

MONETARY COMMITTEE
OF THE EUROPEAN COMMUNITIES

**TWENTY-SEVENTH REPORT
ON THE ACTIVITIES**

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The Committee held a total of eight ordinary meetings in 1985. Two extraordinary meetings were held, in July on the occasion of the Italian realignment and in November to consider the Greek request for assistance under the Community Loan Mechanism. The Chairman reported nine times to the Council (Economic and Financial Affairs) on the results of the Committee's work. He also informed the *ad-hoc* Committee on Institutional Affairs of the Committee's position on basic monetary issues.

I. General situation

1. The environment of monetary policy at Community level was largely free from strain in 1985: with growth somewhat more rapid, it proved possible to achieve further convergence between most countries on major economic objectives. In a number of countries, the main burden of economic management again fell on monetary policy. In others, further consolidation of the public finances created improved conditions for stability and growth, particularly through a fall in nominal interest rates. At the international level, the Community faced, after the extremely strong demand boost of the previous year, a more moderate expansion of the world market. As economic fundamentals were all working in the same broad direction, the still high and sharply fluctuating dollar had a less disruptive impact on the EMS than in previous years.

2. Whereas strong movements in the dollar in the past always gave rise to fears, especially at times of a sharply declining dollar, that the EMS would have to endure major internal strains, the EMS proved to be relatively stable in 1985 thanks to the prospects for convergence. There was substantial intervention in some cases in the second half of the year, but the economic situation was marked by greater stability and an improvement in current account positions which provides a good basis for the maintenance of a generally stable parity grid.

3. The further fall in the rate of price increases in 1985, allied to a dampening of the downward trend of nominal interest rates by exchange-rate considerations in the second half of the year, implied higher real interest rates; indeed this movement even strengthened in 1986 with the fall in oil prices. However, the favourable trend of consumer prices conceals the persistence of an element of hard-core domestic inflation and it must be the aim of policy to reduce this.

In this context, the Monetary Committee noted that the trend of unit wage costs between realignments can sometimes provide a more reliable criterion for the economic assessment of EMS currencies than, for example, differences in consumer prices. Full compensation for accumulated price differences through central rate adjustments would be tantamount to abandoning the discipline imposed by the EMS.

4. Notwithstanding the more favourable economic background, the Monetary Committee emphasized that coordination of monetary policy — bearing in mind the different responsibilities of the various economic policy makers — calls for a conver-

gent and supportive course on the part of public finance policy. The Committee in particular expressed concern about the high and, in most countries, still rising government debt ratios and the consequent burden of interest payments on public finance. There was a clear need for action in a number of countries in this regard.

II. Main fields of action

5. The Monetary Committee concentrated on the following main issues in 1985:

- The EMS continued to be the main focus of the Committee's work. There were regular consultations on monetary and macroeconomic problems with a view to consolidating and deepening the consensus on the priorities of economic policy. Views were exchanged on the type of measures to be taken in the light of developments made in the international currency markets. A high degree of convergence is still seen as the best way of ensuring monetary stability and thus success of the EMS.
- There was detailed consideration of the longer-term aims of the EMS and the fields of action for the medium term. The Committee stressed that the EMS has an intrinsic value against the background of the ultimate aim of economic and monetary union. The EMS should therefore continue to be strengthened by building on its proper foundations and should not be burdened with excessive demands for action from outside. The Committee agreed that there are two areas where action is possible and necessary: the securing of further convergence and progress in the liberalization of capital movements. Furthermore it singled out the possibilities of developing the ECU as one field of action in the medium term on which detailed technical examination was necessary (see Annex).
- As in the previous year, the Committee continued to press for renewed progress towards the full liberalization of capital movements. On several occasions it examined practical measures for improving as well as for extending the obligation to liberalize them.
- In the second half of the year, it stated its opinion on the texts relating to monetary capacity incorporated in the Single European Act supplementing the EC Treaty.
- The Committee's responsibility for the EMS and the Community's position in the world economy meant that high priority was given to questions relating to international monetary relations. A key theme was international indebtedness on which it presented an assessment as a Community institution in March 1986 which was later endorsed by the Council.
- Exercising its functions under Community legislation, the Committee carried out, in accordance with its responsibility to the Economic and Financial Minis-

ters, a devaluation of the lira in July; it stressed, as it has in other cases, the need for the devaluing country to take accompanying economic measures. The Committee also examined the devaluation of the Greek drachma — which does not participate in the exchange-rate mechanism — and the programme for stabilizing the Greek economy including protective measures under the Treaty, and the Greek application for assistance under the Community Loan Mechanism.

6. The Committee continued its regular exchange of views on the economic policy stance of the Member States and their implications for the Community as a whole. As in previous years, the Committee was helped in its work on monetary policy by close cooperation with the Committee of Governors of the Central Banks. The regular examinations of individual countries are carried out with an eye to the objective of promoting closer convergence. The Committee attaches special importance to its mid-year discussions on the coherence of monetary policy and on its end-of-year coordination of money supply targets for the year ahead. In these discussions, the Committee pays particular attention to the money supply counterparts, because in that way other areas of economic policy, such as budgetary policy, are included in the coordination exercise. It repeatedly emphasized that the satisfactory degree of convergence on the monetary front needed to be reinforced by increased efforts to improve public finances.

In its efforts to achieve better and sustained convergence, the Committee established a number of guiding principles:

- a) In the EMS, which aims to achieve internal price and cost stability and stable exchange rates, the countries which have had most success in stabilizing their prices and costs tend to have low real exchange rates while those which have had less success in this respect tend to have high real exchange rates. As long as perfect convergence has not been achieved, divergencies between nominal and real exchange rates are bound to occur. The narrowing of such differences needs to be achieved primarily through a more intense stabilization effort in countries with comparatively high real exchange rates.
- b) In countries with large current account deficits, it is not enough to ensure that the overall rate of monetary expansion is apparently consistent with the guidelines; the expansion of domestic credit and the external counterpart of money creation must also be closely monitored. Rapid domestic credit expansion that pulls in more imports and fuels outflows of capital is incompatible with a balanced development of the economy.

In such a situation, monetary and credit policy should ensure that liquidity creation from domestic sources (including official funding through external borrowing) does not fully compensate for the liquidity drain caused by the current account deficit. If liquidity is not squeezed, there is no incentive for private capital flows to compensate for the current account deficit.

- c) In countries where official external borrowing has traditionally been high and accompanied by a substantial external deficit, problems of domestic monetary control may occur if the external account improves faster than the budget deficit. In such cases, it is appropriate to reduce official external borrowing gradually and to switch to more non-monetary financing of the persistent public deficit, accepting the consequences described at (iv) below.
- d) In countries where credit to the public sector is the main source of money creation, the achievement of monetary expansion consistent with stability represents a very difficult problem, requiring either a substantial squeeze on private sector borrowing or the acceptance of excessive domestic credit expansion accompanied by the destruction of liquidity by the external sector, or some combination of these two. In such circumstances more use of non-monetary financing by the public sector is clearly essential; high long-term interest rates would then reveal more clearly the fact that financial demands of the public and private sectors are competing for a limited supply of savings. In the final analysis, the effective solution must be to reduce the public deficits.
- e) In countries with a high rate of price inflation and/or a large fiscal deficit, in which monetary growth has been brought down partly with the aid of financial innovations through the development of relatively liquid financial instruments, it is clearly right to take account of the velocity of circulation of such instruments in assessing the evolution of the monetary aggregates.

7. Examination of the longer-term aims of the EMS, which the Committee Chairman suggested in February should form part of the Committee's work programme, was a dominating Community theme in 1985. Appearing several times on the agenda of the Committee and the Council and forming the subject of a report from the President of the Council (Economic and Financial Affairs) to the European Council, the report stated: 'In April 1985 the Ministers asked the responsible committees — the Committee of the Central Bank Governors and the Monetary Committee — to examine further questions in connection with the longer-term goals of the EMS and the ECU. In particular:

- to assess the implications of the expansion of the private use of the ECU and to what extent this expansion may affect monetary policies and favour progress towards the objective of monetary integration;
- to study the implications of the development of the role of the ECU as a reserve asset for European economic integration and for the international monetary system. In this context, the impact of its increased use on the dollar should be explored with a view to furthering the monetary identity of Europe . . . '

The report went on to point out that: 'Given the fact that, in the area of monetary integration, technical measures can have far-reaching political effects, and in view of the balanced functioning of the EMS, the Ministers consider it appropriate that the

further development of the EMS should continue to be a matter for the Economics and Finance Ministers and the two competent committees.'

Any debate on the long-term goals and prospects of the EMS must raise the question of the completion of the EMS: the participation of the United Kingdom in the exchange-rate mechanism, the gradual abolition of special rules for Italy's broad band and the development of criteria for the future participation of Greece, Spain and Portugal in the EMS. In the Committee's opinion these subjects require more detailed examination.

The Committee's conclusions concerning the ECU were set out in a report from the Chairman (see Annex). At a number of meetings held during the course of the year, the Committee members and their alternates looked into the monetary effects of the use of the private ECU. It was not possible to report on the outcome of these discussions until 1986.

8. International monetary relations played a major part in the Monetary Committee's discussions. 1985 saw the completion of the Group of Ten's work on the functioning of the international monetary system. In the autumn, the Plaza agreement between the Group of Five led to an adjustment of exchange rates intended to contribute to a better balance in the world economy. Although this reversal of exchange-rate trends was welcome, great stress was laid at the same time on the need for a direct correction of fundamental economic factors.

More specifically the Committee concentrated on the repercussions of the movement of the dollar, on monetary relations with Japan, including the bilateral negotiations on the opening up of the Japanese financial market to European financial institutions, and on the question of international indebtedness.

The Committee outlined a number of principles on which further treatment of the problems of indebtedness should be based:

- a) The 'case-by-case' approach remains the best way in which to resolve the debt problem. This is justified by the basic situation, which has not changed, and by past experience as well as by the probability that situations will become even more varied in the future. It is clearer than ever that there cannot be a global solution.
- b) Debtor countries, industrialized countries, international organizations and commercial banks all share a collective responsibility for resolving the debt problem and should not hold back from fulfilling their obligations.
- c) There can be no solution to the problems of indebtedness if the debtor countries are not ready to implement adjustment measures.

- d) The talks and negotiations with the debtor countries should continue to take place exclusively in the competent fora, in particular in the IMF and the World Bank.
- e) While the large debtor countries clearly merit special attention, the problems of the small countries, especially the poorest among them, notably in Africa, should also be given particular emphasis.

9. In 1984 the Committee succeeded in giving a new impetus to the liberalization of capital movements, and on a number of occasions in 1985 it examined measures which could and should be taken to accelerate this process. In its view, the liberalization of capital movements must be allowed to increase the pressure for the coordination of monetary policy within the Community, and in particular for cohesion within the EMS. Moreover, such measures form an essential part of the task of creating a genuine Community-wide internal market.

Indeed so long as European financial markets are divided into separate national markets through restrictions imposed by a number of Member States, balanced progress towards a common internal market will be considerably impeded, as will monetary integration.

In the spring of 1985, the chairman of the alternates reported on an examination of the restrictions on capital movements still in force. He singled out three main criteria for selecting the transactions which should be liberalized:

- the role of liberalization in promoting convergence, strengthening the EMS, and fostering economic and financial integration in the Community and the free movement of goods, services and capital;
- the contribution of liberalization towards a greater coordination and consistency of national rules governing financial markets;
- the impact of liberalization on countries' balances of payments and exchange rates, partly with a view to preserving the coherence of EMS exchange-rate arrangements . . .

In the course of the ensuing debate, the Committee recommended that the Commission should draw up a proposal for a Directive revising the 1960 Directive on Capital Movements to extend the range of unconditionally liberalized transactions included in list A. In December 1985, having examined in detail a draft put forward by the Commission departments, the Committee welcomed the significance of such an initiative and suggested that a formal proposal, revised in the light of the Committee's discussions, should be presented to the Council as soon as possible. In the interests of the Member States and the economic strength of the Community, freedom of capital movements within the Community should not be purchased at the price of sealing off the Community from the rest of the world. The Monetary Committee welcomed the signs which had emerged in 1985 of moves towards the liberalization of capital movements in France and Italy.

Luxembourg, 11 June 1985

**The long-term goals of the EMS and the fields of action
in a medium-term perspective**

Oral report by the Chairman

The Finance Ministers, at their informal meeting in Palermo, asked the Monetary Committee to present a short report for the meeting of the ECO/FIN Council of 11 June 1985 on the long-term goals of the EMS, as well as on the fields of action in a medium-term perspective. Given the short delay involved, the report at this point in time can basically only offer an outline of the issues with general indications and questions, rather than definitive answers.

1. The Monetary Committee has treated the goals of the EMS against the background of the more far-reaching goals of Economic and Monetary Union, as set out in the Council Resolutions of 1971 and 1972. In the Committee's view the goals outlined at that time for the creation of an economic and monetary union remain valid in the longer term. Indeed the requirements for its realization do not exist at present; this is especially the case for the goal of a common currency. In fact a broadly-based political and institutional process of integration would be required for the realization of economic and monetary union.
2. Against this background the EMS has more limited objectives. It is a scheme for 'closer monetary cooperation' which should lead 'to a zone of monetary stability'. The EMS aims above all at 'policies conducive to greater stability at home and abroad'. This goal has at the same time a longer-term dimension. In particular this means as stable as possible price levels and as stable as possible exchange rates between the EMS currencies.

The EMS suffered from certain difficulties at the start: substantial shortcomings with respect to the convergence of economic policies and as a result relatively frequent central rate changes. In the last two to three years, however, it has been possible to make distinct progress in convergence. The exchange rate stability within the EMS stands out positively compared to the movements of the USD and other currencies.

3. Independently from the goals of Economic and Monetary Union, the EMS has its own worth. In accordance with the intentions of the European Council Decision of 1978 it has become a 'durable and effective scheme'. The willingness of all the EMS partners to follow the goal of a zone of monetary stability in practical economic policy has grown perceptibly. At the same time very close cooperation between the monetary authorities, particularly the central banks, has developed. The existing

objectives and rules provide a sufficient level of realism and flexibility for further development.

4. The transformation of the EMS into a so-called 'final system', as foreseen in the introduction of the European Council Resolution of the year 1978, has since not taken place. This is because — at least in the opinion of several Members — for this to happen an institutional threshold would have to be surmounted, for which the process of political integration has not provided the preconditions. Given the present and foreseeable circumstances, the Committee considered that this issue does not arise at the moment.

5. From these discussions by the Monetary Committee which have to be further intensified, there are already several observations which can be made:

- a) all the Members are of the view that steps to strengthen the EMS in a pragmatic way and taking into account the long-term goals, are both possible and desirable;
- b) there is already a broad measure of agreement on the assessment of two areas where action is possible and necessary: the securing of further convergence and progress in the liberalization of capital movements. There is also agreement that progress is desirable towards the completion of the exchange rate system. Against this, differences of view still exist in the area of the ECU for which more detailed technical examinations, in close cooperation with the Committee of Central Bank Governors, have been started.

6. The Committee considers — as already stated earlier — further progress in and the consolidation of *convergence* as the central task for strengthening the EMS. The tasks which arise from this are less of a procedural nature but rather are more a function of practical economic policy decisions, which the Committee will influence within the possibilities given to it. It will make special efforts to give the existing coordination and surveillance procedures more weight.

7. One field of action which has lagged behind in the past is the *liberalization of capital movements*, as was prescribed in the Treaty of Rome. A free capital market would not only strengthen the economy of the Community but also the convergence constraint in the EMS. The Committee is aware that advances in this area must be made with appropriate caution, and that the steps introduced for gradual liberalization should, nevertheless, be reinforced. The Committee itself has set up a procedure entailing a more rigorous examination of the existing restrictions. It welcomes the fact that the Commission, at the last examination of the application of the safeguard clauses, set stricter criteria. Moreover, it encourages the Commission to put forward proposals to the Council as soon as possible for the transfer of transactions from lists C and D of the liberalization Directive to lists A and B. The Committee will deal actively with questions of the liberalization of capital movements.

8. A debate on the long-term goals and perspectives of the EMS also brings up questions of the completion of the EMS: the participation of the United Kingdom in the

exchange rate mechanism, the gradual abolition of special rules for Italy's broad band, criteria for future participation by Greece, Spain and Portugal in the EMS. In the Committee's opinion these subjects require more detailed examination.

9. The Committee spent a substantial amount of its time discussing *ECU questions*, where a distinction has to be made between the official and the private ECU. As has already been pointed out, this is the field of action which still needs the most detailed technical examinations. A number of members have indicated that here any further steps require firstly the clarification of the long-term goals and perspectives for the ECU.

The official ECU was described in the Resolution of 1978 as being 'at the centre' of the EMS. There it was given in particular four functions (denominator for the exchange rate mechanism, basis for its divergence indicator, denominator for the credit mechanism and means of settlement). Its function as a means of settlement has remained limited. According to the Resolution the 'final system' should, however, bring with it 'the full utilization of the ECU as a reserve asset and a means of settlement'; as yet the requirements for the entry into the 'final system' have not been fulfilled. It is — as indicated — also not within sight at present.

The *private ECU* is in contrast not a constituent instrument of the EMS. It has developed spontaneously as a kind of 'by-product'.

So far the Committee's discussions have shown that there are divergent views of the further room for manoeuvre in the area of the ECU. Some see room for manoeuvre for further measures within the existing institutional threshold. Others feel it is necessary to clarify certain questions, some of which are fundamental (possible repercussions of the ECU on national monetary policy and on the future role of the central banks). It would, however, be premature and would contradict the still open character of the discussion in the Committee, to already report on conclusions at this stage, or even to give indications concerning concrete steps.

10. I would therefore like to outline for you in the following section some of the questions which the Committee must still deal with in more detail. These include, in the first place, the question of a reserve function for the ECU, official or private; here the question arises of whether, and under which conditions — concerning both substance and the institutional aspect — the ECU could fulfil this function. What advantages would such a development have for the Community and for the international monetary system and what disadvantages would be connected with this? Another central question is that of how this development would take place. Can and should such a development be actively encouraged? How would other changes in the area of the ECU's official use affect the EMS, its disciplinary action and convergence? The Committee has already taken up these questions; it feels, however, that more detailed investigation is required before its conclusions can be put before you.

Finally these discussions have shown that, at least in the view of some Members, the reserve function of the ECU should probably be developed primarily via the private ECU rather than via the official ECU.

As far as the *use of the private ECU* is concerned, the question asked above all was what is the specific contribution of the private ECU for the EMS. Here, as well, the question arose of whether the monetary policy of the Member States is impaired by the use of the private ECU. The Committee will also comment on whether control or supervision is necessary for the use of the private ECU and, if so, how it should be carried out. Lastly some Members requested that the use of the ECU as a trade denominator should be examined.

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As a preliminary conclusion from an examination of the long-term goals and perspectives of the EMS which is still under way, I would like, as Chairman of the Monetary Committee, to make the following remarks: The EMS represents important progress in the process of integration; it should continue to be reinforced from within itself and to be further developed to the extent that this can be justified. However, it should not be burdened with exaggerated pressures for action from the exterior. The Monetary Committee will continue intensively to explore the possibilities for strengthening the EMS. Technical work is presently under way; the clarification of the longer-term effects of certain steps may possibly widen the room for action. For these reasons the Committee requests that the promotion of the EMS should continue to remain a matter for the responsible bodies.

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