EUROPEAN COMMUNITIES

MONETARY COMMITTEE

TWENTY-THIRD REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

Brussels, 15 May 1982

Blank pages not reproduced: 2, 4, 12, 20, 24

This publication is also available in the following languages:

DE	ISBN	92-825-3113-9
FR	ISBN	92-825-3115-5

Cataloguing data can be found at the end of this publication

Luxembourg: Office for Official Publications of the European Communities, 1982

ISBN 92-825-3114-7

Catalogue number: CB-35-82-522-EN-C

Printed in Belgium

Summary

FOREWORD

In 1981, the Committee held nine sessions; the Committee's working parties and the Alternates met on several occasions. The list of members in office during 1981 is annexed.

I. INTRODUCTION

1. World economic trends in 1981 were subject to a number of unfavourable influences: the aftermath of the second oil shock of 1980; the worsening of domestically generated imbalances (in particular budgetary imbalances); wide and sometimes erratic swings in interest rates and exchange rate relationships with the United States dollar. The effects of these factors on the economies of the major country groupings varied, but on balance activity may have picked up slightly in the course of 1981. The volume of world trade remained at the same level as in 1980, since the volume of imports by members of the Organization of Petroleum Exporting Countries continued to offset to some extent the low level of other countries' imports, which was accounted for by a marked slowdown in consumption and importation of oil. The imports of the non-oil developing countries, which have large external deficits to finance, increased at a slower rate in 1981. The oil-producing countries' surpluses on current account decreased in 1981, after almost doubling from 1979 to 1980. The industrialized countries recorded an aggregate deficit, although the overall picture masks sharp individual differences.

2. In the Community, the recession that began in 1980 continued into 1981. The rate of inflation remained generally high, and unemployment continued to rise. On the other hand, the slowdown in imports combined with an improved export performance led to a reduction in the current deficit in spite of a deterioration in the terms of trade over much of 1981. These aggregates, of course, mask differences between the countries, particularly between inflation rates.

The European Monetary System (EMS) continued to function satisfactorily, despite conditions that were generally unfavourable to the convergence of economies, and in the face of the destabilizing effects of wide variations in the exchange rates and interest rates of third currencies. Fluctuations in exchange rates between participant currencies were much smaller than during the 10 years prior to the inception of the system. There were however two EMS parity adjustments in 1981: the first, on 22 March, involved only one currency; the second, on 4 October, was the first general realignment since that of 23 September 1979. These two adjustments, though different in character, confirmed that the EMS can cope in an orderly fashion with realignments based on fundamental economic criteria.

II. COMMUNITY ACTION AND THE ACTIVITIES OF THE COMMITTEE

3. Against this general economic and monetary background, marked by strong pressures and turbulence, the Committee felt it was more than ever necessary to strive for cohesion and monetary stability in the Community: it concentrated on the operation of the European Monetary System and its possible development, on improving convergence of the economies of the participating countries, and on international monetary relations.

4. The Committee kept a close watch on economic and monetary trends and on the resulting policies, both at Community level and in the individual Member States. On several occasions, in the course of 1981, it examined in detail particular aspects of the Community's economic situation. An in-depth discussion on balance of payments and exchange rates in the European Monetary System allowed, for example, an examination of the fundamental trends affecting the exchange rates of participant currencies. Furthermore, at its October meeting, the Committee studied the stance of monetary policy in Member States in connection with the setting of monetary objectives for 1982, about to be decided by the monetary authorities of most Member States.

5. At a time of persistent disequilibria, aggravated by unstable exchange rate relations with non-member countries and volatile interest rates outside the Community, it was increasingly necessary to ensure the smooth functioning of the EMS, and to monitor its evolution. Both the realignment decisions taken in 1981 — and in particular the general realignment of 4 October — were preceded by discussions in the Committee; the decisions taken by the Ministers were based on the Committee's conclusions. Furthermore, important work was carried out by the Alternates on the technical aspects of the system's future development. This work culminated in a comrehensive inventory of the problems raised by the system's development and in proposals for adequate solutions. The findings were examined and discussed by the Committee, which identified a number of possible developments. The European Council meeting in London on 26 and 27 November 1981 asked that this preparatory work lead to concrete proposals for reinforcing the system.

6. The Committee, aware that the reinforcement of the European Monetary System depends on considerably greater convergence of the economies of the participant countries, stepped up its work in this field.

First, it examined the effects of certain rigid systems of indexation on economic trends in the Member States, and studied the possible monetary consequences, taking into account the proposals put forward by the Commission in its communication to the Council of 23 July 1981. In particular, the Committee felt that indexation presented serious drawbacks in the face of present adjustment requirements. No indexation system should be operated in such a way that it offsets for certain categories of income the consequences of economic policy changes or of variations in the terms of trade. The Committee's position on this question is stated in the Opinion of 16 November 1981 to the Council and the Commission (see Annex I).

Secondly, the Committee made thorough studies of the economic and monetary situation in two countries with special difficulties, Italy and Belgium. It examined the conditions which had led the Italian authorities to take emergency measures on foreign currency purchases, and put forward proposals for their gradual abolition. The Committee emphasized that the policy to be pursued must attack the fundamental problems of the Italian economy; its position and recommendations were the subject of two oral statements by the Chairman to the Council. As regards Belgium, the Committee noted the Commission's recommendation to the Government under Article 11 of the 1974 Decision on convergence. It fully approved the Commission's initiative, in particular as the smooth functioning of the European Monetary System requires stronger Community discipline; it discussed the economic and monetary situation in Belgium on several occasions, together with the corrective measures envisaged, and repeatedly confirmed its intention of closely monitoring the implementation of principles expressed in the Commission's recommendation.

Thirdly, the Committee continued its regular examinations of the economies of the Member States, independently from its discussions on exceptional situations or significant changes in economic policy.

7. The trends of dollar interest rates and exchange rates had a decisive impact throughout the world, including the Community. The Committee analysed the consequences of these trends on several occasions, in the light both of the objectives of the US authorities and of the possibilities open to the European authorities to guard against the effects of US policy. In an opinion to the Council and the Commission (see Annex II), the Committee, while firmly supporting the general anti-inflationary thrust of US policy, expressed reservations on the effects of high and volatile US interest rates, provoking strong fluctuations in the dollar exchange rate. In particular, the Committee stressed the overriding importance, in an increasingly interdependent world, of close international coordination and cooperation: no country should frame its domestic policies without due regard to their international consequences, and large economies and leading reserve currency centres have a special responsibility in this respect.

8. The Committee continued its work pursuant to the Council Decision of 8 May 1964, which provides that consultations shall take place within the Monetary Committee in respect of any important decision in the field of international monetary relations. The Committee discussed the main points on the agenda of the Bretton Woods institutions; as it does every year, it prepared the statement of the Council Presidency on behalf of the Community to the IMF Interim Committee and the Annual Meeting of the IMF and the World Bank.

With a view to the deliberations concerning North-South relations, the Committee considered the monetary and financial aspects of the Commission's communication to the Council of 7 May 1981 on Community policy for the North-South dialogue and, reaffirming the approach laid out in its 1980 opinions and reports on recycling and on global negotiations, stated its position on the various aspects of international financial cooperation and the responsibility of the Bretton Woods institutions (see Annex III). The Committee believes that international financial cooperation should be developed with a view, in particular, to associating the oil-exporting countries and industrialized countries in the financing and exploitation of the energy resources of the non-oil developing countries. It furthermore considers that the World Bank's activities in the energy field should be extended.

III. WORKING PARTIES OF THE MONETARY COMMITTEE

9. The Working Party on the Harmonization of Monetary Policy Instruments, a joint group of the Monetary Committee and the Committee of Governors of the Central Banks, submitted in October its report on the technical problems stemming from the coexistence of monetary and exchange rate objectives within the EMS. This report compares potential conflicts and empirical evidence of conflicts between the two, given the requirement for convergence towards stability, and analyses the techniques used to mitigate temporary conflicts. According to the report, it is unlikely that the potential for conflict will disappear; only active coordination between monetary authorities in the EMS countries can prevent the actual emergence of conflict situations.

10. The Working Party on Capital Markets completed its work on the development of savings in equities in the Community countries, and continued to monitor trends in the capital markets of the Member States and in the international capital market, and reviewed policies on these markets.

LIST OF MEMBERS AND ALTERNATES OF THE MONETARY COMMITTEE

Chairman

J.-Y. Haberer	Directeur du Trésor (Paris)

Vice-Chairmen

Sir Kenneth Couzens	Second Permanent Secretary, HM Treasury (London)
Dott. L. Dini	Direttore Generale, Banca d'Italia (Rome)
M. Horgan	Second Secretary, Department of Finance (Dublin)

Members

S. Andersen	Member of the Board of Governors, Danmarks Nationalbank (Copenhagen)
M.J. Balfour	Assistant director, Bank of England (London)
F. Boyer de la Giroday	Director in the Directorate-General for Economic and Financial Affairs, Commission of the European Communities (Brussels)
J.-M. Camdessus	Chef du service des affaires internationales à la direction du Trésor, ministère de l'économie (Paris)
D. Chalikias (since 16 November 1981)	Vice-governor, Bank of Greece (Athens)
G. Drakos (until 15 November 1981)	Vice-governor, Bank of Greece (Athens)
Dr. L. Gleske	Mitglied des Direktoriums der Deutschen Bundesbank (Frankfurt-am-Main)
Prof. L. Izzo (since 9 June 1981)	Consigliere, Ministero del Tesoro (Rome)
P. Jaans	Commissaire au contrôle des banques (Luxembourg)
G. Janson	Directeur de la Banque nationale de Belgique (Brussels)
R. Kirsch	Conseiller de gouvernement, Ministère des finances (Luxembourg)
C. Mavraganis	Deputy director general, Ministry of Coordination (Athens)
T. O'Grady Walshe	Deputy General Manager, Central Bank of Ireland (Dublin)
T. Padoa Schioppa	Director-General for Economic and Financial Affairs, Commission of the European Communities (Brussels)
A. Prate	Premier sous-gouverneur de la Banque de France (Paris)
Dott. F. Ruggiero (until 8 June 1981)	Direttore generale, Ministero del Tesoro (Rome)

Dr H. Schulmann	Staatssekretär, Bundesministerium der Finanzen (Bonn)
Drs A. Szasz	Executive Director, De Nederlandsche Bank NV (Amsterdam)
N. Ussing	Kommitteret, Det Økonomiske Sekretariat (Copenhagen)
J. van Ypersle de Strihou	Chef de Cabinet du Premier ministre (Brussels)
Dr A.H.E.M. Wellink	Thesaurier-generaal bij het Ministerie van Financiën (The Hague)

Chairman of the Alternates

Dr W. Flandorffer	Bundesministerium für Wirtschaft (Bonn)

Alternates

Drs D.H. Boot	De Nederlandsche Bank NV (Amsterdam)
S. Boyer-Søgaard	Danmarks Nationalbank (Copenhagen)
P.J. Bull	Bank of England (London)
A. Chalkiadis	Ministry of Coordination (Athens)
M. Emerson	Directorate-General for Economic and Financial Affairs, Commission of the European Communities (Brussels)
Drs F.A. Engering	Ministerie van Financiën (The Hague)
R. Floc'h (since 15 January 1981)	Banque de France (Paris)
C. Georgoutsakos (until 15 November 1981)	Bank of Greece (Athens)
Mrs M. Hedley-Miller	H. M. Treasury (London)
P. Jurgensen	Ministère de l'économie (Paris)
G. Lefort (until 14 January 1981)	Banque de France (Paris)
Dott. S. Masera (until 7 June 1981)	Banca d'Italia (Rome)
D. McCutcheon (until 8 November 1981)	Department of Finance (Dublin)
M. Papageorgiou (since 16 November 1981)	Bank of Greece (Athens)
D. Quigley (since 9 November 1981)	Department of Finance (Dublin)
J.-J. Rey	Banque nationale de Belgique (Brussels)
G. Reynolds	Central Bank of Ireland (Dublin)
Dr W. Rieke	Deutsche Bundesbank (Frankfurt-am-Main)
Dott. F. Saccomanni (since 8 June 1981)	Banca d'Italia (Rome)
M. Schmit	Ministère des finances (Luxembourg)
J. Thomsen	Det Økonomiske Sekretariat (Copenhagen)
J. Vanormelingen	Ministère des finances (Brussels)
P. Zimmer	Commissariat au contrôle des banques (Luxembourg)
Dott. A. Zodda	Ministero del Tesoro (Rome)

Secretariat

Dr A. Kees	Secretary of the Committee
R. Barthélemy (since 1 May 1981)	
H. Carré (until 30 April 1981)	
A. Leipold	

ANNEX I

OPINION TO THE COUNCIL AND THE COMMISSION ON INDEXATION MECHANISMS

(16 November 1981)

At its meeting in Maastricht on 23 and 24 March 1981 the European Council took the view that 'high and divergent inflation rates are a threat both to the prospects of growth and to the economic and monetary cohesion of the Community. In this context the European Council also discussed the effects caused by rigid systems of indexation of incomes and expressed the opinion that an adjustment of such mechanisms should be considered'. On 23 July 1981, the Commission issued a Communication to the Council on the principles of indexation in the Community (COM (81) 457 final). Lastly, on 17 September, the Council called upon the Coordinating Group and the Monetary Committee to examine this Communication and to report on it at a future meeting.

In response to these initiatives, and with a view to contributing to greater convergence of economic trends within the EMS, the Monetary Committee has looked at this question; it stresses however that since the implications of indexation are not solely monetary, the Committee's Opinion does not claim to cover all aspects of the problem, regarding which other Community bodies might feel concerned. Furthermore, it notes that the question of indexation, especially as regards its effects on competitiveness, cannot be examined in isolation from the other elements affecting labour costs and other production costs. Structural adaptation and the re-establishment of European competitiveness require a global approach affecting the totality of production costs.

I. General observations

1. Indexation is predominantly used as a means of offsetting the social consequences of economic disequilibria. Yet indexation is by no means the only method to shield certain sectors or groups in the economy from the detrimental effects of these disequilibria and from inflation in particular. When such protection is effective, the result is clearly that the economic agents enjoying it — and only they — become to some extent insensitive to inflation. The return to a more balanced economic situation, in which the purchasing power of money is stabilized, requires a conscientious effort of rigour and determination, difficult to realise in a rigidly indexed environment.

2. In conformity with the Council's request, the Committee has examined the Commission Communication on the principles of indexation in the Community. It observes great

convergence between the content of this document and most of the views expressed within the Committee. In particular it notes close similarity in the analysis of the effects of indexation, which leads the Commission, as the Committee, to consider that an essential objective should be to adjust existing mechanisms so as to remedy their main disadvantages.

The Committee considers that the adjustment of indexation systems according to the principles outlined below would constitute an important step towards achieving greater convergence of economic performance within the Community and the maintenance of stable exchange rate relationships within the EMS.

II. Indexation of incomes

3. The indexation systems applied in the Member States vary widely. Three Member States (Germany, the United Kingdom and Greece) have no system for indexing incomes, wages and salaries in particular. The situation in the others is very varied, ranging from indexation solely of the minimum wage (France) or the occasional introduction, in wage agreements, of cost-of-living adjustments (Ireland), to general indexation (Italy, the Benelux countries and Denmark).

The indexation of retirement pensions and transfer incomes is fairly general. Lastly, the adjustment of income tax allowances and thresholds, to prevent inflation from distorting the progressive nature of taxation, must also be considered a form of indexation affecting the formation of incomes.

4. The Committee recognises that, during certain periods of relative price stability and moderate adjustments of nominal incomes, indexation mechanisms may have settled pay issues in a helpful way and encouraged the conclusion of agreements lasting more than one year, avoiding overfrequent wage negotiations and thus lessening social conflict. Further, wage determination is a complex process, in which indexation is only one of many elements. The Committee stresses, however, that in a period with large changes in relative prices and the ensuing problems of structural adaptation of output and demand, the rigidity in economic adjustments introduced by automatic or semi-automatic compensation for price increases may constitute a considerable drawback. In practice indexation is often based on a concept of maintenance not only of purchasing power but also on a specific basket of expenditure which is irreconcilable with the need for income adaptation, substitution and structural change.

5. In particular, the Committee emphasizes that if external economic relationships are suddenly altered (deterioration in the terms of trade due to an inflationary shock or to a change in exchange rate relationships), indexation impedes the necessary adjustments and therefore tends to perpetuate the external disequilibrium. The same is true of price increases due to internal forces — either demand or cost induced — which will tend to be perpetuated. Then again, if indirect taxation is increased in order to obtain certain adjustment effects (e.g. on the structure of consumption), the effects may be neutralized by the action of indexation; furthermore, higher taxation will, through indexation, push up wage costs and help to damage competitiveness. The room for manœuvre of the authorities, in terms of monetary and taxation policy, is constrained by the existence of such mechanisms.

6. It is true that the rigidities and distortions caused by — *de jure* or *de facto* — indexation arrangements do not necessarily take the form of more rapid inflation. Through a non-accommodating monetary policy, the authorities may, in certain countries, indeed

succeed in moderating the wage-price spiral and inflationary expectations. However, the costs of taking monetary measures strong enough to offset the inflationary pressures of indexation will emerge elsewhere, e.g. in terms of growth and employment, and such costs are likely to be higher than would be the case under a smooth income adjustment to changes in external conditions or to fiscal policy measures.

7. In view of these considerations, the Committee feels that the recourse to indexation presents drawbacks for the conduct of economic policy faced with the need for adjustment, and makes it more difficult to defend the value of money. It is therefore of the opinion that no additional indexation procedures should be introduced and that the scope of the present systems should not be extended. Where such systems exist, it would be desirable that, by a combined action of the public authorities and the two sides of industry, their scope be reduced so that they no longer undermine the effectiveness of certain economic policy instruments.

To this end, no indexation system should be operated in such a way that it passes on from prices into incomes the consequences of factors that are exogenous to the labour-business relationship, such as economic policy changes or variations in the terms of trade. This could be allowed for in the definition of the index, or in the degree and frequency of compensation, including, possibly, *ad hoc* agreements to forego indexation portions in circumstances clearly characterized by imperative needs for economic adjustment.

The effort to reduce the scope of indexation should extend to all its forms, including property income and professional fees.

III. Financial indexation

8. The Commission Communication to the Council does not deal explicitly with financial indexation. However, the Commission has already had occasion to express its position on the question of the protection of savings in times of inflation, [1] and the Committee itself has several times examined this specific question. Such examination highlighted in particular the two major problems confronting an economy using indexation of financial assets: first, the risk of an extension in the application of indexation measures and of an accentuated distortion in monetary functions, and second, the risk of disrupting financial circuits, entailed in the introduction of measures discriminating in favour of certain transactions.

9. For these reasons amongst others, the Committee requested that the inclusion of indexation clauses in a foreign loan by a Member State be subject to prior consultation within the Committee and that, as far as possible, there should be a similar consultation on internal loans. The Committee has furthermore on several occasions [2] warned against the opening of discussions on techniques which would endeavour to safeguard automatically the real value of monetary or financial assets, whether they are held by developing or by other countries. In the context of the adjustment of the Community loan mechanism, it also indicated that for borrowings under this heading variable rate loans should not be given preference over fixed rate borrowing and should in particular be avoided when borrowing directly from surplus countries. [3]

---

[1] Commission Communication to the European Parliament — 'The protection of savings in times of inflation and the question of indexation' (COM (77) 549 final — November 1977).

[2] See in particular the Opinion on the financial aspects of North-South relations (Annex III).

[3] Report to the Council and the Commission on recycling (See Annex II of the 22nd Report on the activities of the Monetary Committee).

10. The Committee has not this time reconsidered the question of the indexation of financial assets in detail. It is however of the opinion that generalizd financial indexation should be opposed as it would be regarded as a capitulation to inflation and a demonstration of the inability to eliminate the mechanisms that perpetuate inflationary pressures in our economies, thus entrenching inflationary expectations. Financial assets and the returns they provide must be encouraged to adapt to overall economic conditions (not only to rates of inflation). This presupposes increased competition between financial intermediaries, less segregation of financial channels and greater contractual freedom between debtors and creditors.

The Committee acknowledges that a high rate of inflation is likely to have undesirable effects on the distribution of income and wealth between debtors and creditors. In such a situation, marked by great uncertainties about future interest rates and about the time-scale for the easing of inflation, certain limited forms of inflation-proofing may temporarily help to meet the needs of lenders and borrowers alike, bringing them together on terms which both fird acceptable; such forms give financial markets the necessary flexibility to adapt to rapidly changing circumstances and thus protect the existence of a long-term market. However also cetain other techniques for long term lending (such as variable rates) may in some cases reduce the effectiveness of interest rate management for monetary authorities, aligning financial market conditions automatically on those of the money markets, which are influenced by a different order of considerations.

ANNEX II

OPINION ON DOLLAR INTEREST RATE AND EXCHANGE RATE DEVELOPMENTS

(25 June 1981)

1. As requested by the Council on 15 June 1981, in full awareness that the difficulties experienced by Community countries are of both internal and external origin, the Monetary Committee has examined the consequences of dollar interest rate and exchange rate developments for the Community economy. The present Opinion, adopted at its session of 25 June, sets out the main results of its discussion.

2. In the 20 months since the change in techniques of monetary control announced by the Federal Reserve Board on 6 October 1979, US interest rates throughout the maturity spectrum have fluctuated over a very wide range, both in nominal and in real terms, thus attracting unprecedented attention to their variations and their level. European interest rates were broadly compelled to follow the upward movement of US rates, but did so on a generally steadier course. Both short and long term nominal interest rates within the Community are now either at or close to record levels, and in the lower inflation countries real interest rates are also extremely high.

3. Many factors affect exchange rates but, among these, high and variable US interest rates in 1980-81 have powerfully contributed to a marked fluctuation in the dollar exchange rate around a strongly rising trend against EMS participating currencies, which have however remained remarkably stable *vis-à-vis* each other. In the twelve months to mid-June 1981, the dollar has appreciated by between 35% and 42% against EMS currencies.

4. It is in the interest of the world economy that US inflation should come down as rapidly as possible: the Community should thus firmly support the general anti-inflationary thrust of US policy. At the same time it is important that the United States take into account the international consequences of the choices in the framing and executing of monetary, budgetary and public debt management policies, all the more so at the present time when the prospects for improved growth and employment are so tenuous.

5. The Committee considered the main problems raised by the above developments, taking in turn the variability of interest rates, the level of interest rates and exchange rate developments. It draws attention on the following aspects of these three problems: