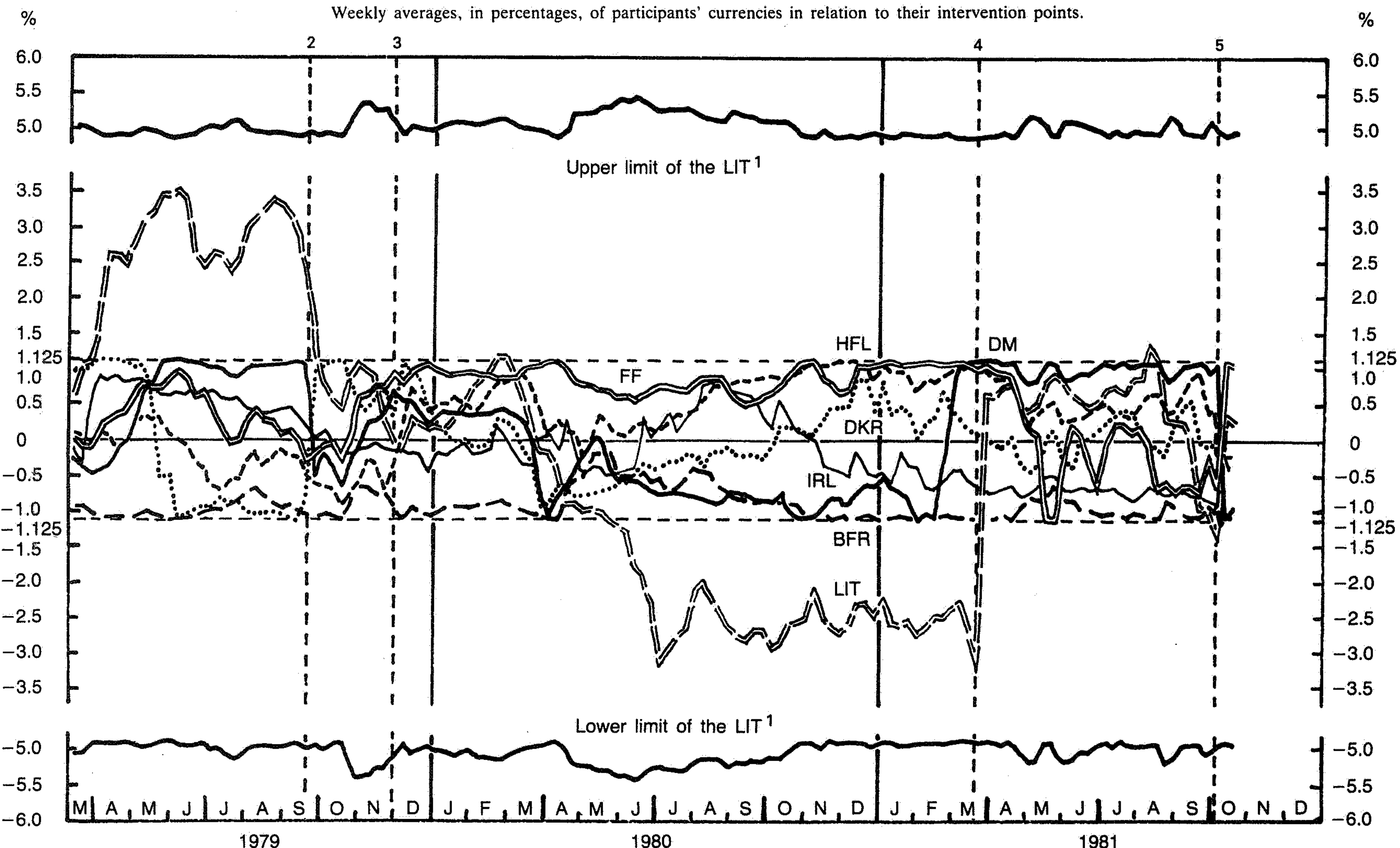
Representative money market rates

XX/YY: Periods of fully stretched EMS band and currencies at the upper and lower limits respectively.

CHART 2

Spot exchange rates in the EMS exchange rate mechanism, 1979-81.

Weekly averages, in percentages, of participants' currencies in relation to their intervention points.



[1] The LIT's position is shown by its percentage deviation from the weakest and the strongest currency within the 2¼% band; its maximum and minimum permissible position is indicated by the top and the bottom line in the graph.
[2] With effect from 24 September 1979, the DM was revalued by 5% *vis-à-vis* the DKR and by 2% *vis-à-vis* all other currencies.
[3] With effect from 30 November 1979, the DKR was devalued by 4.76% *vis-à-vis* all other participating currencies.
[4] With effect from 23 March 1981, the LIT was devalued by 6% *vis-à-vis* all other participating currencies.
[5] With effect from 5 October 1981, the DM and the HFL were revalued by 5.5% *vis-à-vis* the DKR, the BFR and the IRL. At the same time the FF and the LIT were devalued by 3% *vis-à-vis* the DKR, the BFR and the IRL.

16 October 1981

MANDATE

The Working Party on Harmonization of monetary policy instruments is requested by the Monetary Committee with the concurrence of the Committee of EEC central bank governors to further the study of the technical issues raised in the Commission departments' note 'Monetary policies 1979-80' (Doc. II/562/80), with particular reference to the following points:

- *Quantitative analysis of certain past experiences of stabilization policies in the Community, describing the interaction between monetary and other policies (taking into account the different instruments in the countries examined).*
- *Examination of the technical problems — particularly on interest rates and other operational variables — stemming from the co-existence of monetary and exchange rate objectives within the EMS, given its requirement of convergence towards stability.*
- *Definition and analysis, on the basis of time series, of indicators of the stance of monetary policies within the Community and the EMS and identifying sources of tension in the system. In this context the Working Party could examine developments in monetary aggregates, interest rates and exchange rates, both in relation to each other and to non-monetary variables.*

The Governors expressed the wish that when the Group begins to tackle the wide-ranging task entrusted to it, it should establish an order of priorities and thus seek to concentrate its first report, which might then be submitted by, say, the autumn, on the subject matter of the second indent.

Lastly, the Committee continued its activities in the field of international monetary relations; in particular it prepared the declaration adopted by the Community before the Bretton Woods institutions; it also several times studied the monetary and financial aspects of North-South relations.

The Working Party on Harmonization of Monetary Policy Instruments, a joint working party of the Monetary Committee and the Committee of Governors, produced a report on 'Technical problems stemming from the co-existence of monetary and exchange rate objectives within the European Monetary System'. The Working Party on Capital Markets continued to examine developments on the capital markets of the Member States on the international capital market.

European Communities — Monetary Committee

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The twenty-third report on the activities of the Monetary Committee gives an account of the chief areas of the Committee's work for 1981.

A short introduction reviews the economic situation and the main events of 1981: the stagnation of world trade, the sharp fluctuations in interest rates and exchange rate relationships, and the further deterioration in the Community's terms of trade. The EMS continued to work satisfactorily; there were two realignments in 1981, one of which, on 4 October, was the first extensive realignment since 1979.

In 1981, the aim of a number of the Committee's activities was to contribute to the Community's monetary cohesion and stability. Important internal studies were also carried out on the technical aspects of developing the European Monetary System further.

As regards the strengthening of convergence, the Committee examined the economic and monetary situation of two countries in particular difficulties: Italy, in connection with her temporary measures concerning foreign exchange purchases, and Belgium following the Commission Recommendation to the Belgian authorities pursuant to the 1974 decision on convergence. The Committee also continued with its regular examination of the economies of the member countries.

The Committee studied the effects of certain rigid indexation systems on national economies and their possible monetary consequences, and produced an opinion on this subject. The Committee also several times analysed the implications for the world economy and notably the Community economy of interest rate movements in the United States and of the dollar exchange rate, and examined the possibilities available to the European authorities for guarding against the effects of United States policy.