EUROPEAN ECONOMIC COMMUNITY

NINTH REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

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Brussels, 1 March 1967

INTRODUCTION

The purpose of this report is to show briefly how the policies of the Member States are being co-ordinated in the monetary and financial fields, which are those with which the Monetary Committee is specifically and directly concerned.

In the course of the year the Committee held ten meeting, and the working parties dealing with the monetary and financial situations in the member countries met on several occasions.

The officers having completed the two-year term fixed in the Statute, the Committee unanimously re-elected Jonkheer E. van Lennep, Treasurer-General in the Netherlands Ministry of Finance, as Chairman, and M. B. Clappier, 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.

The report was adopted on 1 March 1967. It does not take into account economic developments or measures adopted after that date, whether in the Community or elsewhere.

PART I

Chapter I

GENERAL CONSIDERATIONS

1. Ten years have passed since the Treaty establishing the European Economic Community was signed in Rome. This is therefore a not inappropriate moment for the Committee to ask themselves what were the intentions of its authors with regard to co-operation on monetary and financial policy — those with which the Committee is directly and specifically concerned — and to see how far the procedures used have been effective and to consider whether experience suggests improvements. The experience gained in these ten years will be the first topic to be covered, the second will be the prospects for the future.

The general background

2. Article 104 of the Treaty of Rome requires each of the Member States to pursue "the economic policy necessary to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while ensuring a high level of employment and the stability of the level of prices". Article 105 created the Monetary Committee to help in the attainment of these objectives in the monetary and financial fields.

3. With the work allotted to it since the signing of the Treaty of Rome, the Committee today faces four main tasks:

— To promote the co-ordination of the monetary and financial policies of the Member States;

— To follow and report regularly to the Council and the Commission on the monetary and financial situations of the Member States and on their general payments arrangements;

— To elaborate opinions on ways and means of eliminating — to the extent necessary for the smooth working of the Common Market — all restrictions on the free movement of capital between the Member States;

— To carry out consultations with a view to harmonizing the major decisions and policies of the Member States in the field of international monetary relations, notably with regard to the functioning of the international monetary system and the participation of the Member States in major monetary support operations.

4. Article 104 sets for the Member States three economic objectives which are well known and universally approved: payments equilibrium, high employment, and price stability.

This article, which comes immediately after the declaration that short-term economic policy is a matter of common interest, is the first in the Chapter on the balance of payments. It specifies in a particular field the import of the general objective set for the Community by Article 2 of the Treaty, which calls for "steady and balanced expansion" of the member countries' economies.

The emphasis in this article is on the fact that equilibrium in the overall balance of payments is the over-riding objective of economic policy in each Member State — it being understood that the latter cannot of course disregard employment and price-levels. This approach reflects the climate of opinion at the time, when the main threat to the effective implementation of the Common Market was felt to be the precarious international payments relations and the inadequacy of the reserves held by certain Member States.

5. In fact there have been a number of developments in the last ten years which could hardly have been foreseen in 1957 and which have to some extent changed the conditions under which the Treaty has been implemented.

The re-establishment of the external convertibility of the European currencies at the end of 1958 and the complementary measures taken to facilitate the movement of capital have gone far towards eliminating the obstacles that were hampering external trade and capital movements across frontiers. The momentum of the Common Market, too, has been an incentive for more capital from other industrialized countries to flow towards the Community.

Growth in the Common Market has continued at a high rate, and this has been mainly due to the considerable expansion of production capacity that has stemmed from the high rate of investment coupled with a sharp increase in productivity. These developments have helped to strengthen substantially the competitive position of the Member States vis-à-vis non-member countries, thus engendering large and persistent surpluses on the Community's trade with the rest of the world.

Meanwhile, the deficits experienced by the United States of America in recent years have been exerting a profound influence on international monetary relations and in particular on the EEC.

The Community's progress has also been facilitated by the substantial and lasting improvement in the economic, monetary and financial situation of France that has followed the stabilization measures adopted by that country in 1958 and the new exchange rate subsequently adopted.

Lastly, all member countries have suffered, at different times and to varying degrees, from periods of inflationary pressure due to internal factors.

Internal and external equilibrium

6. From the point of view of the co-ordination of economic policy within the European Economic Community, these developments have meant that the problems connected with internal and external equilibrium have not been of the types anticipated. Instead of heavy and persistent payments deficits or a marked weakening of domestic demand, the Member States have had to cope with external surpluses and domestic strain. For this reason the Committee has devoted a considerable part of the time at its disposal to examination of these economic and monetary problems which are at one and the same time internal and external. It has frequently stated its views on these problems in the regular reports it makes to the Council and to the Commission on the monetary and financial trends in the Member States and in the opinions which it has formulated on specific proposals submitted by the Commission to the Council.

7. The emergence of heavy payments surpluses or deficits is almost always evidence that the domestic equilibrium has been upset. Since the task of ensuring general economic equilibrium is the responsibility of the public authorities in each Member State, it is not sufficient for the Committee to consider only the overall payments balance between the Community and non-member countries. For example, no one could claim that the Dutch payments deficit of 1966 was immaterial because in the same year Italy had a heavy surplus. It would also be a mistake to imagine that the heavy external payments surplus expected for 1967 in Germany would be a development of no importance because it is likely to be offset, at least in part, by a deterioration in the external payments balances of Italy and of France. Such changes in the balances between the individual countries in the Community inevitably upset the economic equilibrium of each, and therefore call for corrective measures, which should not be delayed by excessive resort to the palliative offered by compensatory movements of short-term capital.

8. The growing interpenetration of the national economies within the EEC has meant that economic trends in the Member States are increasingly dependent one upon the other. The development of inflationary strain in one member country has often provoked inflationary symptoms in the economies of the others, contamination being carried by the balances on current account. The Committee has on several occasions drawn attention to this phenomenon in its annual reports.

Today, then, attainment of the economic objectives of each Member State depends in very large measure on the way the economy develops in the other member countries. But despite what the authors of the Treaty may have feared, the essential danger has lain not in developments which might have forced the authorities to abandon measures to liberalize the movement of goods and capital and thus have jeopardized the establishment of the Common Market: it is the actual domestic equilibrium of the countries themselves which has been threatened. Price stability has been endangered and in all member countries experience has shown that when sufficient vigilance is not exercised in this field, employment and the economic growth in general will in the long run suffer. It has thus become clear that the Community, and consequently the Monetary Committee, cannot avoid concerning itself with the conditions which affect the economic and financial equilibrium in each Member State.

9. But it has also become clear that even in the present advanced phase of integration economic trends may differ from one country to another, leading the Member States to adopt conflicting measures which inevitably affect the economies of the other countries and may in certain cases produce results which actually hamper achievement of the objectives being pursued by the authorities of these other countries. The divergent trends in the various member countries have certainly sometimes contributed to greater short-term economic stability in the Community taken as a whole, but on other occasions inflationary trends have had a cumulative effect. The principle of co-ordinating national policies should therefore be applied in such a way that the measures adopted in one or more Member States hamper as little as possible the economic policies pursued by their partners and enable the common objectives outlined in the Treaty to be safeguarded in the Community as a whole.

The instruments of economic policy

10. In previous annual reports, the Committee has repeatedly stressed the importance of the range of instruments available for ensuring that the objectives of internal and external monetary and economic policy will be attained; it has also stressed how important it is that the countries should in fact be ready to use these instruments.

a) Budget policy

11. In this context, budget policy has a major role to play. It must, however, be conceded that in the past there have been many gaps in the fabric of budget policy. In most member countries the authorities, and in certain cases the local authorities in particular, have definitely helped to aggravate economic strain.

12. By 1962, central government expenditure was almost everywhere beginning to expand at a rate which soon tended to exceed that of the increase in the national product at current prices. Expenditure by the local authorities also expanded at a rapid pace, mainly because of the needs of urbanization. These considerations have made increasingly clear the limits of work in the purely monetary field and induced the Council of the Community to break new ground.

13. The Council's short-term economic policy recommendations of 15 April 1964 laid the main emphasis on the need to curb sharply the net contribution to economic activity made from public funds. These recom-

mendations were confirmed on 8 April 1965 and re-issued in slightly amended form on 22 December 1966. In general, the Member States have endeavoured to comply with these rules, but the difficulties they have encountered have often been considerable. The Committee nevertheless still considers that criteria in this field are necessary.

14. The Committee appreciates the difficulties involved in a more flexible manipulation of the budgetary instrument — especially because public expenditure is relatively inelastic in the short-term — but wishes to stress once again that greater use should be made of this instrument in re-establishing and maintaining general economic equilibrium. In this connection, the establishment of public expenditure forecasts covering several years should make possible more flexible handling of public finance policy in the medium term. Such forecasts would also help to strengthen the stabilizing impact of variations in fiscal revenue due to business fluctuations, and would enable the authorities to put this factor to better use. The budgetary instrument must none the less be improved if it is to play its proper counter-cyclical role.

b) Monetary policy and capital movements

15. A more deliberate use of budget policy by no means implies neglect of monetary policy: it would be unrealistic to imagine that a budget policy could be applied with such detail and that it could be geared so closely to the changing course of events that the support of monetary policy would become superfluous. The experience of recent years has shown that the generally accepted objectives of monetary policy have not been fully achieved, so the instruments of monetary policy must be strengthened and adapted. The Committee is therefore highly appreciative of the measures taken by certain Member States in recent years to improve and modernize the monetary instruments at their disposal. For example, the experience of certain member countries in using instruments such as minimum reserves and credit ceilings has induced several others to adopt the same techniques as a means of strengthening the effectiveness of their monetary policies.

The Committee has from the outset taken an interest in this problem and in 1962 it published a study on the instruments of monetary policy. A factor strengthening its conviction that these instruments and the conditions in which they can be used must be improved is that the monetary measures taken by one country may have a great impact on the development of the situation in the other countries. Progress in this direction is the more necessary now that firms and commercial banks in the member countries can make use of the increasingly large-scale facilities offered by the Euro-dollar market. Failing harmonization of the range of monetary instruments available to the Member States and greater co-ordination of national policies, this situation is liable to diminish the effectiveness of these policies, which will still have an important role to play in maintaining internal and external equilibrium.

16. Article 69 of the Treaty gives the Committee a part to play in the liberalization of capital movements, which, according to Article 67, must be brought about "to the extent necessary for the proper functioning of the Common Market". In the early years of the Community, the adoption of the two directives on capital movements went far to promote freedom in this field. Today the Netherlands and Italy, and in lesser measure France, still impose exchange restrictions on certain transactions, particularly the short-term movement of money and the issue of foreign securities. In all the Member States, however, capital movements are still hampered by certain administrative, fiscal, or institutional difficulties. This situation unquestionably can and should be improved, if only in view of the objectives laid down in the Treaty of Rome, particularly in Article 3 and 67.

17. It looks very much as if fuller liberalization of capital movements would lead to better utilization of savings and might even, for this very reason, encourage its formation. However, this purpose will be fully attained only to the extent that the liberalization of these transactions is accompanied by fuller interpenetration of the EEC capital markets.

18. The liberalization of financial transactions undoubtedly raises difficulties in present circumstances. It is because of these difficulties that certain Member States still maintain exchange restrictions: there is much to be said for retaining the right to pursue monetary policies tailored to fit the trends prevailing in the several countries as long as these trends diverge, but in financial relations with other countries these policies may lead to results which are not consonant with those sought in the domestic field. More generally, it should be remembered that if the movement of short-term funds is completely liberalized it may, in certain circumstances, be found necessary to adapt the arrangements by which each Member States ensures general economic equilibrium.

This is why endeavours to achieve increased liberalization of capital movements not only entail fuller co-ordination of monetary and budget policies but also require efforts to devise techniques that would make possible the effective control of economic trends in the Member States without exchange restrictions despite the progressive elimination of the manifold obstacles to capital movements.

c) Wages and price policy

19. The Committee has devoted more and more attention to the rise of prices and production costs. In recent years, and particularly since 1963, prices and costs have increased appreciably, although to differing degrees, in all the member countries. More generally, the price trend has not been sufficiently in line with the objectives laid down in the Treaty of Rome.

20. In addition — and this state of affairs is perhaps even more serious — it would seem that the authorities are all too apt to take a price increase of several points per year for granted. Quite apart from all the harm which may be caused, especially from the social angle, by a steady upward

movement of prices, it betrays the existence of excessive strains that could engender liquidity crises or induce periods of recession. The persistent upward movement of prices also encourages a tendency to increase indebtedness at the same time as it diminishes the propensity to save, and this leads to higher interest rates. If prices go on rising more rapidly in the Community than in the rest of the world, the balance of payments may be affected, because the Community's exporting industries lose their ability to compete on world markets.

21. But to confine inflation in the Member States merely to the level recorded in the countries which are the EEC's main trading partners would be a modest objective. The economies interact, just as they do within the Community, in the wider framework of the western world, and it may be wondered whether the Common Market countries could not make a useful contribution to the world economy by endeavouring to apply a policy which would make the EEC a centre of price stability. The more countries implementing such a policy, the greater their influence would be on the rest of the world.

In this connection, as the Committee has stressed in several of its reports, an incomes policy is indispensable. This instrument is particularly valuable in that it enables the Member States to pursue a policy of harmonious expansion without overstepping the increasingly narrow bounds beyond which lurks the threat of inflation or of recession. But an incomes policy can succeed only if budget and monetary policies are pursued in such a way as to ensure that generalized strain on the labour market is avoided.

Outlook

22. The Treaty of Rome requires that Member States shall co-ordinate their policies with a view to the attainment of the Treaty objectives. Since it came into force, this co-ordination has in fact been making progress. The Committee is, nevertheless, aware that current developments in the Community mean that the need for increasingly close and effective co-ordination is greater than ever.

In its seventh annual report, the Committee had already discussed the implications of this evolution, which was leading to de facto monetary integration. It had, at the time, mentioned as one factor in the proposed common agricultural policy, a policy which is now complete on paper and will be implemented stage by stage between 1 July 1967 and 1 July 1968. The customs union will also be complete on 1 July 1968. In addition, as already mentioned in this report, the movement of capital between the Member States is tending to grow more intense. And finally, a recent Council decision has already set in motion the process of fiscal harmonization.

23. In these circumstances, further advances in the co-ordination of economic and monetary policies are proving necessary. First, something should be done to make the national policies more effective. Certain Member States have in recent years allowed home demand to fluctuate to such an extent that domestic equilibrium was threatened and that the economies of the other countries were affected, when more appropriate policies would have enabled demand to be contained within reasonable limits. It is true that to some extent these trends derive more from inadequacies in the execution of national policies than from lapses in co-ordination, and progress in the execution of these policies would considerably enhance the benefits to be obtained from co-ordination. But co-ordination work must increasingly assume the form of consultations prior to every economic or monetary decision which will affect in any appreciable degree the economic development of other Member States. Progress could be made in this connection if quantitative objectives were worked out at Community level to back up the policy chosen. As mentioned above, the establishment of guide lines for the implementation of budget policies would be one improvement, although there would be no need for the objectives to be made identical for all the countries. The form of such guide lines could be worked out in more systematic consultations and by agreement on the best method of putting them forward.

24. The co-ordination process has already been strengthened and extended by the establishment, in 1960, of the Short-term Economic Policy Committee, and in 1964, of the Budget Policy Committee and the Medium-term Economic Policy Committee. The Committee of Governors of Central Banks was also set up in 1964. The Ministers of Finance of the six countries meet regularly, and the Council itself is devoting increasing attention to general economic policy problems.

The chairman of the Monetary Committee attends ex officio the meetings of the Short-term Economic Policy Committee and of the Budget Policy Committee, and this strengthens the Commission's efforts to ensure close co-ordination of the work carried out by all three committees. In addition, the chairman attends the meetings held at regular intervals by the Ministers of Finance. Similar arrangements are being made to ensure co-operation with the Council.

25. At these meetings information is exchanged on the economic and monetary situations and on the intentions of the authorities of each country. To some extent, too, the members of the Committees evolve agreed basic concepts with regard to economic and monetary policies and their meetings are an experiment in management of national policies. Economic policy is pragmatic by nature, and growing co-operation in this field cannot be expressed in rigid rules or in terms of formal obligations. It constitutes nevertheless an essential and increasingly important contribution to the actual institution of the common market. While the day-to-day co-operation certainly goes as far as could have seemed possible when the Treaty of Rome was drawn up, it is none the less clear that further progress is needed today.