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Report

drawn up on behalf of the Economic and Financial Committee

on the future activities of the Community in the field of monetary policy and on the establishment of a European monetary union

Rapporteur : Mr. Hans Dichgans

ENGLISH EDITION *)

*) This translation must not be treated as an official text. Readers are reminded that the official texts exist only in the Dutch, French, German and Italian languages.

In a letter dated 16 December 1965 the President of the European Parliament instructed the Economic and Financial Committee to submit a report on the future activities of the Community in the field of monetary policy and on the establishment of a European monetary union.

On 19 January Mr. Dichgans was appointed Rapporteur by the Economic and Financial Committee.

The Committee studied this report at its meetings of 21 July, 25 October, and 4 and 21 November 1966 and adopted it unanimously, with a motion for a resolution, at the last of these meetings.

The following were present : Mrs. Elsner, Chairman ; Mr. van Campen, Vice-Chairman ; Mr. Dichgans, Rapporteur ; Messrs. Aigner, Baas, Battista, De Winter, Dröscher, Dupont, Gerlach, Hougardy, Kriedemann, de Lipkowski and Miss Lulling.

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I — Developments to date

Introduction

1. On 16 December 1965 the Bureau of the European Parliament instructed the Economic and Financial Committee to draw up a report on the Community's future activities in the field of monetary policy. At its meeting of 25 November 1965 the Committee had already gone into this question in the light of statements by the EEC Commission. The Committee appointed Mr. Dichgans its Rapporteur at a meeting held on 11 January 1966.

Past activities of the European Parliament

2. Parliament has stressed the importance of monetary policy for European integration in a number of reports and motions for resolutions. In addition to older publications (1), the following deserve special mention :

(a) Report drawn up by Mr. van Campen for the Economic and Financial Committee on the co-ordination of monetary policies in the EEC (Doc. 17/1962-63) ;

(b) Report drawn up by Mr. Bousch for the Economic and Financial Committee on the co-ordination of budgetary and financial policies (Doc. 19/1962-63) ;

(c) Report drawn up by Mr. Vals for the Economic and Financial Committee on co-operation in monetary and financial matters in the European Community (Doc. 103/1963-64).

3. Mr. van Campen's report shows how important co-ordinating monetary policies is for achieving the Treaty aims, and examines the means by which monetary policies might be co-ordinated both in the Community and in its relations with non-member countries. The report concludes that a federal organization of EEC central banks should be set up under a centralized body with a view to making a gradual transition from co-ordinated national monetary policies to an effective common monetary policy. The European Parliament's resolution of 17 October 1962 gives the Executives a policy mandate along these lines (Annex I).

(1) e.g. report by Mr. van Campen (Doc. 54/1958-59) and report by Mr. Deist (Doc. 23/1960-61).

4. The resolution passed on the same day on Mr. Bousch's report dwells upon the interrelationship existing between the various aspects of economic policy and upon the need to ensure that they make parallel progress (Annex II).

5. The last special report of the European Parliament on monetary policy—the Vals report—similarly stresses the need for closer and closer co-operation in monetary and financial matters. The report deals with the progress that might be made at the institutional level, widening the Monetary Committee's powers, setting up a Committee of Governors of Central Banks, consultation in the event of changes in parity. The European Parliament passed the resolution adopting the Vals report (Annex III).

6. Mention should also be made of the European Parliament's reports on the EEC Commission's annual general reports. In Nos. 52 to 56 of Mr. Charpentier's report on the Eighth General Report on the activities of the EEC (Doc. 93/1965-66) a position is taken up with regard to questions of monetary policy. Parliament welcomes the Commission's efforts to render fluctuations in the rate of exchange between EEC countries impossible and, indeed, unnecessary.

The Commission is asked to pay particular attention to foreign investment in the six member States. Parliament regrets that progress in liberalizing capital movements has recently slowed down.

Growing urgency of monetary policy tasks

7. In its seventh annual report (*Official Gazette* No. 42 of 15 March 1965) the EEC's Monetary Committee notes that with the progress made towards economic integration, inflationary and deflationary trends in certain member States are spreading more and more rapidly to other Community countries and disturbing their economies. This growing danger of a rapid spread of local disturbances calls for urgent counter-measures in terms of co-ordinated monetary policies.

The EEC's Monetary Committee rightly observes that co-ordination measures are likewise becoming more and more pressing in external monetary policy relations. The transactions of the International Monetary Fund (IMF) have recently been financed largely by the EEC countries. Capital imports from non-member countries are a further major problem of common concern. The EEC Commission reaches similar conclusions in its Eighth General Report (Doc. 50/I-II of 1 June 1965).

Monetary policy and economic policy

8. Monetary policy cannot be treated separately from other aspects of economic policy. Every monetary policy measure has repercussions on short-term economic policy. All such measures exercise an influence on external trade, and many of them on structural or regional policy. Only within the framework of an overall economic policy that weighs up the possible effects of every conceivable kind of economic intervention can it be decided which monetary policy measures are the most appropriate. The following observations are made on this subject in No. 9 of Mr. van Campen's report :

> ' Monetary policy is characterized more by the instruments that are available to it than by its ends. Broadly speaking, it pursues the same ends as economic policy as a whole, although working towards some more directly than others. It is its instruments, however, that distinguish it most sharply from other branches of economic policy. It could be defined as one whose economic policy instruments act directly upon monetary aspects, particularly on the volume of money, credit, foreign exchange reserves and the rate of exchange. This head covers practically all the government's powers—mostly exercised in practice by the finance minister—and certain powers of special institutions set up in a number of countries to regulate the capital and money market. '

These observations remain as valid as ever.

Progress at the institutional level

9. Considerable progress has been made at the institutional level :

(a) Before any major decision affecting international monetary relations is taken by member States, the Monetary Committee has to be consulted. The powers of this committee have therefore been widened ;

(b) A Committee of Governors of Central Banks was set up and has held regular meetings since 1964 ;

(c) The Budget Policy Committee has started out on its work ;

(d) The Short-term Economic Policy Committee deals with monetary policy questions in the course of its normal duties ;

(e) The same applies to the Medium-term Economic Policy Committee ;

(f) Member States have undertaken to consult one another before any change is made in their pars of exchange ;

(g) The panel of experts on capital markets carries out the preparatory work for the Commission in the field of monetary policy integration ;

(h) Recently the EEC Commission suggested that the Council could reach agreement, at least once a year and in the light of a report by the Commission, on the monetary policy to be pursued vis-à-vis non-member countries.

Some of these bodies have been in existence for only a short while and a great deal of the work is still in the initial stage. But the organization as a whole appears at present to be complete and adequate for the purpose, although this obviously does not mean that working parties or committees of experts may not later have to be set up to study other aspects of the matter and to give the Commission's departments a helping hand.

Review of the work done by the institutions

10. Of the work done by the Council, the EEC Commission and the various committees, the following in particular should be mentioned :

(a) On 15 April 1964 the Council, on a proposal by the Commission, recommended the introduction of a common and general programme for fighting inflation (1) ;

(b) On 8 April 1965 the Council, on a proposal by the Commission, again recommended guidelines on short-term economic policy that took monetary and financial policy instruments into account (2) ;

(c) The Commission has submitted proposals for harmonizing indirect taxes on accumulated capital ;

(d) The Commission is seeking to secure a better statistical basis for the study of

(1) See *Official Gazette* No. 64 of 22 April 1964.
(2) See *Official Gazette* No. 65 of 15 April 1965.

capital movements (Doc. 38/1966-67 ; see also Baas report) ;

(e) The Council has issued two guidelines on the liberalization of capital movements (see No. 26).

(f) The Monetary Committee's discussions have helped to bring closer the views of member States on the improvement of the world monetary system ;

(g) The recommendations put forward by the Monetary Committee after studying the position in the different countries, and by the Short-term Economic Policy Committee after studying the economic budgets, provide a suitable basis for co-ordinating monetary policies.

11. The permanent contacts existing at various levels between the political bodies and experts of member States can serve as a stepping-stone to further progress. All concerned are in this way kept informed of the situation and interests of their partners. Mutual understanding fosters a concerted approach both inside and outside the Community. The system of contacts and exchanges of information should therefore be extended.

From the results so far achieved in the field of monetary policy it can be clearly seen that the longest stretch of the journey still lies ahead. The Community can only succeed if it progresses in every sector. As pointed out in Mr. Vals' report (Doc. 103/1963-64), unless parallel progress is made in all sectors the entire foundations of the Common Market will become distorted. The bases of a co-ordinated economic policy of the member States have in many cases yet to be created at national level. A co-ordinated monetary policy cannot be brought into existence until budget and fiscal policies have been more closely co-ordinated. Only by using all the available instruments in combination can success be achieved in the long run. European monetary union can be used as the keystone but not as the foundation of economic unity.

EEC Commission proposals

13. In its Eighth General Report the EEC Commission mentions four main directions in which it is seeking a solution (No. 134) :

(a) Complete unification of the Community in the matter of capital movements, whether for long-term or short-term investment ;

(b) Increasing harmonization of the instruments of monetary policy and greater solidarity between the member States in the matter of their policy towards non-member countries ;

(c) Intensified co-ordination of economic and financial policies to counteract economic imbalances.

The Parliament's task

14. In Mr. Kreyssig's report on the EEC Commission's Sixth General Report (Doc. 76/1963-64 of 8 October 1963, No. 415) attention is drawn to the problems arising from the restricted scope for supervision available in the parliamentary sphere. The danger of ill-defined responsibilities is evident. The European Parliament reiterates the request already made in Mr. Vals' report that the EEC Commission and Parliament participate in discussions at the various levels and study the results together at regular intervals. Of course, no country in the world plans changes in its currency's parity in the course of parliamentary debates. Parliament must however be able, in times of crisis, to form and express an opinion at short notice so that the executive bodies concerned can take its advice into account in reaching their decisions. Whetever happens, the existence of a large number of institutions must not be allowed to create doubts as to the unity of European economic policy. It is one of Parliament's major tasks to ensure this unity.

A federal monetary organization in Europe as a long-term objective

15. The European Parliament is fully alive to the difficulties of co-ordinating monetary policies. It welcomes the EEC Commission's cautious approach which keeps within the terms of the Treaty and takes existing structures into account. Only gradually, step by step, can a common monetary policy be brought into being. The final goal has already been described in Mr. Vals' report : *a federal organization of central banks of the EEC under a centralized body, a common monetary policy.*

First of all the obstacles standing in the way must be swept away one after the other. All member States today are experiencing the same difficulties. The pursuit of an identical end by a number of different routes must not be allowed to hamper the introduction of a common monetary policy.

II — Monetary problems inside the Community

The Community's monetary policy

16. What steps can be taken in the near future to advance the Community along the road leading to monetary union ? A study of the Monetary Committee's report, of the EEC Commission's Eighth General Report and, more especially, of the statements made by Vice-President Marjolin before the European Parliament on 23 March 1965, would suggest the following measures :

(a) Harmonization of fiscal, budget and short-term economic policies must be such as to establish in the Community a state of balance which would rule out the need for internal changes in rates of exchange and permit contractual consolidation of the rate ;

(b) The fact that the rate of exchange in individual EEC countries can be altered to an appreciable extent (as in the case of devaluation or upward revaluation) has a braking effect on the integration process. The Community must therefore outlaw such practices or make them impossible. In the meantime, however, it would serve a useful purpose if all settlements within the EEC could be carried out on entirely different lines. In fact, the existing clearing system, which in no way differs from that applied between the EEC and non-member countries, entails unnecessary costs and formalities and, owing to the authorized fluctuations of rates of exchange about parity, a measure of uncertainity. These peculiarities are hardly appropriate to a Community in which payments should be effected as in a unified monetary area.

17. Results of the kind desired can only be hoped for when co-operation is no longer confined to the intervention of central banks but is extended to budget policy, which is often more important for progress in monetary matters than the policy of central banks. In this respect the influence of budget policy on liquidity is of particular importance. The principles of a budget policy geared to monetary policy requirements must still be examined in detail.

Integration of capital markets

18. The Parliament has repeatedly deplored the inadequate progress made in creating a liberalized European capital market.

Liberalization of the movement of goods and services in the Community also depends on the free flow of capital. Uniform conditions of competition in a free market can only be established if all partners in a comparable position enjoy the same access to capital. The movement of capital among Community countries must therefore be freed.

Reform of national capital markets

19. All Community countries are today studying ways and means of increasing the availability of capital and directing it to points where it would be of the greatest economic utility. The Commission must bring the various national reforms into line with each other and with the Community's objectives.

20. The continued existence of restricted capital markets and of an excess of demand over supply remains the major source of common concern. This shortage of capital has not been without tangible results :

(a) In some Community countries the rate of interest has climbed to levels previously only experienced in overseas countries where risks were high ;

(b) The distribution of capital in some Community countries is subject to tight control. The treatment given varies from industry to industry so that the conditions of competition are distorted.

Interest rates

21. Movements of money and capital across the frontiers in a liberal, smoothly-running economy are the natural result of the pull exerted by areas of maximum productivity. Such movements should be encouraged rather than hindered. Problems arise only when capital movements are influenced by political rather than economic considerations.

22. In some European countries interest rates on medium-and long-term credits have climbed to 9 and even beyond 10 per cent. These are well above those demanded for comparable loans in the USA and Switzerland (where incidentally the trend is also upwards, though not to anything like the same extent as in Europe). What is at the root of these excessively high interest rates in Europe ?

Capital accumulation

23. The disparity between supply and demand on the capital market reflected in these exaggeratedly high rates of interest is not, as might be thought, the result of inadequate capital accumulation. Capital accumulation in relation to the gross national product is highly satisfactory in the Community. In the individual countries it accounts for between 20 and 27 per cent of the GNP, with the Federal Republic of Germany and the Netherlands in the lead. Capital accumulation stands at more or less the same level in Switzerland and a little lower (below 20 per cent ; see Annex IV) in Great Britain and the USA.

Comparison with the USA and Switzerland

24. A comparison of the Community's economic structure with that of the USA or Switzerland does not disclose the economic causes of the existing disparities in interest rates. To say that in the United States a higher proportion of capital is employed, and therefore gives a lower marginal yield, does not account for these differences in interest rates. Since economic and financial policies are the same, interest rates in all these countries should be more or less at the same level. This opinion is shared by American banking experts, who believe that the rate of interest on capital would settle down to about 5 per cent in the Community if inflationary trends could be mastered and if excessive political demand on the capital market—whether direct or through interest subsidies—could be brought down to an economically acceptable level.

Results of inflation

25. The main cause of excessively high interest rates is the inflationary trends that have set in in a number of member States. If the saver has to face an annual drop in the value of money of 4 per cent, he will be prepared to save only if he receives a rate of interest that offsets such depreciation. This pressure for higher interest rates is all the more marked if the prospective saver is fully aware of the existence of inflationary trends—still by no means always the case. It should also be remembered that interest is liable to income tax even where it merely offsets a fall in the value of money. In the event of an annual fall in value of 4 per cent with income tax standing (in the top bracket) at 50 per cent, interest at 8 per cent, which after tax leaves the saver only 4 per cent, does nothing more than compensate for the reduced value of the capital which, in fact, is earning no interest.

26. Now a lender can only secure a high interest rate if he can find a borrower prepared to pay it. The borrower, for his part, will only entertain a high rate if he anticipates an inflationary trend. Anyone who feels that the price of a purchase made today will be 4 per cent higher in a year's time, can tranquilly accept a relatively high rate of interest and, in fact, does so.

Steep interest rates have the following effects on the international capital market : inflation, when attended by a risk of devaluation, leads to a flight of capital which cannot be checked even by raising interest rates. But as long as there is no imminent danger of devaluation, high interest rates induced by inflationary trends attract foreign capital which, in its turn, may accentuate such trends. A capital influx of this kind can only be resisted by ridding the interest rate of inflationary elements through anti-inflationary measures.

Political pressures on the capital market

27. In addition to these inflationary factors, excessive demand for capital in the public sector also tends to send up interest rates. This excessive demand takes one of two forms :

(1) loans floated by governments and regional and local authorities ;

(2) loans in the private sector encouraged by grants of interest subsidies from the State (e.g. housing, agriculture).

Public loans

28. The loan policy pursued by the public authorities differs widely from one Community country to another. In some countries State requirements of capital, and demands from the private sector which the State considers worth encouraging, are met at interest rates which the States keeps at a low level by denying access to the capital market to other would-be borrowers. Such a course is particularly easy to follow in countries where the banking system is in the hands of the State.

29. The proportion of capital absorbed by the public sector traditionally varies from country to country. It differs widely in countries such as France and Italy where the capital market is controlled by the State. In the Federal Republic of Germany it has ranged in recent years between

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Comparable figures for other Community countries are not available.

34. If interest subsidies in Europe send up interest rates from 5 to 8 per cent, this means that a special charge of 3 per cent is being borne by other capital users—this in addition to the direct burden borne by the State in the form of interest subsidies. The proceeds of this special charge flow not to the State but to the saver to whom this additional income must be conceded. In the production sector, however, excessive interest rates send costs higher and higher. In this way, excessive demand for capital induced by State intervention exercises an additional inflationary influence.

35. Interest subsidies, which in many cases date back over a long period, have become an accepted and established fact and cannot therefore be abolished overnight. A basic decision must, however, be taken, and this should be on the following lines :

In the long run anyone engaging in economic activity ought to meet the actual cost of the goods or services he demands.

36. Now there will always be citizens whose incomes are too low to permit them to satisfy their wants at the prevailing cost price. In such cases the modern State must obviously extend a helping hand. Fellow-citizens must be assured of a decent standard of living even if they are incapable of achieving this through their own efforts.

This problem should, however, be tackled only in terms of specific cases and not by overall cuts in prices. The Community's interest subsidies are leading to a system whose consequences cannot be foreseen and which in individual cases is manifestly unjust.

37. In so far as economic policy requires intervention (see No. 31), interest subsidies should only be resorted to when capital is in ample supply and if the rise in demand resulting from such subsidies will not drive interest rates above the normal international level.

Where, on the other hand, an interest subsidy would ruin the capital market, the overall damage would exceed its specific utility. Loans out of public funds would then be preferable, even if they entailed a rise in taxes.

Anti-cyclical capital market policy

38. The State ought therefore to pursue an anti-cyclical capital market policy. In the event of a boom in interest rates, it should keep clear of the capital market as far as possible, even if this forces it to increase taxes. On the other hand, if the supply of capital is excessive, it should step in as a borrower. If, in previous years, it has granted loans out of current revenue, in years of low interest rates it can equally well cover current expenditure by borrowing, and in this way offset earlier lending operations on the capital market.

Increase in the supply of capital

39. If economic policy is to create and maintain a capital market operating at reasonable interest rates on a par with those of other major industrial countries, it must protect the capital market from excessive policy-related pressures. In addition it must seek out ways and means of achieving the highest possible volume of savings, and of bringing savings, which are mostly of a short-term nature, into line with the requirements of long-term capital investment. At the same time, the special features of individual member States and areas must not be lost sight of.

The route covered by savings capital from saver to borrower is sometimes costly and involved. Any reform should take into account the need to give small and medium-sized industry easier access to outside capital.

The European capital market

40. Only a large capital market can satisfy the needs of a large economic market.

The size of European undertakings must be increased to enable them to withstand competition from non-member countries. For this, capital is needed. Increasing competition, and the resulting fall in prices and rise in costs, have everwhere narrowed the scope for financing out of internal resources. In the long run only a capital market that is at once larger and more efficient than national markets can accumulate the funds needed to finance investment by major enterprises.

41. A large capital market is just as necessary for savers as for borrowers. Providers of capital would have more scope for placing their funds, with more evenly spread risks, and those seeking capital would be assured of far ampler supplies. The Economic and Financial Committee therefore supports the EEC Commission's aim of complete integration of capital markets in the Community.

Progress made in liberalization

42. What stage of liberalization has so far been reached? Two directives issued by the Council on 11 May 1960 and 18 December 1962 set out the liberalization measures so far decided upon [1]:

(a) *Liberalized unconditionally*: direct investment, transactions involving stock exchange securities, capital movements of a personal nature, real estate investment and short- and medium-term credits connected with commercial transactions. In these cases liberalization can only be cancelled under the Treaty's safeguard clauses.

(b) *Liberalized conditionally*: issue and placing of securities of foreign enterprises on national capital markets and loans of a purely financial nature. For these capital movements member States may maintain the restrictions in force on 11 May 1960, or introduce others, if the aims of their economic policy are threatened. Only three member States (France, Italy and the Netherlands) avail themselves of this facility. In France and Italy there is a trend towards extending this liberalization process. The remaining restrictions stem from the tendency found in these and other Community countries to gear economic policy onesidedly to credit and monetary policy, and therefore to assign to monetary tasks which it is incapable of carrying out on its own.

(c) *Not liberalized*: most short-term transactions, in particular those not connected with commercial operations. Annex I of the Council's second directive shows exactly what stage of liberalization has been reached. As regards the capital movements showns in List D, all Community countries exhibit a mixture of freedom, bans, and compulsory returns.

(d) *Excluded from liberalization*: in accordance with Article 68.3 of the EEC Treaty, loans issued by member States or their territorial sub-divisions on the territory of other member States. The State in which the issue takes place must signify its approval.

In the meantime the EEC Commission has put forward a proposal for a third directive providing for further cases of liberalization. The Council has not yet reached agreement on this proposal.

[1] See *Official Gazette* No. 43 of 12 July 1960, p. 921/60, and No. 9 of 2 January 1963, p. 62/63.

Fiscal obstacles to capital movements w
be reduced by the Commission's proposal f
directive which provides for the abolition or
monization of indirect taxes on capital m
ments (stamp duty and tax on capital bro
into companies by members). This proposal,
has not yet been approved by the Council.

Limits of a national monetary policy

43. The restrictions resulting from the exch
controls referred to in No. 41 no longer
their former role. At one time their purpose
to safeguard currency. Experience has sh
that there are many ways of evading these
visions, particularly in the case of short-t
movements of money and capital. The fact
such evasion is easier for large enterprises
the smaller ones, of course, at a disadvanta

44. In favour of the last remnants of the
exchange control system—in its time both com
hensive and effective—it is sometimes ar
that they serve as a valuable adjunct to nati
short-term policy instruments.

Experience with discount policy has sh
the extent to which the scope of a detached,
tional policy has been narrowed down. M
borrowers today show a large measure of in
ference to rises in interest rates, particularl
the public sector. This point has already
raised in No. 29.

This is why an interest policy that
higher interest rates to combat excessive upw
trends generally attracts a flow of money
capital from abroad that can accentuate in
tionary tendencies.

The discount rate remains, as in the p
a major tool of monetary policy, but in
present state of liberalization any attempt t
fluence economic trends simply with the ai
monetary policy instruments leads to unde
ble side-effects which at times more than n
the success achieved by manipulating the
count rate. A return to the old system of
control of money and capital movements is
of the question. New solutions must be sou

Community policy in place of national poli

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29. The proportion of capital absorbed by the public sector traditionally varies from country to country. It differs widely in countries such as France and Italy where the capital market is controlled by the State. In the Federal Republic of Germany it has ranged in recent years between

17 and 24 per cent, in Belgium between 50 and 60 per cent. The percentage in Switzerland has been appreciably lower, while in the United States it has fluctuated between 11 and 53 per cent. Detailed figures are given in Annex V.

The share of the capital market taken up by the public authorities does not appear as yet to give cause for concern. Nevertheless demand in that sector has, for various reasons, accentuated the rise in interest rates caused by inflationary trends.

30. It has been found that demand for capital in the public sector is in some cases largely unaffected by a rise in interest rates. Where expenditure is planned for policy reasons and cannot be met out of current tax receipts, the necessary capital is frequently raised, once a project has taken shape, at the prevailing interest rates, even where these are excessive. In the public sector, therefore, the braking effect of rising interest rates sets in only after a substantial lag.

Interest subsidies

31. In addition to the demand for credit in the public sector, there is a policy-related demand far in excess of requirements the return on which would justify the rates charged on the market. Most Community countries grant interest subsidies which artificially reduce the cost of credits allotted for housing, agriculture and many other projects. There are housing loans on which the owner pays interest at only 1 per cent per annum, the balance being borne by the public authorities.

Steps for promoting certain sectors of the economy

32. This state of affaires, as experience has shown, is hotly defended by its champions who stress the importance of, say, agriculture and housing for progress in the Community, and reject any reduction of an existing subsidy as unacceptable.

It should be pointed out right from the start that no one questions either the importance of these sectors or the need for State intervention in this or that particular sector.

All that is at issue is the form taken by such intervention. Among the means that may be resorted to, interest subsidies, which apparently place a relatively light burden on the national budget and are therefore highly popular,

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overlooked.

Artificially swollen

33. Interest subsidies
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subsidies

Moreover, in the
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on the capital market
words, had it not been
the public sector would
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for interest subsidies
sector's share of the
33 per cent. Even on th
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to in No. 23 above,
Europe would settle d
if it were not for intere
policy-related demand f

Comparable figures for other Community countries are not available.

34. If interest subsidies in Europe send up interest rates from 5 to 8 per cent, this means that a special charge of 3 per cent is being borne by other capital users—this in addition to the direct burden borne by the State in the form of interest subsidies. The proceeds of this special charge flow not to the State but to the saver to whom this additional income must be conceded. In the production sector, however, excessive interest rates send costs higher and higher. In this way, excessive demand for capital induced by State intervention exercises an additional inflationary influence.

35. Interest subsidies, which in many cases date back over a long period, have become an accepted and established fact and cannot therefore be abolished overnight. A basic decision must, however, be taken, and this should be on the following lines :

In the long run anyone engaging in economic activity ought to meet the actual cost of the goods or services he demands.

36. Now there will always be citizens whose incomes are too low to permit them to satisfy their wants at the prevailing cost price. In such cases the modern State must obviously extend a helping hand. Fellow-citizens must be assured of a decent standard of living even if they are incapable of achieving this through their own efforts.

This problem should, however, be tackled only in terms of specific cases and not by overall cuts in prices. The Community's interest subsidies are leading to a system whose consequences cannot be foreseen and which in individual cases is manifestly unjust.

37. In so far as economic policy requires intervention (see No. 31), interest subsidies should only be resorted to when capital is in ample supply and if the rise in demand resulting from such subsidies will not drive interest rates above the normal international level.

Where, on the other hand, an interest subsidy would ruin the capital market, the overall damage would exceed its specific utility. Loans out of public funds would then be preferable, even if they entailed a rise in taxes.

Anti-cyclical capital market policy

38. The State ought therefore to pursue an anti-cyclical capital market policy. In the event of a boom in interest rates, it should keep clear of the capital market as far as possible, even if this forces it to increase taxes. On the other hand, if the supply of capital is excessive, it should step in as a borrower. If, in previous years, it has granted loans out of current revenue, in years of low interest rates it can equally well cover current expenditure by borrowing, and in this way offset earlier lending operations on the capital market.

Increase in the supply of capital

39. If economic policy is to create and maintain a capital market operating at reasonable interest rates on a par with those of other major industrial countries, it must protect the capital market from excessive policy-related pressures. In addition it must seek out ways and means of achieving the highest possible volume of savings, and of bringing savings, which are mostly of a short-term nature, into line with the requirements of long-term capital investment. At the same time, the special features of individual member States and areas must not be lost sight of.

The route covered by savings capital from saver to borrower is sometimes costly and involved. Any reform should take into account the need to give small and medium-sized industry easier access to outside capital.

The European capital market

40. Only a large capital market can satisfy the needs of a large economic market.

The size of European undertakings must be increased to enable them to withstand competition from non-member countries. For this, capital is needed. Increasing competition, and the resulting fall in prices and rise in costs, have everywhere narrowed the scope for financing out of internal resources. In the long run only a capital market that is at once larger and more efficient than national markets can accumulate the funds needed to finance investment by major enterprises.

41. A large capital market is just as necessary for savers as for borrowers. Providers of capital would have more scope for placing their funds, with more evenly spread risks, and those seeking capital would be assured of far ampler supplies. The Economic and Financial Committee therefore supports the EEC Commission's aim of complete integration of capital markets in the Community.

Progress made in liberalization

42. What stage of liberalization has so far been reached ? Two directives issued by the Council on 11 May 1960 and 18 December 1962 set out the liberalization measures so far decided upon [1] :

(a) *Liberalized unconditionally :* direct investment, transactions involving stock exchange securities, capital movements of a personal nature, real estate investment and short- and medium-term credits connected with commercial transactions. In these cases liberalization can only be cancelled under the Treaty's safeguard clauses.

(b) *Liberalized conditionally :* issue and placing of securities of foreign enterprises on national capital markets and loans of a purely financial nature. For these capital movements member States may maintain the restrictions in force on 11 May 1960, or introduce others, if the aims of their economic policy are threatened. Only three member States (France, Italy and the Netherlands) avail themselves of this facility. In France and Italy there is a trend towards extending this liberalization process. The remaining restrictions stem from the tendency found in these and other Community countries to gear economic policy onesidedly to credit and monetary policy, and therefore to assign to monetary tasks which it is incapable of carrying out on its own.

(c) *Not liberalized :* most short-term transactions, in particular those not connected with commercial operations. Annex I of the Council's second directive shows exactly what stage of liberalization has been reached. As regards the capital movements showns in List D, all Community countries exhibit a mixture of freedom, bans, and compulsory returns.

(d) *Excluded from liberalization :* in accordance with Article 68,3 of the EEC Treaty, loans issued by member States or their territorial sub-divisions on the territory of other member States. The State in which the issue takes place must signify its approval.

In the meantime the EEC Commission has put forward a proposal for a third directive providing for further cases of liberalization. The Council has not yet reached agreement on this proposal.

Fiscal obstacles to capital movements would be reduced by the Commission's proposal for a directive which provides for the abolition or harmonization of indirect taxes on capital movements (stamp duty and tax on capital brought into companies by members). This proposal, too, has not yet been approved by the Council.

Limits of a national monetary policy

43. The restrictions resulting from the exchange controls referred to in No. 41 no longer play their former role. At one time their purpose was to safeguard currency. Experience has shown that there are many ways of evading these provisions, particularly in the case of short-term movements of money and capital. The fact that such evasion is easier for large enterprises puts the smaller ones, of course, at a disadvantage.

44. In favour of the last remnants of the old exchange control system—in its time both comprehensive and effective—it is sometimes argued that they serve as a valuable adjunct to national short-term policy instruments.

Experience with discount policy has shown the extent to which the scope of a detached, national policy has been narrowed down. Many borrowers today show a large measure of indifference to rises in interest rates, particularly in the public sector. This point has already been raised in No. 29.

This is why an interest policy that uses higher interest rates to combat excessive upward trends generally attracts a flow of money and capital from abroad that can accentuate inflationary tendencies.

The discount rate remains, as in the past, a major tool of monetary policy, but in the present state of liberalization any attempt to influence economic trends simply with the aid of monetary policy instruments leads to undesirable side-effects which at times more than offset the success achieved by manipulating the discount rate. A return to the old system of rigid control of money and capital movements is out of the question. New solutions must be sought.

Community policy in place of national policy

45. If Community countries were to step up the use of other tools of short-term economic policy, particularly their budget and fiscal policies, and to co-ordinate such action more closely

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[1] See *Official Gazette* No. 43 of 12 July 1960, p. 921/60, and No. 9 of 2 January 1963, p. 62/63.