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COUNCIL AND COMMISSION

FIFTEENTH REPORT
ON THE ACTIVITIES OF THE MONETARY COMMITTEE

FOREWORD

The purpose of this report is to give a brief account of the activities of the Monetary Committee during 1973.

During this year, the Committee held 17 sessions and the working parties drawn from its own members or set up at its initiative met on occasions. A list of members as at 31 December 1973 is annexed.

As a result of the accession of Denmark, Ireland and the United Kingdom to the European Communities on 1 January 1973, the delegates from these countries became full members of the Monetary Committee.

INTRODUCTION

In 1973 the Community encountered serious difficulties in its efforts to harmonize economic policies mainly on account of severe disruptions on the foreign exchange markets and the consequences of persistent inflation in the world, particularly in the Community.

The pattern of exchange rate relationships between the majority of the industrialized countries changed drastically. However, developments on the foreign exchange markets remained subject to many factors of uncertainty, due to the oil crisis at the end of the year.

In addition, the pace of inflation accelerated further throughout the Community, despite a significant improvement in the terms of trade in some member countries resulting from modifications of exchange rate relationships, the spectacular fall in the external deficit of the United States and the restrictive measures instituted by almost all the national authorities. Although it was possible in 1973 to make progress towards the goal of economic and monetary union, existing and newly created monetary and economic machinery worked under increasingly difficult conditions.

The first chapter reviews events on the foreign exchange markets, and the second chapter gives an account of the institutional progress towards the establishment of economic and monetary union, and the policy measures introduced to combat inflation. The third chapter is devoted to a review of the economic and financial trend in the Community, and the fourth summarizes the Committee's activities in the monetary field, both in a Community and an international context.

CHAPTER I

THE FOREIGN EXCHANGE MARKETS IN 1973

1. In 1973 the persistent instability of the international monetary system led to erratic movements on the foreign exchange markets. Speculative, monetary, economic and even political

factors forced many countries to take measures of exchange rate policy, so that in the course of the year a completely new pattern of exchange rates evolved, as the dollar, the pound, the lira, the yen and the Swiss franc were allowed to float independently and at the same time six Community currencies floated jointly in relation to all other currencies. In most countries these measures were accompanied by new restrictions on the international movement of capital. All these measures, together with the improvement in the external position of the United States, which became apparent from the beginning of the autumn and resulted in a gradual return of confidence in the dollar, restored some quiet to most foreign exchange markets in the closing months of 1973.

2. The institution of a two-tier exchange market in Italy to put a brake on the outflow of capital (22 January 1973) and the decision by the Swiss authorities to cease intervening on the foreign exchange market so as to discourage the inflow of foreign capital (23 January 1973) marked the beginning of one of the largest waves of speculation that the international monetary system has ever known. The latent lack of confidence in international monetary relations, particularly in the dollar, provoked a flood of capital to most of the Community countries, especially Germany, and Japan. Administrative measures to control capital movements, such as those adopted by Germany on 5 February, proved ineffective against the highly speculative nature of these flows, the result being that between 1 and 9 February over $ 10 000 million were converted into other currencies. This caused most industrialized countries, including all Community countries, to close their foreign exchange markets. After a series of consultations and bilateral and multilateral conferences, of which the main result was a decision to devalue the dollar by 10 %, taken on 12 February by the United States Government [1], all the foreign exchange markets reopened on 14 February. Earlier, on 13 February, Italy had decided to allow the commercial lira, like the financial lira, to float while continuing to operate the two-tier exchange market. As with the United Kingdom in June 1972, Italy thus ceased to participate in the agreement on the narrowing of margins between EEC currencies. Finally, on 14 February Japan decided to allow its currency to float. These last two measures led to a gradual depreciation of the commercial lira and an appreciation of the yen on the foreign exchange markets.

3. But the foreign exchange markets were only granted a brief respite. Lack of confidence in the new pattern of exchange rates quickly reappeared and again gave rise to large-scale movements of capital. As a consequence, on 1 March several countries which had continued to maintain their exchange rates within fixed limits once again experienced an enormous inflow of capital. Germany was the main victim: in one day alone it absorbed the record amount of $ 2 800 million. This situation led to many of the industrialized countries closing their foreign exchange markets on 1 or 2 March.

After several conferences between the Community countries at first, and then between a larger number of countries (the enlarged Group of Ten), this crisis was resolved by the decision of the six Member States of the EEC [2] to adapt the existing Community exchange rate scheme, maintaining the 2·25 % spread between the respective currencies (the 'snake') but ceasing to intervene to maintain fixed margins against the dollar (the 'tunnel'). These Council Decisions of 11 and 12 March, with which Norway and Sweden associated themselves on 14 March, came into force with the reopening of the exchange markets on 19 March. The same day Germany revalued the DM by 3 %. Further, several Community countries tightened the measures they had taken to ward off inflows of capital.

4. The joint float of several Community currencies and the accompanying measures taken by certain participating countries initially brought an easing of the international situation. Exchange rate movements within the Community bloc were fairly orderly, but the snake gradually left the old tunnel, in that the currencies of the participating countries appreciated against the dollar.

Towards the end of June, the monetary climate abruptly deteriorated again. The immediate cause of this crisis, which was much less serious than that of spring 1973, was again the US dollar, which suffered a large fall in its rate, resulting from massive capital outflows. Demand centred mainly on the DM. This situation obliged the German monetary authorities and those of other countries participating in the joint float to intervene massively in German marks and led to an inflow of unwanted liquidity into Germany. For this reason the German Government, after consulting with its EEC partners, decided to

[1] The devaluation of the US dollar, which raised the official price of gold from $ 38 to $ 42·22 per ounce of fine gold, was officially proposed to the IMF on 18 October 1973 and was approved the same day.

[2] Belgium, Denmark, Germany, France, the Netherlands and Luxembourg. The United Kingdom, Ireland and Italy continued to allow their currencies to float independently (cf. para. 9).

revalue the DM by 5·5 % with effect from 29 June, while maintaining the 2·25 % margin of fluctuation in relation to other currencies in the 'snake', based on the new intra-Community parities deriving from this revaluation.

5. At the beginning of July, the dollar rate fell to a level about 15 % lower than its nominal parity against the currencies within the Community snake. After a meeting of the governors of the principal central banks at the Bank for International Settlements on 8 July 1973, concerted action by the US monetary authorities and certain central banks helped to halt the depreciation of the dollar and even to initiate a reverse movement. The action took the form of intervention to support the dollar and of improved harmonization of interest rate policies at the international level, particularly on the part of the United States.

6. After a 5 % revaluation of the Dutch florin on 17 September, which was justified by the strength of the Dutch balance of payments and which was also part of a programme intended to control domestic inflation, a sense of uncertainty once again developed in the foreign exchange markets. Speculation was particularly directed towards the French and Belgian currencies, in the expectation of a possible revaluation of the Belgian franc and a possible devaluation of the French franc. However, the markets quickly returned to normal after the monetary authorities concerned had intervened massively and had, in particular, adapted their interest rate structure.

7. The beginning of November saw a major reversal in the situation on the international exchange markets. News of the extremely favourable US trade figures for September confirming a trend that had already been discernible, brought about a considerable improvement in the position of the dollar. This movement received additional impetus from the oil crisis, since the feeling on the markets was clearly that the economic and monetary consequences of the new energy situation would be less serious for the USA than for most of the other industrialized countries. Thus the 'third' dollar devaluation which had occurred in the exchange markets between February and July was completely reversed in a few weeks. By the end of the year, the dollar rate was back at its nominal parity against the group of currencies in the Community snake.

CHAPTER II

ECONOMIC AND MONETARY UNION

8. At their meeting on 19 and 20 October 1972, the Heads of State or of Government declared that 'the necessary decisions should be taken in the course of 1973 so as to allow the transition to the second stage of economic and monetary union on 1 January 1974'. Although the successive monetary crises have brought about unusual difficulties, it was possible to take some decisions in this connection.

9. On 11 March 1973, the Council decided to adapt the Community exchange rate system: by this decision the fluctuation margin between the German mark, the Danish krone, the Dutch guilder, the Belgian franc, the Luxembourg franc and the French franc was maintained at 2·25 % and the central banks were no longer required to intervene *vis-à-vis* the United States dollar. To protect this Community scheme, which is designed to maintain orderly exchange rate relations, the Council further agreed that the Directive of 21 March 1972 would be more effectively enforced by Member States in order to prevent disruptive capital movements.

10. Pursuant to the declaration of the summit conference of 19 and 20 October 1972, the Regulation establishing a European Monetary Cooperation Fund [1] was adopted by the Council on 3 April 1973 after prior examination by the Committee of Governors of Central Banks, the Monetary Committee and the conference of the Ministers of Finance. This Fund, which commenced operation on 1 June, and intended to be integrated at a later stage into a Community organization of central banks, is, within the limits of its powers, to promote:

— the proper functioning of the progressive narrowing of the margins of fluctuation of the Community currencies against each other;

— interventions in Community currencies on the exchange markets;

[1] OJ No L 89, 5. 4. 1973.

— settlements between central banks leading to a concerted policy on reserves.

In the first stage of its functions, the Fund is to be responsible for:

— the concerted action necessary for the proper functioning of the Community exchange system;

— the multilateralization of positions resulting from interventions by central banks in Community currencies and the multilateralization of intra-Community settlements;

— the administration of the very short-term financing provided for by the Agreement between the central banks of the enlarged Community of 10 April 1972 and of the short-term monetary support provided for in the Agreement between the central banks of the Community of 9 February 1970, to which the central banks of Denmark, Ireland and the United Kingdom acceded with effect from 8 January 1973, with the regroupment of these mechanisms in a renewed mechanism.

11. In order to prepare the transition to the second stage of economic and monetary union, the Commission took several steps in the economic and monetary spheres during the period under review. On 19 April 1973, it adopted a communication 'on the progress achieved in the first stage of economic and monetary union, on the allocation of powers and responsibilities among the Community institutions and the Member States essential to the proper functioning of economic and monetary union, and on the measures to be taken in the second stage of economic and monetary union'. In this report, drawn up in accordance with the Council resolution of 22 March 1971 and the communiqué issued at the Paris summit conference, the Commission reviewed the progress achieved in the first stage and drew the following conclusions: the actions included in this first stage should be consolidated and rigorously applied, particularly those concerning economic policies; structural and regional problems should receive prior attention; in certain important fields effective responsibility must be exercised at Community level; the Community must constitute a single monetary zone as soon as possible; the principle economic and social groups should be more and more associated with the European enterprise. In addition, this communication from the Commission set out a programme of action for a second stage which was to start on 1 January 1974.

Further, on 27 June 1973 the Commission presented a 'report on the adjustment of short-term monetary support and the conditions for the progressive pooling of reserves' as requested by the Council on 4 February 1973. In this report, the Commission proposed that more important tasks be entrusted to the European Monetary Cooperation Fund. It believes that the reorganization of the credit system and the pooling of reserves should go together and be undertaken without delay. According to these proposals, the Member States should have begun to pool their reserves and to improve Community credit mechanisms on 1 January 1974.

12. In the light of the discussion of these reports on 14 and 15 May and on 28 June 1973 in the Council, and in view of the opinions expressed by the Committee of Governors of Central Banks and by the Monetary Committee on 14 November 1973, the Commission adopted a document entitled 'work on economic and monetary union [1]', which contained a number of legal instruments intended to make possible the transition to a second stage of economic and monetary union.

On the first perusal of these proposals, the Council decided at its session of 3 and 4 December 1973 to separate the adjustment of short-term monetary support from the progressive pooling of reserves. It called on the Monetary Committee, the Committee of Governors of Central Banks and the Board of Governors of the European Monetary Cooperation Fund to submit, by 31 March 1974 reports on the still outstanding technical problems inherent in the pooling of reserves, and invited the Commission to amend its proposals by 30 April 1974 in the light of these reports. The Council stated that it intended to examine the Commission's revised proposal at the latest by 30 June 1974. The Commission was further invited to prepare a new proposal for the adjustment of short-term monetary support to be discussed by the Council before the end of 1973.

13. At its session of 17 December 1973, the Council and the representatives of the Governments of the Member States agreed in principle on a resolution on the implementation of a second stage of economic and monetary union in the Community. This resolution lists the objectives to be achieved during a second stage, from 1 January 1974 to 31 December 1976, as a prerequisite for the establishment of full economic and monetary union.

(1) OJ No C 114, 27. 12. 1973.

However, the resolution could not be formally adopted, pending the solution of problems with regard to the Regional Development Fund. During the same meeting the Council reached an agreement in principle with regard to a number of important instruments to strengthen economic and monetary union.

These instruments which were formally adopted on 18 February 1974, are as follows:

— a Directive [1] concerning stability, growth and full employment in the Community, whereby Member States undertake to enlarge the range of their economic policy instruments, thus fulfilling an essential condition for more effective coordination of their economic policies at Community level;

— a Decision [1] concerning the achievement of a high degree of convergence of the economic policies pursued by the Member States of the EEC; this decision aims at substantially strengthening and improving consultation procedures in the economic and monetary field within all competent Community bodies (Council, Committee of Governors of Central Banks, Monetary Committee, and Coordination Group);

— a Decision [1] setting up an Economic Policy Committee; by this Decision the Budgetary Policy Committee, the Conjunctural Policy Committee and the Medium-term Economic Policy Committee are merged to form a single Economic Policy Committee, thus ensuring greater effectiveness when it has to examine Community problems or, as a consultative body, to deliver technical opinions on specific problems;

— a resolution on short-term monetary support which requests the Board of Governors of the European Monetary Cooperation Fund to amend the short-term monetary support mechanism by doubling the debtor quotas, quadrupling the creditor quotas and increasing the extensions beyond the debtor and creditor quotas to 1 500 million units of account each.

14. In application of the Council resolution of 5 December 1972, the Member States took a series of anti-inflationary measures (cf. paragraph 26). However, the efficacy of these measures appears to have been limited: in 1973 inflation in the Community continued and even increased at a faster rate than in previous years. Although the influences from outside the Community should not be underestimated, the inflationary process in member countries was probably largely due to factors of internal origin.

It is clear that the persistence of a high rate of inflation in member countries constitutes a grave threat to the maintenance of a satisfactory equilibrium growth rate and the achievement of economic and monetary union. Under these circumstances, Member States therefore devoted considerable attention during the year to examining measures that might be taken to combat inflation and to coordinate their policies in this field.

15. On 22 March, on the basis of a Commission communication concerning the adjustment of the economic policy guidelines for 1973, the Council undertook, in accordance with Article 2 of the Council Decision of 22 March 1971 on the strengthening of coordination of short-term economic policies of the Member States, a first examination of the economic situation for 1973. After studying the results of the anti-inflationary action programme laid down in its resolution of 5 December 1972, the Council invited the Coordination Group on Short-term Economic and Financial Policies, the Monetary Committee, the Conjunctural Policy Committee and the Budgetary Policy Committee, to submit by 1 June 1973, reports on methods of supervising trends in prices and incomes, the implementation of national budgets and the trend of the money supply.

16. In the light of these reports, the Commission drafted a communication as a preparation for the second examination of the economic situation in the Community, which the Council carried out at its session on 28 June 1973. In view of the persistent rise in prices, the Council adopted at that meeting, on the proposal of the Commission, a resolution [2] on further measures to be taken against inflation.

17. Similarly, at the third examination of the economic situation of the Community by the Council on 9 November 1973, the problem of inflation was central to the discussion. At that session, the Council examined the measures taken by Member States pursuant to the resolution of 14 September 1973 [3], and on the Commission's proposal, adopted the annual report on the economic situation in the Community. It also agreed on the economic policy guidelines for 1974 set out in the report and decided, mainly on

[1] OJ No L 63, 5. 3. 1974.

[2] This resolution was only formally adopted on 14 September 1973 (OJ No C 75, 19. 9. 1973).

[3] OJ No C 107, 8. 12. 1973.

account of the new situation arising from the energy crisis, to lay down at its meeting of 3 and 4 December additional measures to combat inflation in the coming months.

18. On a Commission proposal, the Council set out these additional measures on 3 and 4 December in the 'resolution [1] on measures to be taken against rising prices and the maintenance of a high level of employment in the Community'. The programme of action which is to be implemented immediately and in parallel in the various countries of the Community covers measures in the fields of budgetary policy, monetary and credit policy, prices and incomes policy, agricultural policy and commercial policy.

[1] This resolution is dated 17 December 1973 (OJ No C 116, 29. 12. 1973).

CHAPTER III

ECONOMIC AND MONETARY DEVELOPMENTS IN THE COMMUNITY

19. The developments on the foreign exchange markets in 1973 did not have any perceptible adverse effects on international trade. There was in fact a sharp upswing in international trade, stimulated by an appreciable acceleration in economic growth in the industrialized countries, especially during the first half of the year. Whereas economic growth in the United States continued at much the same rapid pace as during the preceding year (6 %), Japan and the other OECD countries which are not members of the Community achieved growth rates which were distinctly higher than 1972. The considerably increased proceeds from the sale of raw materials also helped to boost economic expansion in many developing countries. These various factors gave a strong impetus to international trade which rose by some 13 % in volume. The expansion of world trade was however accompanied by an upsurge in prices which reached record proportions in almost every country.

20. All the Member States of the Community experienced boom conditions in 1973. Economic activity expanded at a very rapid pace especially during the first half of the year; it was not until the second half of the year that certain differences in trend between countries and between sectors of activity led to an overall slowdown in growth.

The growth rate of the Community's gross product in real terms in 1973 was nevertheless higher than in 1972 (plus 5 % against 3·7 %). Year on year, expansion speeded up in almost all the Member States: in France, Germany, Ireland, Luxembourg, Italy and the United Kingdom.

21. In general, export demand was a major factor in growth throughout the year; in Denmark and Italy, however, the volume of exports rose more slowly than in 1972. Domestic demand also expanded at a very rapid pace in most countries, although indications of deceleration were apparent in the second half of the year. While public investment showed only moderate growth or no growth at all, the pace of private investment quickened appreciably in France, Belgium, Denmark, Ireland, Italy and the United Kingdom.

The sharp rise in household money incomes, the persistence of inflationary expectations and, in certain countries, the effects of a decline in the propensity to save, which became particularly noticeable during the final months of the year, stimulated private consumption expenditure, which climbed particularly steeply in Ireland and Italy. The rate of growth of public current expenditure in money terms slackened a little in France, Belgium and Ireland, but accelerated in Germany and Italy. In the Netherlands, this expenditure stopped falling in real terms.

Finally, the continued upsurge in the prices of a large number of raw materials and the expectation of further increases contributed to a rise in stocks which was sometimes considerable.

22. The high level of economic activity led to a rise in employment in all countries until the end of the autumn. The improvement was particularly marked in Italy and the United Kingdom. However, labour market trends were relatively disappointing in Belgium and the Netherlands, where the unemployment rate was almost as high as during the previous year. In these countries, as in some others, in some of which a large number of foreign workers are employed, residual unemployment is due in part to structural causes. Towards the end of the year unemployment rose again in most countries and there was an increase — quite considerable in some cases — in the number of persons on short time, principally because of the repercussions of the energy crisis.

23. The boom in the Community was accompanied by very heavy inflationary pressures throughout the year. While in some countries the upward movement of prices slackened a little at the beginning of the summer, inflation in all member countries accelerated again during the final months. Consumer prices in the Community as a whole showed an increase in December 1973 of more than 8 % on December of the previous year. In Denmark, Ireland, Italy and the United Kingdom the rise in the cost of living even exceeded 10 % over this period.

This trend was due to the particularly sharp rise in the cost of raw materials and to an increase in labour costs which largely exceeded the growth of productivity. The vigorous expansion in domestic and export demand in most countries led to a high degree of capacity utilization from the beginning of the year. Even in countries such as Italy, where there still had been a certain amount of spare capacity at the beginning of the period, the speeding-up of economic activity gave rise to bottlenecks which soon impeded the growth of production in some sectors. Moreover, towards the end of the year, the situation deteriorated still further as a result of the massive increase in the price of oil and the strengthening of the dollar on the foreign exchange markets.

24. The domestic demand boom in the Member States, together with the appreciable increase in the cost of imports, entailed a considerable deterioration in the Community's balance of payments on current account, the surplus falling from $ 6 700 million in 1972 to $ 700 million in 1973.

Within this overall result the trends differed very sharply from one member country to another. There was a very marked deterioration in the balance of payments on current account in Italy and the United Kingdom — notably as a result of the adverse swing in their terms of trade — and in Denmark. In the United Kingdom, the 1973 trade balance closed with a deficit of £ 2 375 million and the current account showed a deficit of £ 1 468 million, compared with a surplus of £ 69 million in 1972; in Italy the trade deficit totalled Lit 3 366 000 million in 1973 and the current account deficit Lit 2 352 000 million; in Denmark the deficit on current account also rose sharply, principally because of the deterioration in the trade balance. In Germany, on the other hand, where the deterioration in the terms of trade was relatively moderate owing to the effects on import prices of the revaluation of the German mark, the trade surplus reached the record figure of DM 33 000 million, while the balance of payments on current account closed with a surplus of DM 12 400 million (compared to DM 3 300 million in 1972).

25. This generally poor trend in the Community's balance of payments on current account contrasts with a spectacular improvement in the United States' foreign trade position. After very heavy deficits during the first half of 1973, the US balance of payments on official settlements basis (less SDRs) showed surpluses of $ 2 100 million and $ 2 700 million in the third and fourth quarters respectively (seasonally adjusted), bringing the deficit for 1973 as a whole to $ 5 300 million, compared to $ 11 000 million in 1972. This turnaround was due mainly to the trend in the trade balance (fob), which after recording a deficit in 1972 of $ 6 400 million moved into a surplus in 1973 of £ 1 700 million (fob). The basic balance closed with a surplus of $ 1 200 million following a deficit of $ 9 800 million in 1972. This development enabled the US authorities to relax the restrictions on outflows of capital in November.

26. Faced with alarming price increases, all the Member States implemented restrictive economic policies at the beginning of the year, although Italy, which had suffered from a period of stagnation during the two previous years did not do so until the end of the second quarter. In order to combat inflation they employed a wide range of instruments, ranging from monetary and fiscal policy to prices and incomes policies.

The policy of restricting liquidity, initiated in 1972 in most Member States, was tightened repeatedly during the year in order to limit supply and curb demand. Implementation of this policy was helped by the floating of the dollar and by increases in interest rates on the principal foreign markets and on the international market generally, which afforded the monetary authorities more room to manoeuvre.

Most countries restricted access to central bank finance and implemented general or selective increases in compulsory reserve ratios, relating either to banks' liabilities or to their assets and liabilities. Some countries also introduced or strengthened arrangements for setting quantitative ceilings on lending. In order to protect their domestic economies from external influences and to lessen the impact of such influences on the Community's exchange rate system, capital movements were subjected to restrictive measures bearing on commercial banks' net external positions; non-residents' balances or foreign borrowing by non-bank institutions. The monetary authorities of all the Member States raised the cost of rediscounting with the central bank by putting up official discount rates several times. Discount rates in almost all the Member States therefore reached new record levels at the end of the year. These measures led to a considerable increase