EUROPEAN ECONOMIC COMMUNITY

SEVENTH REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

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Brussels, 12 February 1965

INTRODUCTION

The purpose of this report is to give a general picture of the activities of the Monetary Committee of the European Economic Community. The Committee itself held twelve meetings in 1964, while the Committee of Alternates and the working parties set up by the main Committee during the year to examine the monetary and financial situations of the member countries also met on a number of occasions.

Article 7 of its Statute provides that: "The Committee shall elect from among its members, by majorities comprising not less than eight votes, a chairman and two vice-chairmen for a term of two years." These officers of the Committee having completed their term, the Committee unanimously elected jonkheer Mr. E. van Lennep, Treasurer-General in the Netherlands Ministry of Finance, as chairman and M. B. Clappier, second Vice-Governor of the Bank of France, and Dr. O. Emminger, a member of the Bundesbank Direktorium, as vice-chairmen. A list of members is appended to this Report.

In 1964 the Committee co-operated even more closely than in the past with the other Community committees and authorities. The chairman attended or was represented at all the meetings of the Short-term Economic Policy Committee, and the chairmen of these two Committees took part in the periodic meetings of the Ministers of Finance. The chairman also participated in the discussions in the EEC Council devoted to the Council's Recommendation for measures to be taken to restore the internal and external economic equilibrium of the Community.

This report was completed on 1 February 1965. It therefore does not take into account economic developments or measures adopted after that date, whether within the Community or, for example, in the United States.

Chapter I

GENERAL CONSIDERATIONS ON THE CO-ORDINATION OF MONETARY POLICIES

1. Although 1964 was not a year of spectacular developments, the gradual process of monetary integration within the European Economic Community advanced in a number of fields. The monetary authorities made every endeavour, when implementing their domestic policies and when taking decisions or fixing their attitudes on matters more concerned with the international sphere, to carry economic union between the six Member States a stage further. The co-ordination of their activity in this direction is one of the main tasks of the Committee; it must also see that integration develops in a climate of economic and monetary stability within the Community and of constructive co-operation with the outside world.

2. The general economic development of the Community – with the imbalances that appeared in 1963 and began to recede towards the end of 1964 – has illuminated the considerable degree of interdependence already reached by the economies of the Member States. Inflationary pressures originating in certain member countries spread very rapidly to the other countries of the Community, impairing the internal balance of these countries also. The problem of financing the deficits has not been critical in the Community, since it disposes of ample foreign exchange reserves. In the circumstances, the right solution to the "contamination" problem lay in the implementation of adjustment policies designed to remedy the causes of imbalance.

When on 15 April 1964 the Council adopted, on a proposal from the Commission, a common and generalized anti-inflation programme – the implementation of which it is now watching – it showed a correct appreciation of what the situation required. The Committee, which helped elaborate the Recommendation put forward by the Council and is closely associated with its implementation, attaches the greatest importance to this first joint decision on the main lines of the economic and financial policy to be pursued by the competent authorities of the Community member countries.

3. Discussions on international monetary problems, in which the member countries have taken an active part, have also shown how necessary it is to secure close co-ordination between the policies followed by these countries. In accordance with the practice introduced some years ago and to which the Council's decision of 8 May 1964 gave a formal basis, the Committee has done everything in its power to promote such co-ordination. One example is its work in connection with the preparation of the study on the general functioning of the international monetary system and on international liquidity problems, which was published in 1964 by the "Group of Ten", and another is its action when certain

questions arose relating to the International Monetary Fund, such as the provision of additional resources for this institution and the IMF's call on the "General Arrangements to Borrow" when the United Kingdom made a drawing on the IMF.

4. In 1964 the Committee also discussed the monetary problems involved in the working out of a common agricultural policy – to be applied from July 1967 onwards – notably in the fixing of common farm prices. The Committee has consequently had to express their views on the monetary implications of the fixing of common farm prices and whether these prices should be expressed in units of accounts or otherwise.

5. Developments in the three fields referred to above are discussed in more detail below.

6. At regular intervals the Committee has examined the economic and monetary situation in the member countries, and the results of these examinations will be outlined in Chapter II. It should be recalled here that early in 1964 both France and Italy were suffering from clearly inflationary movements and that strains had grown severer in the Benelux countries, while the Federal Republic of Germany was enjoying conditions of near stability; a very heavy deficit on current account in Italy contrasted with a considerable surplus in the Federal Republic : in the first quarter of 1964 the surplus in the Federal Republic was $425 million. Gross gold and foreign exchange reserves of the Bank of Italy had dwindled by $235 million in the same period.

The main source of these payments disequilibria was intra-Community trade. In the first quarter of 1964, for example, the Federal Republic's surplus on trade with the other Community countries was nearly $200 million higher than in the same quarter of 1963, while in Italy the deficit on trade with the other EEC countries was nearly $70 million heavier than a year before.

7. These facts not only indicated that economic trends in the various member countries were out of phase, but – and this is more important – that by a contamination process excess demand was spreading from one country to another. This was a threat to the internal stability of the economies of all member countries and might have meant that inflationary strain had come to stay in all six countries, thus undermining the Community's external position. The new trend also raised a series of political problems, since if balance-of-payments difficulties had got out of hand they might have endangered the internal cohesion of the Community.

8. When carrying out its periodic examination of the economic situation in the member countries, the Committee had drawn the attention of the Council and of the Commission to the need for the Member States to co-ordinate their policies and to strengthen the measures adopted to adjust these trends and to bring inflation under control. It had, in particular, emphasized the direct impact of any serious strains in one country on the economy of the entire Community. It was the development of such strains, on a scale which had been particularly pronounced in the

case of Italy, which had led the Commission to initiate, in agreement with the Italian authorities, the procedure laid down in Article 108 of the Treaty. In accordance with the provisions of this article, the Community authorities recommended the adoption of an adjustment policy aimed at the prompt and effective correction of inflationary tendencies.

The EEC Council, faced with the threatening situation in the Community, adopted a Recommendation, dated 15 April 1964, which calls on the Member States to take action with a view to the re-establishment of the internal and external equilibrium of the Community. The Council adopted in this document the principle of giving stability of prices and costs priority over all other economic policy objectives. The Recommendation specifies the means to be employed, and lays down in particular that the expansion of public expenditure should not exceed 5% per annun. What is significant is that here, for the first time, a decision was taken establishing a scale of priorities and giving rules backed by figures. This joint decision on the main lines of the economic and financial policies to be pursued in the member countries of the Community also gave the authorities in each of the countries considerable additional support in their fight against inflation.

9. In general the policies pursued by the Member States have been in line with the Recommendation. Among the measures adopted, the following may be noted: in France, maintenance of the action initiated early in 1963 to contain the expansion of credit, and curbing of the expansion in public expenditure, thanks to which budget transactions yielded a surplus in 1964; in Italy, the implementation of a restrictive monetary policy during the first half of 1963, the increasing of a number of indirect taxes and the limitation of the growth of central government expenditure; in the Federal Republic, the curtailing of the expansion of central government expenditure, steps taken by the Bundesbank to encourage exports of short-term capital as part of a more restrictive monetary policy, the advance reduction of rates of duty on imports from Community countries and the announcement of the decision to levy a tax on securities held by non-residents; in the Netherlands, the increasing of certain indirect taxes, the spreading over a longer period of public works programmes, the application of a restrictive monetary policy, and the limitation of the expenditure of local authorities; in Belgium, the strengthening of price supervision, the introduction of credit restrictions, the spreading over a longer period of public investment expenditure, the curbing of the increase in overall central government expenditure and the introduction of more stringent terms for the granting of loans for building and for hire-purchase sales.

10. The total effect of the measures taken by the Member States was a gradual move back towards equilibrium.

The deficit on the Community's trade balance, which was still growing at the beginning of 1964, started to decline towards the middle of the year. Trade between the member countries developed on appreciably more balanced lines: the surplus on the Federal Republic's trade, which had been running at nearly $400 million in the fourth quarter of 1963, fell to about $40 million in the last quarter of 1964. At the same time, the heavy deficit of $200 million on Italy's trade was replaced by a surplus of $70 million, and the Netherlands deficit fell appreciably ($25 million in the last quarter of 1964, against $130 million in the fourth quarter of 1963). For the full year 1964 the Community as a whole had a surplus on current account somewhere between $200 million and $500 million. Monetary reserves (i.e. net gold and foreign exchange holdings of the banking system plus claims on the IMF) rose sharply; the increase was about $1 500 million. The increase in the monetary reserves of the Community countries was therefore largely due to net imports of capital.

11. In the Benelux countries, and to a lesser extent in Italy, the upward thrust of consumer prices eased as the year wore on, while in the Federal Republic and France it was relatively mild from the start. There was also a tendency for the rise in unit production costs to level out.

It should, however, be observed that the upward price movement has not yet been brought to a halt; in 1965, an increase of some 3-4% for the Community as a whole is to be feared.

Experience in the past year has shown that inflationary trends cannot successfully be fought unless a wide range of instruments is available to those responsible for monetary policy, public finance policy and wage policy. It would seem that in some member countries the means used were not sufficiently diversified and that too much emphasis was consequently placed on monetary measures.

12. That inflationary tendencies within the Community should have coincided with an increase in monetary reserves raises the question how far strains occurring in the Community can be put down to " imported inflation ", i.e. the transmission of inflationary pressures through the balance of payments. Now, an increase in short-term claims on abroad is apt to lead to an increase in money supply at home. However, the authorities are not entirely helpless in the face of this phenomenon, for by using the various instruments available to them they can put a brake on the formation of domestic liquidity.

But the contraction of domestic liquidity is no easy task when the payments surplus affects domestic demand directly, as it does when it derives from a surplus on current account or from a net inflow of capital for certain kinds of direct investment. In principle, a policy of neutralizing inflationary forces from abroad will encounter fewer obstacles when the surplus stems from purely financial transactions, although beyond certain limits its implementation becomes increasingly difficult. In any case, as long as the accumulation of gold and foreign exchange reserves continues, it is not easy to convince public opinion of the need to accept some degree of discipline.

Although inflation in the Community was in the past due in part to the effects of developments abroad, it should be noted that more recently, and especially during the last two years, the pressure from outside has eased. Inflation is now due mainly to trends originating in the member countries themselves, and it must be fought with domestic measures.

13. Apart from the effects of the recent speculation against the pound sterling, the main counterparts in 1964, as in previous years, of the surpluses of the EEC countries were the continuing deficits of the United States balance of payments, and more especially US exports of capital. This problem is being studied in various quarters, and there have been a number of suggestions on how it should be remedied.

The suggestions sometimes lay emphasis on weaknesses in the organization of certain European capital markets; it is argued that if the markets were operated more efficiently, a better equilibrium in international movements of capital could be achieved. It is true that such adjustments are indispensable in the interests of the harmonious development of the Community itself, given that some of these markets are still suffering from the disturbances and in particular from the inflation by which they were beset in the two postwar periods. But even if such structural improvements had, in the near future, all the hoped-for effects, they would make only a limited contribution to solving the problem posed by the Community's need to step up its exports of capital, particularly to the developing countries. The Community's role as net exporter of capital is particularly important at the present time in view of the persistent net inflow of capital.

14. For it must not be forgotten that capital movements towards the Community countries are encouraged by the continued availability of relatively ample funds on the American capital market. The question therefore arises as to what should be the attitude of the Community countries towards the recurrent deficits on the United States balance of payments. This problem has since 1960 been the subject of many international discussions at which the American authorities have presented programmes designed to bring their balance of payments into equilibrium. The execution of these programmes has achieved appreciable results; the surplus on current account last year is thought to have been of the order of $8 000 million. It is doubtful whether it will be wise or desirable to work towards a further increase in a surplus of this magnitude. Between 1960 and 1964 the balance of all transactions on current account and of government transactions of all kinds showed a net improvement of about $3 000 million. But during the same period the balance of capital transactions deteriorated by about $2 000 million net.

15. There is therefore no doubt that capital transactions are the item which calls for attention if the American deficit is to be corrected. It is hard to see how this can be done as long as the American capital markets enjoy their present ample supplies of funds. Accordingly it is pertinent to inquire how far it is right for the Member States to contribute, through the accumulation of short-term claims on the United States, to the financing of a payments deficit due at least in part to an outflow of capital which, because much of it finds its way into the Community, is liable to hamper the stabilization drive in the six countries.

16. In this respect it should be noted that in 1964 the American deficit was financed largely through the holding of dollars by developing countries, which can be expected to use part of these increased funds in 1965 to step up their purchases. If and in so far as the dollar holdings of the developing countries are transferred to Community countries, which usually

hold a large share of their reserves in gold, the United States might find itself required to cope not only with the problem of financing the 1965 deficit, but also with the need to refinance that of 1964.

17. Last year the Committee exchanged views on a number of occasions in connection with the decision to place special resources at the disposal of the IMF under the General Arrangements to Borrow.

The General Arrangements were called into play because the United Kingdom — faced with a 1964 payments deficit of some £800 million, or more than $2 200 million — drew $1 000 million on the IMF. Since the assistance rendered under the General Arrangements comes largely from the Community countries ($335 million out of a total of $405 million) and since the Central Banks of these countries also contributed a large share of the international assistance which it subsequently proved necessary to afford the Bank of England, consultations are still needed within the Monetary Committee on the attitude to be adopted by Member States in their talks with the United Kingdom authorities and in the IMF.

18. The Member States of the Community have a direct interest in the pursuit by the British authorities of a policy ensuring the re-establishment of equilibrium in the United Kingdom balance of payments. This is because this account must be brought back into balance if serious disturbances in the international monetary system are to be avoided, and also because the United Kingdom deficits add to the inflationary pressures that still persist in the Community. Moreover if the freedom of international trade built up at the price of considerable effort since the end of the second world war is to be maintained, the UK import surcharge must be dropped in the near future.

19. Consultations have also been held in the Committee concerning the general raising of IMF quotas. It has examined the details of this operation and more particularly the measures that might be taken to reduce the drain on United States and United Kingdom reserves that may result from the gold payments made to the Fund: those countries holding the greater part of their reserves in dollars or in sterling might find it necessary, because of the raising of their quotas, to convert reserve currency holdings into gold so as to be able to discharge their obligations to the Fund.

20. The general raising of quotas, possibly accompanied by an additional increase in the quotas of certain Community countries, would further swell the resources which Member States are already placing at the disposal of the IMF. At the end of 1964, outstanding drawings on the IMF totalled $2 622 million. Of this total, $857 million was financed by IMF sales of gold, while of the balance of $1 765 million, $1 473 million — more than 80% — was in the form of drawings on Community currencies.

21. The Committee continued its consultations on the general working of the international monetary system. A study was published last year by the group of ten countries which had concluded the General Arrangements to

Borrow with the IMF. As part of the General Arrangements they have undertaken to procure special resources for the Fund in specific situations; consultation in the Committee has meant that certain opinions held within the Community have been aired in discussions in the Group of Ten.

22. The Committee welcomes the agreement reached in the Group of Ten on the usefulness of participating, through the international institutions which are already concerned with these problems, in a "multilateral surveillance" of the ways and means of financing the balance-of-payments disequilibria. Such surveillance is designed to help the monetary authorities to avoid excesses or shortages in the means of financing surpluses or deficits in the balance of payments, as well as to discuss measures appropriate for each country in accordance with the general economic outlook.

The Committee also regards as noteworthy the conclusion reached by the Group of Ten that the smooth functioning of the international monetary system depends on the avoidance of major and persistent international imbalances and on the effective use of appropriate policies by national governments to correct them when they occur.

Lastly, the Committee feels it must stress the importance it attaches to the constitution of a study group to examine various proposals regarding the creation of reserve assets either through the IMF or otherwise. It feels that this study is all the more important since there is no immediate prospect of a currency of one of the six countries assuming the functioning of an international reserve currency. Indeed, at the present junction such a development could raise problems without substantially strengthening the international monetary system.

23. On 15 December 1964, the Council adopted certain decisions concerning the implementation of the common agricultural policy. The Committee has examined the implications in the monetary field of the adoption of common farm prices and the question of how these common prices should be expressed.

24. The common agricultural market in its final stage, which should be reached in 1967, involves the removal of all intra-Community obstacles to the movement of farm produce, and the unity of the market will mean a permanent arrangement for common prices throughout the Community. The Committee has concluded that of the two methods of expressing prices – in national currencies or in units of account – the unit-of-account method is to be preferred, since it would afford an automatic price safeguard in the event of any change in the cross rates between member countries and would more firmly secure the working of the markets at Community level, particularly from the point of view of relations with the outside world.

But the existence of common prices and their expression in units of account would mean that any such change, especially if it were on an appreciable scale, could have major economic repercussions, since prices of agricultural commodities would change automatically and immediately, and these changes would affect both farmers' incomes and consumer prices.

25. The Committee therefore went into the question whether the adoption of the unit of account would mean that the member countries must forgo their freedom to devalue or revalue their currencies – an important instrument of monetary policy. It concluded that progressive integration within the EEC, and particularly the tendency for the respective prices of a growing number of products to settle at much the same level throughout the Community, will make devaluation or revaluation increasingly difficult and unlikely. The establishment of a single agricultural market will strengthen this trend. However, the Comm ttee considered that even so it would still be possible for a State to adjust the exchange rate of its currency, should this prove necessary in order to safeguard, for example, the smooth working of the Common Market itself.

26. Should this happen, it would be desirable for machinery to be available which could be used to soften the impact of the change.

The arrangement could be as follows : while the appropriate EEC authorities examined as rapidly as possible the situation created by devaluation or revaluation in the Community from both the agricultural and monetary points of view and took the necessary decisions – which could, if this were deemed desirable, involve an adjustment to Community prices – interim measures might be taken to cushion the impact of the automatic changes in farm prices in the Member States concerned.

27. Although revaluation and devaluation within EEC have become more difficult and unlikely, circumstances could still render the one or the other unavoidable. Because of the common interest of Member States in this sphere, suitable procedures must be agreed. For this reason the Member States meeting in Council agreed in 1964 on the need for consultation prior to any alteration in the rate of exchange of a Member State's currency, and that the Commission should take part in the discussions.

28. The prospects opened by the implementation of the common agricultural policy and experience gained in the last two years in the fight against inflation have brought out more clearly than before the nature of the evolutionary process of economic integration in the Community. As integration gains ground, changes in overall demand, costs and prices in one or more member countries make themselves felt with increasing speed throughout the Community. Given that the economic situation in each member country depends on economic development in the Community as a whole, it is becoming increasingly difficult for the authorities of a Member State to influence their own economic development in isolation by pursuing independent monetary, fiscal or incomes policies or by altering their exchange rates. Should the internal balance of one or more Member States be severely impaired, the stability of the Community as a whole is more and more likely to be threatened. The overall development of the six Community countries between 1963 and 1964 shows how far they have already travelled along the road to complete interdependence.