EUROPEAN COMMUNITIES

MONETARY COMMITTEE

THIRTEENTH REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

Brussels, 16 February 1972

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INTRODUCTION

The purpose of this report is to give a brief account of the activities of the Monetary Committee during the period from 1 July 1970 to the end of 1971.

During these 18 months, the Committee held 15 sessions and the working parties drawn from its own members or set up at its suggestion met on many occasions.

The Committee's officers were re-elected for a period of 2 years starting on 1 June 1970. Following the departure of Professor W. Drees, Treasurer-General in the Netherlands Ministry of Finance, the Committee elected Professor C.J. Oort, on 23 June 1971, as vice-chairman for the remainder of Professor Drees' term. Professor Oort is also the new Netherlands Treasurer-General. A list of the Committee members is annexed.

The report was adopted as at 31 December 1971. It takes no account of subsequent monetary and financial trends or of measures adopted since, in or outside the Community.

1. Trends during the period under review were heavily influenced by the difficulties besetting the working of the international monetary system, which culminated in a monetary crisis in August 1971, when dollar convertibility was discontinued.

These developments affected the Community in two ways: firstly, with regard to business activity, by stimulating, initially, inflationary trends, and then by posing a threat to orderly growth of the economy, they raised difficult problems for the member countries, for which they were unable to find coordinated solutions; secondly, in respect of the institutions, they slowed down the alignment of the economic and monetary policies of the member countries and impaired the normal working of the agricultural market by compelling the Community to introduce compensatory arrangements at the frontiers.

In view of their importance, the international monetary developments are described in the first chapter of this Report. The second chapter covers economic trends in the Community countries and in leading non-member countries, mainly during 1971, and the third the Committee's own work, which was chiefly concerned with consultations on current problems and with action contemplated to implement the Council of Ministers' plan for achieving economic and monetary union.

CHAPTER I

THE MONETARY CRISIS

Events preceding the crisis

2. The immediate causes of the monetary crisis cannot be isolated without referring to developments at the beginning of 1970: the varying economic trends at that time in the United States, the Community and Japan, and the belated and often injudicious deployment of monetary policy instruments on both sides of the Atlantic in attempts to restore domestic equilibrium largely account for the steady deterioration over the months of the United States balance of payments and for the corresponding growth in other countries' monetary reserves.

3. In the United States, with private consumers' expenditure flagging and investment losing momentum, economic activity declined in 1970. In an effort to curb growing underemployment, the Administration allowed the budget deficit to expand and at the beginning of 1970 the monetary authorities eased previous restrictions, although prices and wages were still rising.

4. On the other hand, in most of the member countries, at least during the first half of 1970, as in 1969, the growth of production was brisk, with inflationary strain spreading to an increasingly disturbing extent. In order to bring the upward price movement to a halt, these countries maintained or actually tightened up the restrictions - especially credit restrictions - introduced in 1969. The steady slow-down in economic activity from the second half of 1970 onwards prompted the authorities in the Member States to withdraw or relax some of the controls.

5. The new trend in United States monetary policy is the key to the spectacular deterioration in this country's external situation in 1970: with borrowing terms substantially more favourable to the lender in Europe than across the Atlantic, there were heavy movements of short term capital particularly to the Euro-dollar market.

Even if the general economic trend had not affected the overall payments balance, there would have been a deficit in 1970 anyway because of the unfavourable swing of the basic balance: since the end of the 'fifties, the traditional deficit on long-term transactions has no longer been offset by current-account surpluses. This change became more marked from the autumn of 1970 onwards: improvements in the competitive situation of the main industrialized countries, especially Japan and Canada, brought a sharp increase in United States imports and entailed an appreciable deterioration in the United States commodity trade balance.

So much so that in 1970 the United States payments balance (official settlements) closed with a deficit of $ 10 700 million, comparing with a surplus of $ 2 700 million for 1969 (1). The counterpart of the United States external deficit was a heavy accumulation of dollar assets in the central banks of the Community countries and more generally in Europe, Japan and Canada. Consequently the European central banks acted to stem the inflow of foreign exchange and neutralize its impact on domestic liquidity; the various bank rates were lowered on several occasions. The United States authorities made a number of attempts to curtail capital exports, achieving, however, only a temporary lull on the exchange markets.

May 1971

6. The increase in the monetary reserves held by the European countries helped to bring about a gradual change in the *motives* underlying the capital inflows. From April 1971 onwards, more and more speculative capital was being attracted by the likelihood of currency revaluations in Europe.

Given the helathy situation of the German economy, the German mark was the main target of speculation, the scale of which is brought out by the following figures. From January to the end of March 1971, the inflow of short-term capital into Germany was DM 7 600 million. In April alone, when the trend started, the sum involved was DM 1 900 million, to which should be added about DM 7 000 million in forward purchases by the Bundesbank. From 3 to 5 May, about DM 8 000 million in foreign capital was placed at short-term in Germany. By the end of May, Germany's monetary reserves stood at about DM 69 000 million of which DM 17 000 million were accounted for by the inflow of short-term capital since the beginning of 1971, mainly accumulated through a "leads and lags" affect and through bank loans contracted abroad by resident firms.

(1) Not including allocation of SDRs.

The expansion of domestic liquidity generated by these inflows largely neutralized the monetary policies pursued by the Community member countries, which were endeavouring to counteract the growth of inflationary strain. For example, the formidable inflow of foreign exchange was the main reason why the money supply (M 1) (1) increased by about 11.4 % in Germany from April 1970 to April 1971, despite restrictions.

7. In these circumstances, several Community countries adopted appropriate external and internal monetary policy measures in May. On 9 May, Germany and the Netherlands decided to float their currencies. Germany also prohibited the remuneration of non-residents' deposits and imposed prior authorization for purchases of short-term negotiable securities by non-residents. France amended exchange controls to tighten up restrictions on inflowing capital. The Belgo-Luxembourg Economic Union adjusted its two-tier exchange system to curb the inflow of foreign capital; for this purpose, transactors were deprived of the option, when selling foreign exchange needed for capital transfers to the BLEU, between the free market and the controlled market (on which rates cannot fluctuate beyond certain limits). The payments must now be made through the free market, on which, by definition, rates are unrestricted. Action to contain domestic liquidity was strengthened, particularly in Germany and in France. Among the Community's neighbours, Switzerland and Austria revalued their currencies.

The crisis of August 1971

8. These changes failed to dispel uncertainty as to the stability of international monetary relations; indeed they tended to highlight the gravity of the United States external account situation. The disequilibrium on this account assumed alarming proportions in the first half of 1971, the external payments deficit having reached a figure of about $ 11 000 million (official settlement) during this period (2). The emergence of a heavy trade balance deficit from April 1971 onwards, after a long series of surpluses, was the main cause of a crisis of confidence in the dollar. Speculative capital movements then took the form of a flight from the dollar, a development which lent increasing credibility to the prospect of a dollar devaluation; the result was a further deterioration in the external position of the United States. The outflow of funds became exceptionally heavy, despite official action in a number of other countries to combat the trend. In the first quarter of 1971 alone, the United States balance of payments showed a deficit of about $ 12 000 million (official settlements), the bulk of which had been incurred before the middle of August.

9. The United States Administration was also anxious to speed up the rather sluggish business recovery, and in these circumstances it adopted exceptional measures. On 15 August, the convertibility of the dollar into gold and into other reserve instruments was suspended and a 10% surcharge was imposed on dutiable imports. At the same time, with a view to encouraging business activity, taxes were eased and investment incentives announced, including the introduction of a tax credit for which imported capital goods would not qualify.

10. The member countries reacted in differing ways to the situation created by the United States decisions, particularly the decision to suspend dollar convertibility. The Bene-

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(1) Notes, coins and sight deposits.

(2) Including allocations of SDRs.

lux countries decided to apply as between themselves the arrangement they had proposed to the other Community member countries at the Council Meeting of 19 August. These included:

(i) Limiting fluctuations between Benelux countries to 1.5% above and below respective parities. For this purpose, the Belgian and Netherlands central banks intervene exclusively in their partner's currency.

(ii) Suspending the fluctuation limits of the other currency rates, including the dollar.

In September the Netherlands Government also introduced a "closed circuit" for non-resident purchases of bonds denominated in florins.

The French Government introduced a two-tier foreign exchange market system and strengthened exchange controls, particularly with regard to the net external position of the banks and to rules concerning payments for imports. Under these arrangements, settlements for merchandise and certain related services were to be made on the official market on which the limits on exchange rate fluctuations around parity would still be enforced; all other authorized operations, except transactions in foreign securities settled through the security foreign exchange market (1), were to go through the financial franc market.

The German authorities maintained the arrangements introduced on 9 May, whilst Italy decided that the lira should be allowed to rise or fall above or below the limits previously observed.

Outside the Community, the United Kingdom introduced arrangements similar to those in Italy, and Japan adopted a fluctuation system for its exchange rates. However, in these countries and in most of the Member States, actual rate variations were controlled - though to varying degrees of strictness - in order to prevent undue appreciation of the relevant currency.

11. In addition, like France, several other Member States strengthened or amplified arrangements to discourage imports of capital (exchange controls, regulation of the banks' external holdings, suspension of remuneration of foreign deposits, higher reserve coefficients on liabilities to non-residents, direct rules concerning the timing of settlements). Speculation on the future realignment of parities nonetheless generated a further inflow of foreign exchange, to Europe and Japan in particular. This led to a gradual - though uneven - revaluation of a number of currencies and increases in the exchange reserves in the relevant central banks in the third quarter of 1971.

Overcoming the crisis

12. Agreements concluded within the Group of Ten and decisions adopted by the Executive Directors of the International Monetary Fund on 18 December 1971 in Washington led to a new exchange rate pattern as between the IMF Member countries changing their parities or adopting "central rates". They also allow member countries, for the time being, to float their exchange rates within 2.25 % either side of the dollar par value or central rate.

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(1) The security foreign exchange market (*marché de la devise-titre*) was discontinued on 21 October 1971.

Further to these decisions, all the Community countries except France (which maintained its old gold parity) notified the IMF of the "central rates". In relation with the previous gold basis, the new rates entail a 4.61% revaluation of the mark, a 2.76% revaluation of the Benelux currencies and a 1% devaluation of the lira. All the Community countries also decided to exercise their right to float their exchange rates within the broader limits authorized by the IMF. However, the Benelux countries agreed not to use this wider arrangement as between each other.

The decisions taken in Washington are only the first step towards international monetary reform, the need for which has been highlighted by recent events. Realignment of exchange relations dispelled uncertainties occasioned by the floating of the currencies, which had already begun to impair growth and trade in a number of countries. However, machinery better adapted to current requirements cannot be implemented unless a number of other problems - including future convertibility arrangements, the role of gold, of the reserve currencies and of the SDRs, an adequate supply of reserve instruments, the degree of flexibility of exchange rates and the control of undesirable capital movements have first been solved.

It is obvious that any contribution the Community can make to such a reform largely depends on the degree of harmonization which the member countries will have reached in defining their positions on the various closely interrelated problems arising (see sec.30).

13. A number of conclusions can already be drawn from the monetary developments of 1971. The difficulties were caused by the spread of inflationary strain - varying in intensity from country to country - and the failure to ensure mutual consistency, either within the countries or between them, in the measures taken to counter this trend. The present increase in strain in a number of countries is all the more disturbing because it is occurring at a time when economic activity is losing momentum almost everywhere. This situation underlines more strongly the importance of national equilibrium policies based on the right combination of economic policy instruments; the effectiveness of the policies largely depends on effective coordination at international level and, in particular, Community level. Such coordination is needed in particular because of the very heavy volume of liquid funds which has built up on international capital markets in recent years and because of the greater mobility which improvements in international credit machinery have made possible: successive monetary crises have shown that international capital movements can distort national economic policies and indeed constitute a threat to the working of the entire monetary system.

CHAPTER II

ECONOMIC AND MONETARY TRENDS IN THE COMMUNITY AND THE MAJOR NON-MEMBER COUNTRIES

14. The crisis occurred at a time when economic activity in the Community was already tending to slow down. The psychological and direct physical effects of the United States measures had not substantial effect on trends in the member countries but did affect the general economic climate, which suffered from an appreciable decline in the growth of domestic demand, due mainly to retrenchment in investment schedules by private firms

as profits fell sharply. On the other hand, private consumers' expenditure was, taken as a whole, still expanding relatively briskly. Lastly, sales abroad faltered in the last months of 1971 because of the uncertainty as to future currency parities.

At the same time, conditions on the labour market tended to ease: unemployment increased slightly in all member countries and the number of foreign workers recruited declined, with the number of unfilled vacancies also falling.

For the full year 1971, the gross Community product was only about 3·4% up in volume on the 1970 figure, compared with a growth figure of 6·3% for 1970. But this overall figure covers widely varying trends in the various countries. The slowdown was particularly sharp in Italy and in Luxembourg, where GNP growth rates fell well short of the 1970 figures. In Belgium, the Netherlands and Germany, on the other hand, real growth was still running at 3 to 4%, while in France, the rate was very nearly 5·5%.

Slower growth failed, however, to curb inflation, which persisted in 1971; wage increases once again far outstripped productivity gains and helped to force up prices, which rose fast for the third year running.

15. In general, persisting inflationary strain was accompanied throughout the year by a rapid increase in the money and near-money supply. In most of the member countries, transactions with abroad initially dominated this trend, leading certain central banks to tighten up restrictions. However, as the growth outlook became less favourable, the authorities in all the member countries gradually relaxed restrictions, though not to the same extent in each country. The central banks relaxed the restraints imposed on the banks and Bank rate was reduced, sometimes more than once. This also helped to render the member countries' markets rather less attractive to foreign capital. In these conditions, the growth of the money supply was, from the autumn onwards, mainly accounted for by an increase in lending to commerce and industry, with the financing of Treasury operations also adding to the money stock in certain countries. By the end of the year, monetary policies had been relaxed virtually everywhere in the Community.

16. In 1971, two factors determined the state of the Community's trade balance (cif-fob, on the basis of customs returns): firstly, the slowdown in business activity weakened the propensity to import, and secondly, the member countries which floated their currencies enjoyed an improvement in the terms of trade. This led to a surplus of about $ 1000 million, against a deficit of $ 400 million for 1970. However, since the deficit on services and unilateral transfers was heavier, the current-account surplus did not increase to the same degree. On the other hand, the surplus on the basic balance climbed steeply (about $ 5000 million, compared with $ 2200 million in 1970), owing to very heavy net imports of long-term capital. Since there was also a fairly heavy inflow of short-term capital (though less, for the full year, than that for 1970), the surplus on the overall balance of payments increased from $ 7300 million in 1970 to about $ 8000 million in 1971. This surplus was reflected in an increase in the external holdings of the monetary authorities (net gold and foreign exchange reserves, IMF position, SDRs) of more than $ 9000 million, while the net short-term external position of the banking sector deteriorated by more than $ 1000 million.

17. The underlying trend of economic activity in Germany lost momentum in the second half of 1970. Early in 1971 the slowdown was halted. Thereafter, however, and especially after the external and domestic stabilization measures were adopted in May, growth again slackened.

Once the DM was floated, export demand weakened and the investment trend, particularly in capital goods, faltered. Nonetheless, inflationary trends, which had grown much stronger in 1970, mainly because of the considerable increase in wage costs, persisted in 1971. In December 1971, the cost-of-living index for households showed a 5.8% increase over the December 1970 figure. Expansion of the gross national product, which had been 5.3% in volume and 13% value in 1970, was 2.9% and 10.9% respectively in 1971.

In 1971 there was a surplus of DM 500 million on the current account, comparing with a surplus of DM 2500 million in 1970. Until May, there were heavy inflows of short-term capital from abroad, while the total net gold and foreign exchange reserves of the Bundesbank increased by DM 19600 million in the first five months, not including heavy purchases on the forward market maturing at later dates. In June, net reserves declined by DM 7800 million, to increase again in the second half of the year by DM 5100 million. Thus, from the end of May to the end of the year, the reserves contracted by DM 2700 million (without adjustment to take account of the DM revaluation).

The stabilization drive was maintained. In May 1971 the Federal Government adopted a number of budgetary measures designed to curb the increase in the expenditure of public authorities and to freeze tax revenues exceeding estimates in a "business activity equalization fund". Similar measures were adopted by the Länder authorities, Money supply and credit policy, hamstrung in the period up to May by very heavy borrowing abroad by the banks and industry, began to bite from June onwards and the expansion of the money supply lost momentum. The increase in the DM exchange rate in the autumn led the Bundesbank, however, to relax its credit policy to some extent. A further step along this road was taken at the end of December, in order to narrow the gap between domestic and external interest rates and thus consolidate the re-alignment of the exchange rates.

18. In France, the relatively brisk growth rate achieved in 1970 continued in 1971 till the end of the summer. Since then, there have been signs that growth has been slowing down, particularly in the output of capital goods, although the level of industrial production is not unduly affected: the growth rate of industrial production has continued at a rate near to 6 % per year, though it slowed down a little in the third quarter. The consumption of households staged a fairly strong recovery as compared with 1970, so that the consumer goods industries are once again working at full capacity. The spurt in the expansion of household demand largely offset the slowdown in the growth of investment and exports. The result was a real growth rate in gross national product of nearly 5.5%, compared with 6% in 1970.

The upward wage and price movement was substantially more vigorous than predicted at the beginning of the year. On the price side, this was partly due to special factors (substantial increase in oil prices, adjustment of agricultural and other prices subsequent to the 1969 devaluation). With regard to wages, it was probably due to the shortage of skilled labour, which remained severe during most of the year. In addition, the higher prices that had to be paid for certain imported items because the currencies of several countries were dearer acted as a shield against international competition, which was therefore unable to act fully to moderate domestic prices. In the course of the year, consumer prices rose by 6% and wages in industry by nearly 11% (annual average).

The improvement in the trade balance recorded in 1970 continued in 1971. For the full year, the surplus of exports over imports totalled FF 4500 million (including the franc area), although business activity had been slowing down in a number of the countries trading on an appreciable scale with France. For 1970, the surplus had not exceeded FF 700 million. With a deficit on current account (transactions), the overall payments balance showed a heavy surplus (1) due to long-term capital transactions but especially to short-term capital movements and to change in the timing of settlements ("leads and lags").

When direct restrictions on the expansion of credit were lifted at the end of October 1970, the money supply swelled rapidly. Faced with persisting and heavy inflationary strain, the authorities, wishing also to neutralize the effect of heavy inflows of capital, imposed restrictive measures from the second half of 1971 onwards. On 1 April, a new minimum reserves system for distributed credits was introduced, reserve coefficients on credits and on deposits were raised several times in the subsequent months, and Bank rate was raised from 6.5% to 6.75%. Measures were also taken from August onwards to combat the inflow of foreign exchange (see sec 10).

In the later months of 1971, money-supply and credit policy were relaxed a little to maintain economic growth. The reserve ratios were lowered and Bank rate cut back to 6.5% in October. It should be noted, however, that Bank rate has a less important role than before and that the money market rates, now more important, were running well below the official discount rate. The central government budget was designed to sustain economic activity, although the equilibrium aimed at in the current Finance Act was in fact not affected to any substantial extent.

19. In Italy, the direct and indirect effects of the current social disturbances, which began in the autumn of 1969, are still weighing heavily on the trend of economic activity. After a distinct loss of momentum in 1970, a growing number of industries (particularly building and construction) suffered in 1971, from the symptoms of recession. At the present time there is plenty of slack in the economy, both on the labour market and in the area of technical production capacity.

The key to these difficulties is a slowdown in demand, particularly in the capital goods sector, due mainly to the sharp reduction in profits squeezed by the rapid rise in wage costs and the decline in productivity. It is also due, though to a lesser extent, to certain difficulties - strikes, absenteeism, etc. - affecting the factors of production. Despite some increase in consumption and particularly in exports, the gross national product in real terms grew by only 1.2% in 1971 (compared with 5.1% in 1970).

The upward price movement was very rapid; on the basis of the implicit SNP index, the price index for the private sector was up about 6% in 1971 (6.5% in 1970). The figures do show, however, a tendency for the trend to slow down despite the continuing sharp disequilibrium between costs and prices.

Benefiting from the decline in domestic demand, the surplus on goods and services rose sharply to Lit. 1000000 million, against Lit. 388000 million in 1970. Net gold and foreign exchange reserves rose by Lit. 590000 million in 1971.

From the middle of 1970 onwards, the monetary authorities sought to increase opportunities for obtaining credit and, from 1971 onwards, to cut the cost of borrowing. In the first nine months of 1971, the money supply exceeded by about 20% the level recorded for

(1) Estimated at nearly $ 1700 million from December 1970 to November 1971.