

Official Journal

of the European Communities

ISSN 0378 - 6986

C 124

Volume 24

25 May 1981

English edition

Information and Notices

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I

(Information)

COUNCIL AND COMMISSION

TWENTY-SECOND 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 in 1980.

The Committee held eleven meetings in the course of the year while the Alternates and the Working Parties set up at its initiative met several times.

At its meeting on 23 January 1980 the Committee elected its officers. Mr. J.-Y. Haberer, Directeur du Trésor, Paris, was elected Chairman, and Sir Kenneth Couzens, HM Treasury, London, Mr L. Dini, Banca d'Italia, Rome and Mr M. Horgan, Department of Finance, Dublin were elected Vice-Chairmen. Mr W. Flandorffer, Bundesministerium für Wirtschaft, Bonn, was appointed Chairman of the Alternates. These officers will end their term of office on 31 December 1981. The list of members in office during 1980 is annexed.

Starting in November, Greek representatives attended the Committee's meetings as observers.

I. INTRODUCTION

1. The world economy in 1980 was hit by the effects of the second oil shock. First, the expansion of economic activity slowed distinctly: world production and trade growth rates fell sharply. Second, the current account balance of payments disequilibria of the major country groupings worsened further: the OPEC (Organization of Petroleum Exporting Countries) surplus swelled considerably; this was matched by a more than twofold increase in the current payments deficit of all the OECD (Organization for Economic Cooperation and Development) countries and a sharp rise in the non-oil developing countries' deficit.

2. The Community's economy was hit head on by these developments. Growth slowed, unemployment

spread, inflation increased and the current payments deficit almost tripled in comparison with 1979 – an unprecedented development. Not only did the rate of inflation rise in the Community, but inflation rate differentials between Community countries widened further, although towards the end of the year a marked reduction of the inflation rate in some countries with relatively high inflation took place. Unlike the situation during the first oil crisis, almost all the Community countries are running current payments deficits. Despite this unfavourable environment, the European Monetary System worked satisfactorily: no realignment took place in 1980, the participating currencies all remained within their fluctuation margins and the observed changes in relative positions did not threaten the overall stability of the system.

II. COMMUNITY ACTION AND THE ACTIVITIES OF THE COMMITTEE

3. The Committee began the year by continuing the work it had started in 1979 on *the evolution of the European Monetary System after the transitional period*. In February, it enumerated the points which it felt needed detailed technical examination. The list of subjects for study is fairly extensive: they range from the characteristics of the ECU and the techniques for its creation, to the role of the future European Monetary Fund and the system's relationship with third currencies. The Alternates devoted much of the year to this technical work with the help of contributions from the Commission departments. Furthermore, on various occasions throughout the year, the Committee closely examined the functioning of the European Monetary System and found that it had been satisfactory.

4. However, it became apparent that there had been profound changes in the international economic and monetary situation since the devising of the European Monetary System. The repeated oil price rises, the emergence of serious current payments imbalances, the resurgence of inflation, the swelling of international liquidity – all these were developments altering the framework within which the Committee had to undertake its work: the problem of reserve assets gained priority and, in this context, the development of the role of the ECU acquired new importance. These issues were set out by the Chairman in a statement delivered to the Council meeting on 17 March 1980.

5. Subsequently, the European Council meeting on 27 and 28 April paid particular attention to these problems, 'to the growing deficit in the developing countries' external accounts, the extent of the petroleum-producing countries' surpluses, the volume of international liquidity and the effects which these factors in combination might have on the stability of the international economic and financial system and on trade.' Shortly afterwards, the President-in-Office of the Council invited the Monetary Committee to examine what initiatives the Community could take in the field of recycling, and their practical details.

6. In response to this request, the Committee, at its meeting on 4 June, adopted an opinion on the *issues raised by the recycling process* (Annex I) which it forwarded to the Council and the Commission. This opinion sets out the various aspects of the problem, examines the role of the Community in the recycling process and concludes by suggesting that, as a contribution to the smooth development of this process, various proposals could be considered, such as the adaptation of the Community loan mechanism and of other existing Community instruments.

7. After examining this opinion, the Council, at its meeting on 9 June, called upon the Committee to examine in greater depth certain points relating to *the Community's role in the recycling process*. The Committee therefore resumed its work, and, after devoting several meetings to this subject, on 10 October adopted a report on recycling (Annex II) which it forwarded to the Council and the Commission. The report deals mainly with the role which the Community can play in recycling in favour of member countries: it describes how the Community loan mechanism – set up in 1975 to aid Member States in balance of payments difficulties caused by the increase in prices of petroleum products – should be adapted to the requirements of the new structure of external payments disequilibria with the aim of improving its effectiveness. The report also examines aspects of possible measures in favour of individual third countries faced with grave balance of payments difficulties, and contains in annex an opinion on the use of the ECU as denominator for loans by the Community, a subject which is also relevant to recycling.

On the basis of this report the Commission in November presented the Council with a proposal for a Regulation adjusting the Community loan mechanism designed to support the balances of payments of Community Member States. The European Council at its meeting on 1 and 2 December asked that work on the subject be actively pursued.

8. The Committee concerned itself with other *international monetary problems* besides recycling. As it does every year, it prepared for the spring and autumn meetings of the Interim Committee of the International Monetary Fund and for the IMF and World Bank annual meeting: for each of these meetings, it examined the draft text of the statement to be made by the President of the Council on behalf of the Community. On 2 April, the Committee also delivered an opinion (Annex III) on the substitution account under examination at the IMF: this formed the basis of the joint position put forward by the Community countries at the April meeting of the IMF Interim Committee. Lastly, in November, it took the initiative of delivering an opinion on the monetary and financial items on the agenda of the United Nations global negotiations, in which it reaffirmed the guiding principles in the approach to these problems.

9. During its February meeting the Committee examined proposals presented by the Commission departments for improving *economic policy coordination*. The Committee recognized the paramount importance of improving coordination, both for the proper operation of the EMS and for cohesion within the Community. It stressed that it was preferable to use the

existing mechanisms more intensively and more effectively rather than introducing new procedures; but that consultations on monetary developments in the Community countries needed to be held as often as possible, so that sudden changes in one country did not take its partners by surprise. These views were brought to the knowledge of the Commission, which took them into account in its March communication to the Council on this subject. The Council recorded its general approval of the ideas put forward in this communication and invited the various specialised Committees to strengthen the coordination of their economic policies on the basis of this communication.

10. It is in this perspective of permanent consultation that the Committee continued its regular 'tour d'horizon'

of monetary policy developments: on three occasions, in April, June and December it concentrated on interest rate developments in particular. During the year, it also held in-depth examinations of economic and monetary policy in the Netherlands and Belgium. The examinations were based on analytical documents prepared by the Commission departments, and were led by an examining member appointed for the occasion.

11. As it does every year and in accordance with its prerogatives, the Committee was several times consulted on *agri-monetary matters*, such as the alterations in the exchange rates of national currencies applicable in the agricultural sector, the codification of existing agri-monetary regulations, or the exchange rate to be applied in 1981 in the agricultural sector for Greece.

III. WORKING PARTIES OF THE MONETARY COMMITTEE

12. The Working Party on the Harmonization of Monetary Policy Instruments, a joint group of the Monetary Committee and the Committee of Governors, was in May 1980 invited to study from a Community viewpoint, the proposals put forward in the United Kingdom's Green Paper on Monetary Control, and in particular their consistency with UK membership of the EMS exchange rate mechanism. It met three times for this purpose and in August presented a report (Annex IV) to its parent Committees. In this report the Working Party draws some conclusions and notes that they indicate certain difficulties which might arise once the United Kingdom participated fully in the EMS if the proposed control methods were adopted. In September

the Monetary Committee examined the Working Party's report, endorsed its conclusions, and expressed the wish that the United Kingdom authorities take them into consideration.

13. The Working Party on Capital Markets (formerly Securities Markets) held four meetings in 1980. It continued to examine developments in the capital markets of the Member States and in the international bond markets, and reviewed the policies pursued with regard to these markets. It also completed its study on the variability of interest rates and the right to cancel contracts and continued its work on the development of savings in equities in Community countries.

Drs F. A. Engering	Ministerie van Financiën (The Hague)
Mrs M. Hedley-Miller	HM Treasury (London)
P. Jurgensen	Ministère de l'économie (Paris)
G. Lefort	Banque de France (Paris)
Dott. S. Masera	Banca d'Italia (Rome)
D. McCutcheon	Department of Finance (Dublin)
J.-J. Rey (since 22 February 1980)	Banque nationale de Belgique (Brussels)
G. Reynolds	Central Bank of Ireland (Dublin)
Dr W. Rieke	Deutsche Bundesbank (Frankfurt am Main)
J. Roelandts (until 21 February 1980)	Banque nationale du Belgique (Brussels)
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)
<i>Secretariat</i>	
Dr A. Kees	Secretary of the Committee
H. Carré	
A. Leipold	

ANNEX I

**OPINION TO THE COUNCIL AND THE COMMISSION ON ISSUES RAISED BY THE
RECYCLING PROCESS**

1. Introduction

1.1. The conclusions of the Presidency of the European Council of 27 and 28 April 1980 state that 'the Council paid particular attention to the growing deficit in the developing countries' external accounts, the extent of the petroleum-producing countries' surpluses, the volume of international liquidity and the effects which these factors in combination might have on the stability of the international economic and financial system and on trade. The Council took the view that to deal with these problems it would be necessary to step up cooperation in appropriate forms between States and with the relevant international institutions.' The President-in-Office of the Council subsequently invited the Monetary Committee to examine what initiatives the Community could take in the field of recycling, and their practical details. The Committee accordingly met on 20 May and 4 June 1980 and the present opinion sets out the results of its examination.

1.2. Following the 1973-74 oil price rise, the financing of the resulting payments imbalances was managed with greater ease than originally envisaged. In the first place, the import-absorbing capacity of OPEC revealed itself to be larger than forecast, while the relative price of oil declined fairly rapidly, so that the overall OPEC surplus - which had been predicted to persist for many years - declined to modest and manageable proportions by 1978, while a number of OPEC countries began to incur deficits. Secondly, the international financial markets and the commercial banks provided finance on a considerable scale, amounting to about two-thirds of the net external financing required by the non-oil developing countries.

1.3. The present situation seems to be more difficult. The large oil-induced payments imbalances (the OPEC surplus is projected to reach US \$ 100-120 billion or even more in 1980 and the counter-part deficit some US \$ 80 billion for the OECD area - of which US \$ 33 billion for the Community - and US \$ 60 billion for the non-oil developing countries) are likely to raise much more serious and lasting problems than in the period after 1973-74, and this for a variety of reasons:

— the OPEC surplus is expected to persist for a longer period, as the relative price of oil is likely to be maintained or even increased. Although the imports

of goods and services by the oil-producing countries should again grow substantially, it remains to be seen to what extent the exceptionally marked increase which took place after the 1973-74 oil price rise can be repeated;

— though the role of the commercial banks will remain prominent, they may well be reluctant to continue net lending on as large a scale in real terms as in the past and to disproportionately increase their exposure, at least *vis-à-vis* certain individual developing country borrowers; private balance of payments financing could thus become both quantitatively tighter, with higher spreads and shorter maturities, and more selective, with the poorer countries and perhaps some of the major borrowers finding their borrowing capacity more circumscribed. These tendencies have already shown some signs of developing in the syndicated medium-term credit market;

— the debt burden of the non-oil LDC's is now considerably larger: their outstanding public and publicly guaranteed medium- and long-term external debt has increased threefold in nominal terms between end 1973 and end 1979 (from US \$ 75 billion to about US \$ 250 billion) and nearly doubled in real terms, and the debt-carrying capacity of certain countries may be approaching its limit.

1.4. The Committee feels that recycling will be effected without major difficulties in 1980, and possibly in 1981, given especially the build-up of reserve holdings by the majority of the developing countries in recent years and the volume of bank credits committed but not yet disbursed. It cannot however be assumed that recycling will be automatically smooth and problem-free in the years beyond, when access to the international markets is expected to become more restricted and debt servicing difficulties could arise for a number of individual countries.

2. Aspects of the recycling problem

2.1. Although credit systems and markets have played their role with effectiveness and flexibility, the whole range of domestic and international financial relationships has been deeply affected by the first oil

shock. The stability of the international banking system has been subjected to unprecedented strains, flows through the international markets have increased very rapidly without control and exchange rate movements have been wide and sometimes erratic. Adjustment has been insufficient in a number of countries where inflation rates in 1978 were still well above pre-1973 levels. In recent years, the need to improve the supervision of the system has been recognized. It has led to internationally coordinated actions in prudential bank supervision, to new proposals to improve still further the surveillance of Eurocurrency markets and to various initiatives to render less disruptive the process of currency diversification. The launching of the European Monetary System has to be seen in the same context. The Committee expresses the view that after the second oil shock, reinforced international and Community action on these various fronts is even more necessary and that it will greatly contribute to a smooth process of recycling.

2.2. Recycling is a process by which the surpluses run by certain countries – in this case the oil-producing countries – are made available to countries in balance of payments deficit. This process is based to a large extent on international financial intermediation, both public and private, which ensures a certain transformation between the forms of investment offered to the surplus countries and the financing terms offered to the deficit countries.

2.3. This process involves a transformation of maturities, and sometimes a substitution of currencies, since the oil-producers generally wish to lend for a shorter period than that desired by the borrowers and sometimes in a currency other than the dollar. Costs and risks are associated with – though not specific to – recycling operation: transformation costs, possibly exchange risks, and default risks. These costs and risks can vary, depending on the extent of the transformation undergone by the financial assets in the intermediation process and on the financial situation of the funds' final recipient; they also vary with the procedures adopted for making the funds raised available to the recipient. If funds are lent on conditions more favourable than those on which they were raised, budgetary costs ensue. All these costs and risks must be shouldered in one way or another.

2.4. The Committee stresses that while financing payments imbalances due to the new oil price is necessary, adjustment to the new terms of trade through appropriate demand and supply policies is the fundamental way to restore a stable growth path in the importing economies. The achievement of the proper mix of financing and adjustment cannot be assured by

markets alone. Indeed, it should be the major preoccupation of policies in the years to come. The right combination of adjustment and financing needs to be defined for each country, but the financing granted must not be the pretext for postponing the necessary adjustment either in the rapidly industrialising countries or in the industrialized countries; for the poorest countries, an increase in development aid seems a necessary element in any solution.

2.5. Financing can be granted either mainly through the international banking system, i.e. by the markets, or through official channels (Governments, international institutions). The Committee feels that in official interventions in favour of recycling the Bretton Woods institutions have an essential role to play, not only in view of the IBRD's particular vocation to the financing of developing countries, but above all because they constitute the fora in which all the main actors of the recycling process are present: the United States, whose exchange rate policy is a central element, as well as the OPEC countries, and the other international participants. The distinction between official and private forms of financing is very important for the distribution of risks and for setting the conditions of financing operations. It has, however, become increasingly clear that rigid separation would not be desirable and would entail the danger of official bodies being brought in only at a stage when the general economic conditions in the debtor countries were already seriously deteriorated. This is evidenced by the emergence and success of intermediate formulae in which international institutions cooperate with commercial banks (consortia, cofinancing). In addition, in the majority of cases, deficit countries make joint calls on the two forms of credit and often the banks grant financing only after the international institutions have themselves done so: for commercial banks, this is a way of taking account of the country risk since they are not themselves in a position to impose economic policy conditions on the recipient countries.

2.6. As regards the terms and the use of the funds, it is usual to make a distinction between grant aid and loans on the one hand; and between loans intended for the execution of projects and loans designed to finance the external payments deficit on the other. Different risks, techniques and conditions are associated with these different forms, and these must be taken into account in a recycling policy. In practice, however, when loans carry interest subsidies, a grace period or the granting of a guarantee, they contain a grant element. As regards the loans themselves, the structural adjustment loans towards which the World Bank is moving represent a category which straddles both project and balance of payments financing.

3. The role of the Community in strengthening the recycling process

3.1. Without substituting itself to the normal recycling process nor competing with them, the Community has a particular role to play in the context of the present payments imbalances. It has important trading relationships with OPEC, being the biggest oil importer and at the same time the main supplier of goods and services to the OPEC countries, accounting for 40 % of their imports. In addition, it maintains special relationships with certain groups of countries (Mediterranean, ACP) which are themselves trading partners of the oil-producing countries, and whose financial situation is, in some cases, precarious. Furthermore, because of its geographical proximity to the Mediterranean and oil-producing countries, the equilibrium and the economic and political stability of both of them are of vital importance for the Community. The Community aspect of the problem is also related to the need to shelter the intra-Community exchange relations from the pressures which would result from prolonged monetary disturbances and would concentrate on certain Community currencies, and to the opportunity to use the 'Community potential' if it is more effective and less costly than a mere juxtaposition of national actions, even if coordinated. The Community's collective borrowing capacity is large, its credit standing excellent and it constitutes a zone of monetary stability. Any action which the Community could undertake would have a new character with respect to the events following the first oil shock: it would be the action of a Community in which all members will be in a position of current account deficit. It would therefore have to be effected essentially by means of borrowed resources and not by means of the transfer of surpluses earned by its members. Furthermore, if a deterioration in international political and economic relations and a widening of the gulf between the richest and the poorest countries were to raise concern, the Community must make an active contribution to the solutions, on a world scale, to the serious problems posed by the existence of structural imbalances in current payments.

3.2. Contribution to action at a world level

3.2.1. The Committee agrees that the bulk of the recycling activity will continue to be carried out by *the international financial markets and the commercial banks*. In view of the important contribution of the international banking system in this respect, the Community should fully support efforts directed at safeguarding the soundness and the stability of the system, at strengthening regular and systematic monitoring of its activities and at maintaining sound banking standards in international lending. The press

communique released by the Bank of International Settlements on behalf of the central bank Governors of the Group of Ten countries and Switzerland, on 15 April 1980, marks a positive step forward towards the achievement of these ends.

3.2.2. The Committee stresses that the important role of the international banking system will have to be increasingly supplemented by an expanded activity of the *international organizations*, and primarily of the International Monetary Fund, the World Bank and the regional development banks. These are the institutions suited to this end, all the main participants are adequately represented, the necessary funds are for the immediate future largely available and the mechanisms to incite borrowers to undertake the appropriate adjustment policies are present. The IMF still has substantial funds available. An adequate application of the Fund's principles is required, including a conditionality adapted to the requirements of an adjustment which, at times, is of a structural nature. The Fund's larger role in recycling and its possible recourse to direct borrowing from surplus countries, as recommended by the Interim Committee meeting in Hamburg on 25 April 1980, must also be supported and encouraged, and the efforts directed at implementing a properly designed and operational substitution account must be pursued. The World Bank also has an important contribution to make. Better coordination and close cooperation between the IMF, the World Bank and regional financial organizations should be sought and developed, while their resources could be directed in a larger measure to programme or structural adjustment lending. These institutions could also develop consortium type operations, joint examination of external indebtedness, etc. The Community should further examine these possibilities with a view to playing an active and unified role within these organizations and support new initiatives aimed at improving and expanding their role. The Committee is of the opinion that the Community should define common positions on these different points which would be communicated to the officials who represent the Member States in the IMF and the World Bank.

3.2.3. The *oil-exporting countries* have an essential part in the recycling process. A large part of the oil funds are at present directed towards short-term Eurocurrency deposits. Given the risks involved in this situation for international monetary stability, the Community should encourage the OPEC countries to place the oil surpluses at longer-term, either in the markets or outside them, in the forms of direct loans to the developing countries, to cooperate more actively with the international organizations and to participate in 'triangular' arrangements. The Community should, in any case, endeavour to establish closer contacts with the oil exporting countries.

3.3. *Direct Community interventions*

The member countries

3.3.1. The Community's primary responsibility is towards its members. In all the member countries, whose combined deficit in 1980 will exceed US \$ 30 billion – over one quarter of the OPEC surplus – the adjustment process is envisaged or has begun. However, structural conditions and inflation rates were very diverse at the time of the second oil shock, and adjustment policies are not likely to achieve everywhere the same results. Seen in the light of long-standing difficulties, this represents not only a threat to monetary cohesion and economic convergence, but also a potential danger for the actual unity of the market. It is incumbent on the Community institutions to play their proper part in promoting the convergence of economic results and in helping organize such action as may prove necessary to combine adjustment and financing in the proper proportions to ward off this threat and this danger. The Community has various financing mechanisms and instruments: first, it has a specific mechanism for balance of payments financing based on external borrowing (Community loans), created in 1975, following the first oil shock; it also grants loans to finance investment projects – which often contain an aid element, interest subsidies – and sometimes programmes, through the EIB, and financial instruments for structural purposes (Euratom loans, ECSC loans, new Community instrument).

3.3.2. To support the efforts of its members, the Community should undertake action on two fronts: that of general economic coordination on the one hand, and that of financing instruments, if necessary, on the other.

- The Committee feels that the strengthening of the coordination of economic policies is essential so that the Community authorities can help promote adjustment before a country's balance of payments and exchange rate relationships are threatened, and so that the necessary adjustment is not unduly postponed by resorting to unconditional bank financing. One way in which the Community could help in this respect might be by more closely linking private financing operations with Community credits through a sort of 'early conditionality' which the Community is in a position to recommend for its members, but whose modalities remain to be studied by the Committee.

As to Community financing operations, the Committee is of the opinion that the Community must first and above all make the most of the existing instruments, adapting their size and their terms when necessary to improve

their effectiveness. In this regard the following possibilities were mentioned in the Committee:

- increasing the volume of Community loans, set up in 1975, whose available margin is limited, and improving this mechanism, so that it can make a more effective and more complementary contribution both to the financing of acceptable deficits and to the macroeconomic adjustment of member countries;
- adjusting the Community's borrowing techniques in respect of all its instruments (Community, ECSC, Euratom, new Community instrument, EIB) ⁽¹⁾ in the light of the need to raise from the surplus countries the maximum amount of funds required;
- strengthening the structural instruments – notably the new Community instrument – and giving their management rules the necessary flexibility.

Outside the Community

3.3.3. Beyond its own frontiers, the Community maintains special relations, which include an important financial aspect, with certain countries (applicant and Mediterranean countries, ACP countries). Thus the Community grants loans, usually with interest rate subsidies on the Community budget, or through the EDF for the ACP countries. The loans are granted by the EIB under special financial protocols or by the EDF under the Lomé convention; in each case they relate to the financing of specific projects. The Community is also involved in operations of a wider nature, in particular the guaranteeing of export earnings (Stabex) under the Lomé convention, which is a form of balance of payments support and the financial and food aid operations to the developing countries in general. In the context of recycling, immediate interest centres on the Community's lending activities to the countries with which it maintains special relations. The Lomé convention has just been renewed and involves an expansion of these activities. The Community is also engaged in preparing new financial protocols with the Mediterranean countries for the five-year period beginning in 1981. It is important to bear in mind the need for recycling to the benefit of these countries, in so far as this need can be satisfied by the type of investment financing to which the Community instruments are suited. The Committee also raised the question as to whether the Community could not resort to the technique of structural adjustment loans. Beyond this, the Community, within the framework of the IMF and the World Bank, will have to seek action which brings a positive response to these problems.

⁽¹⁾ The Committee has been informed of the work carried out on this point within the EIB.

