

**MONETARY COMMITTEE
OF THE EUROPEAN COMMUNITIES**

**TWENTY-EIGHTH
ACTIVITY REPORT**

Brussels, October 1987

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The Committee held a total of nine ordinary meetings in 1986. An extraordinary meeting was held at Ootsmarsum in the Netherlands in April in connection with a general realignment of EMS central rates and in August the Committee prepared a realignment stemming from the Irish pound. The Chairman reported five times to the Ministers for the Economy and Finance on the results of the Committee's work.

I. PRINCIPAL DEVELOPMENTS UP TO THE SPRING OF 1987

1. Following the Plaza agreement of September 1985 the wider international environment was marked by the rapid fall of the US dollar against EC currencies and the yen.

In 1986 the Community again faced exchange-rate tensions, after a fairly long period of relative calm, and in April of that year a general realignment of central rates became necessary, although economic fundamentals were in general better than in 1983, when the last general change in central rates took place. Over a period of three years the accumulated cost and price differentials and the divergence in current account positions and trends were clearly factors determining market behaviour.

In the closing months of 1986, tension within the EMS again became acute: in spite of a sustained improvement in the economic fundamentals, the views of market participants, which differed from those of the authorities, and the lack of monetary cooperation increased the pressure on the exchange markets. After a period of massive intervention, and in the absence of changes to interest-rate differentials, another general realignment became unavoidable in the first days of 1987.

2. The last two general adjustments of central rates, in April 1986 and January 1987, differed from their forerunners in two main aspects:

(a) First the change of the parity between the two most important EMS currencies — the German mark and the French franc — was significantly smaller. In March 1983 it was 8%, but in April 1986 the parity change was 6% and at the beginning of 1987 3%. For the first time the change of central rates was smaller than the greatest possible bilateral fluctuation, i.e. 4.5% and the unwinding of positions did not yield profits in all cases. The greater convergence of fundamental economic factors allowed this reduction: significant progress was made in 1986 towards securing price stability and the differences in current-account positions were less marked. The smaller the realignments — provided they remain infrequent — the less the encouragement to speculate in future, especially if adequate interest-rate differentials are maintained between the EMS currencies, and if necessary brought about in a timely and resolute manner. The success of such an exchange-rate policy becomes evident if, after the change in central rates, the market rates of the currencies affected change relatively little initially, as was the case after the central rate change of 12 January 1987.

(b) Secondly, the situation also differed from that of earlier years because the process of freeing capital movements was not interrupted in 1986 when tension arose, but was persevered with. This was particularly notable in the case of France.

3. Broadly speaking, 1986 was characterized throughout the world by an increase of the volume and of the mobility of capital flows. In the Community the deregulation of economic life continued: this included the removal of the remaining safeguard clauses permitting exchange control in France and further progress towards the freeing of capital movements in Italy. Apart from one instance involving Italy at the beginning of 1986, there was no recourse to administrative measures to deal with situations of heightened tension on the exchanges.

Despite the improvement of fundamental economic conditions, the need for greater convergence has not diminished. An EMS with greater freedom of capital movements requires increased cooperation in the fields of economic and monetary policy. The need for stability of the parity grid is also important. The maintenance of adequate interest-rate differentials, the appropriate use of intervention and increased use of the margin of fluctuation can all help prevent the emergence of expectations of central rate changes. More frequent realignments would in the view of the Committee certainly be the wrong way out. The Monetary Committee has drawn the relevant conclusions from this for its future work.

II. MAIN FIELDS OF ACTION

4. The most important topics on which the Committee worked in 1986 were the following:

- (a) the downturn of oil prices and the increased difficulties of some oil-exporting countries prompted a review of strategy on the international debt question and in March the Chairman of the Committee reported to the Council on this issue. The situation of some large debtors had become worse as a result of the oil price fall and the Committee came to the conclusion that therefore, within the framework of the 'case-by-case' strategy, a longer time horizon and additional adjustment would be required;
- (b) the operating procedures of the EMS formed a central theme. Discussion concentrated on three closely interlocking areas: the first was the strengthening of the EMS by a reduction in the differences in the performances of the member countries, not least in the important areas of public finance and price stability. The second was the technical improvement of the EMS mechanism, and in particular a change in the terms attached to the very short-term financing facility which is available to participants in the exchange-rate mechanism in certain circumstances when they intervene in the foreign-exchange markets. The third was the encouragement of the liberation of capital movements; this last can lead to a

durable strengthening of the EMS if it is accompanied by closer cooperation in the field of monetary policy;

- (c) the monetary effects of greater use of the private ecu were also examined. However, given the extent and nature of its use, it is judged that the monetary consequences of the private ecu, at present and in the foreseeable future, are limited, and no serious problems are expected to arise for monetary policy;
- (d) the problem of the access of European financial institutions to the Japanese market was examined. There was discussion of how the Member States and the Commission, in their contacts with the Japanese authorities, might seek to improve the refinancing available to European banks on the Japanese market. In particular, the Community would like to see the faster deregulation of interest rates and the removal of obstacles to the creation of a liberalized inter-bank market in Japan;
- (e) the Committee also contributed actively to the preparatory work on a new directive on the freeing of capital movements, which was adopted by the Council on a proposal from the Commission at the end of 1986;
- (f) the Committee continues to attach importance to its examinations of the economic and financial situations of individual member countries. In 1986, the examinations of the new Member States Spain and Portugal were particularly important. The Committee also continued its surveillance of the economy of Greece and recommended the payment of the second tranche of the Community loan to that country at the end of the year.

5. Although at its origin the EMS may have seemed from the outside to be a system of passive cooperation, which — apart from the central commitment to domestic and external stability — required action to be taken chiefly when a currency came up against the limit of a margin of fluctuation, its essential feature has become more and more an active and comprehensive cooperation. The EMS agreement itself is flexible and offers scope for further steps forward on a basis of consent, without the necessity for formal decisions at each stage. The present cooperation in the area of monetary policy includes agreement on the following key principles:

- (a) in the EMS, which aims to achieve internal price and cost stability and stable exchange rates, the countries which have had most success in stabilizing their prices and costs tend to have falling real exchange rates while those which have had less success in this respect tend to have real exchange rates which rise. As long as complete convergence has not been achieved, these divergencies between nominal and real exchange rates are bound to occur. Their reduction is to be achieved through a more intense stabilization effort by all member countries.
- (b) in countries with large current account deficits, it is not sufficient for the rate of growth of the money stock to be in apparent conformity with targets. It is also

necessary to give close attention to domestic credit expansion and to the external counterpart of money creation. Rapid expansion of domestic credit, having an impact on the propensity to import and on capital movements, must not threaten the general equilibrium of the developing economy. Monetary policy must therefore ensure that liquidity creation from domestic sources does not fully offset the liquidity effects of the current account balance.

- (c) in countries where official external borrowing has traditionally been high and accompanied by a substantial budget deficit, problems of domestic monetary control may occur if the external account improves faster than the fiscal position. In such cases, it is appropriate to reduce official external borrowing gradually and to switch to more non-monetary financing of the remaining public deficit;
- (d) the freeing of capital movements is firmly based in the Rome Treaty and serves two main objectives: first, a more efficient allocation of resources and, second, the completion of the single internal market. It also helps to bring about closer convergence in the EMS;
- (e) increased use of the existing margins of fluctuation can help to discourage speculation on exchange-rate changes. Monetary authorities indicate thereby that when their currency has moved in one direction they will be ready to allow it subsequently to move in the opposite direction as well. A bolder use of the margins must however form part of a coherent policy which also uses interest rates and intervention at times of tension;
- (f) since the markets take different views of different EMS currencies, the stability of central rates in the system depends on the maintenance of adequate interest-rate differentials. The timely and resolute adaptation of interest-rate differentials counteracts speculation. However, interest-rate policy cannot be used in isolation. As in the case of extensive and prolonged intervention, there must sooner or later be other accompanying economic policy measures.

Brussels, 3 March 1986

INTERNATIONAL INDEBTEDNESS*(Report by the Chairman to the Ecofin Council)*

At its February meeting, the Monetary Committee discussed at length problems of international indebtedness. It commented on the latest fall in oil prices and the effect it will have on international indebtedness. A conclusive appraisal of these aspects was not possible since the trend of oil prices and their effect could not be satisfactorily evaluated at the time of the Committee's deliberations. This report, made under the responsibility of the Chairman, summarizes the position of the Monetary Committee.

I. SITUATION AND OUTLOOK

The method adopted to handle the problems of international indebtedness since 1982, which is characterized by close cooperation between all concerned as part of a 'case-by-case' approach, has preserved the international financial system from profound turmoil. Even in the current international economic environment, this strategy offers the best basis for a lasting solution to the debt problem.

In spite of definite progress in adjustment on the part of a number of countries, it is clear that economic and political problems in other major debtor countries have if anything recently grown more serious. This can be seen in the demands of the debtor countries (Montevideo Declaration), as well as in the discernible efforts to find a solution without the full involvement of the IMF.

The exchange-rate adjustments which have occurred between the currencies of major industrial countries, in particular since September 1985, and the recent sharp fall in oil prices both have important implications for the debt problem. The present structure of exchange rates undoubtedly reflects fundamental economic factors better than did that which prevailed a year or even six months ago. This should contribute towards sustainable growth of output and trade, with potential benefits for debtor country exports. Also the real burden of developing countries' debt, most of which is denominated in dollars, has been eroded by the depreciation of this currency. The impact of lower oil prices will be even more important and, as a result of it, the already divergent situations of debtor countries will be further polarized. On the one hand, several major oil-dependent debtors (for example, Mexico, Nigeria, Venezuela, Indonesia, Egypt, Ecuador, Iraq) are facing serious additional difficulties as a result of the fall in oil prices, and this tends to accentuate further the need for real adjustment while at the same time hampering that process in the short term.

On the other hand, the situation of debtor countries that are net oil-importers (for example Brazil and Yugoslavia) is made easier. Above and beyond these primary effects, however, the secondary consequences for world-wide growth, world trade, commodity prices and interest rates must be taken into account. On the whole the fall in oil prices should permit more vigorous economic growth in the industrialized countries, and thus enhance the debtor countries' export prospects.

This outlook leads the Committee to the following observations:

- (a) the position of several oil-exporting debtor countries, and especially a number of major debtors, has worsened because of the fall in oil prices, with the result that resolving their problems will require a longer time horizon and extra efforts;
- (b) the developments in oil prices and the exchange-rate movements that have taken place recently will in due course have a beneficial effect on real economic growth and world trade;
- (c) the resulting improvement in the prospects for a lasting reduction in inflation should have a positive influence on the chances for a further world-wide reduction in interest rates, although some uncertainty persists on the stance of monetary and fiscal policy in the United States;
- (d) on the whole, for a large number of debtor countries the outlook should improve significantly because of these new developments.

Some members pointed out that a distinction should be made between the previous and the new problems of indebtedness.

II. SOME PRINCIPLES FOR THE CONTINUATION OF THE DEBT STRATEGY

1. The 'case-by-case' approach remains the best way in which to resolve the debt problem. This is borne out by the unchanged basic situation and past experience as well as by the latest outlook, which suggests that the situation will become even more differentiated. It is clearer than ever that there cannot be a global solution.
2. There is joint responsibility of all concerned. Debtor countries, industrialized countries, international organizations and commercial banks should not hold back from assuming their common responsibility.
3. There can be no solution to the problems of indebtedness without the readiness of the debtor countries to undertake adjustment. In this connection the efforts made so far and the political implications should be taken into account.
4. The talks and negotiations with the debtor countries should continue to take place exclusively in the competent forums.

5. While some large debtor countries certainly merit special attention, the problems of the small countries, especially the poorest among them, notably in Africa, should be given particular emphasis.

In the light of these orientations, the initiative put forward by Secretary Baker at the autumn meetings of the IMF and World Bank is to be welcomed. It should be put into operation as a matter of urgency.

III. CONTRIBUTIONS FROM THOSE CONCERNED

1. Debtor countries

If debt problems are to be resolved, two sides have to be considered. In first place must be the real economic aspects: only when the debtor countries strengthen their international competitiveness and their external economic position will they again be in the position to meet fully their debt service requirements. Alongside this there is the financing side: the provision of financial resources enable these countries to phase the necessary real adjustment over time. If the problem of indebtedness were approached only from the financing angle, the debtor countries' difficulties could not be durably resolved. The central element of the policy to be pursued by the debtor countries must, for this reason, be real economic adjustment, a process that cannot be avoided. Over and above the short-term improvement in their balances of payments, these countries must follow a confidence-building policy that will be effective in the longer term.

- (a) To this end, inefficient structures and rigidities in the production and distribution system and in the fiscal and other areas must be rectified.
- (b) It is also important that unrealistic exchange rates should be abandoned and that monetary policy should promote internal economic adjustment. In order to ensure efficient utilization of domestic resources and to encourage domestic saving, policies designed to secure positive real interest rates are necessary in principle.

Insofar as such steps reinforce creditworthiness and, in particular, boost the confidence of debtor countries' own populations, the incentive to capital flight will be removed and foreign investment capital attracted.

2. Industrialized countries

- (a) The industrialized countries' most important contribution is to strengthen the conditions for economic growth and world trade. In 1986, the fall in oil prices should provide an extra stimulus to growth and the reduction in inflation. This outlook will also contribute to more favourable interest rates.

- (b) An essential condition for resolving the problems of indebtedness is the preservation and further development of an open, multilateral trading system. In the present situation, this requires above all resistance to the introduction of new trade barriers, as well as steps to dismantle trade restrictions.
- (c) The industrialized countries, in the framework of the Paris Club, have played an essential role in recent years in rescheduling sovereign debt. In the future as well, the creditor countries must be prepared to undertake reschedulings in appropriate cases.
- (d) Where debtor countries have made significant progress in adjustment, the industrial countries could respond in a flexible manner by facilitating the resumption of export credit. For this, consultations among countries providing credits could be useful.
- (e) In the Committee's view, the industrialized countries have a special responsibility towards the poorest countries, whose problems require special efforts. The flow of resources to such countries, including official development assistance, must be maintained and, where possible, stepped up.

3. International financing agencies

(a) International Monetary Fund

In the future as well, the IMF and its 'case-by-case' strategy will continue to play a key role. Through the conditionality which it alone can impose, it is able to mobilize the necessary financial resources, and its role as a catalyst is indispensable for all those involved, not least the highly indebted countries. The attempt by some countries to escape its influence must, therefore, be countered. Indeed the question arises whether the IMF could not present the necessary conditionality in a politically more suitable way in individual cases.

Since some of the large debtor countries will probably face serious transitional and adjustment problems on account of the fall in oil prices, the question was asked in the Committee whether the existing IMF facilities would, where necessary, permit additional support measures. A certain number of members expressed the idea that, in order to assist the debtor countries that have been particularly hard hit by the fall in oil prices, consideration could be given to creating some sort of oil facility within the IMF to the benefit of the oil-exporting debtor countries. In their opinion, such a facility would, in the present situation, underscore the solidarity of the industrialized countries. According to the other members however, there is no need for any new Fund facility. At the moment, the IMF has at its disposal fairly substantial resources that could be deployed provided these debtor countries showed corresponding willingness to undertake adjustment. Moreover, in the context of enlarged access, it is possible in special cases to overstep the agreed access limits.

(b) World Bank group

In line with their responsibilities, the World Bank and the multilateral development banks must in the future make a greater contribution to structural adjustment in the debtor countries. As a priority, cooperation between the World Bank and the IMF must be improved, in particular the IMF's short-term and medium-term programmes must be coordinated with the longer-term lending engaged in by the multilateral development banks. But this must not impair either the specific nature of the institutions or their creditworthiness.

With this aim in mind, the Committee discussed particularly the following moves:

- (i) enlargement of quick-disbursing non-project loans in the closest cooperation with Fund programmes, if and in so far as this gives rise to effective adjustment measures;
- (ii) temporary overstepping of the present maximum sustainable lending limit of the World Bank, provided a commitment by all concerned to raise the World Bank's capital exists. This will of course make all the more urgent a prompt increase in the World Bank's capital, the need for which has already been agreed upon by Community countries;
- (iii) use of the World Bank's resources to mobilize an increased flow of funds from commercial banks and private investors, although an extremely cautious attitude should be adopted towards the provision of guarantees;
- (iv) stronger use of the economic policy leverage of the World Bank on structural adjustment in the borrowing countries, so as to improve their creditworthiness;
- (v) a marked improvement in the World Bank's administrative efficiency and loan procedures. In this connection the changes at the top of the administration should be cleared up soon.

The Committee discussed in brief and welcomed the United Kingdom's proposals for closer cooperation between the IMF and the World Bank, as well as the French proposals for 'joint adjustment-development programmes' provided these are envisaged for specific cases and not as a general rule. The UK and French proposals are to be discussed by the competent bodies of the IMF and the World Bank.

Lastly, the early signing of the MIGA Convention could improve the investment climate in the developing countries and could generally encourage the inflow of direct, private-sector investment.

(c) International Development Association (IDA)

In the present international economic situation, the IDA deserves special support so that it can perform its central role in the provision of concessionary aid. In the Committee's opinion, the forthcoming eighth IDA replenishment should result in a total amount of around USD 12 000 million. However, the willingness of the Community countries to support a replenishment of that magnitude is dependent on fair burden-sharing with the United States and Japan. It also appears desirable in concrete cases to establish a link where appropriate between IDA VIII financing and Trust Fund flows, which would strengthen the need for the closest cooperation between the Fund and the Bank in the poorest countries too.

4. Commercial banks

The Baker initiative, which the commercial banks have basically welcomed, affords them a good opportunity to contribute, through 'coordinated action' involving fresh credits, to improved growth prospects in the debtor countries. Such participation in further lending is also in their own interest. It should be on their own responsibility, that is to say, governments should not take over private risks. Equally, it is the banks' responsibility to ensure, in organizing their cooperation, that small banks, especially, continue to participate.

Serious consideration should be given by commercial banks to a better use of their new money. The objective should be to use the additional financing thus provided, not only to relieve the balance of payments, but also to develop the economy of the recipient countries. By financing productive and sound development projects, the 'new money' would directly contribute to the growth of exports and GDP, thereby avoiding problems of capital flight. Commercial banks could in this way benefit from the expertise which the World Bank has developed in this field.

Lastly, the preferential position of the IMF and the World Bank in reschedulings should in no way be called into question.

IV. CONTRIBUTION BY COMMUNITY COUNTRIES

The Community countries are contributing in numerous ways to the resolution of the problems of international indebtedness.

As regards the economic growth that is of particular importance for developing countries' exports, there are presently good prospects that the growth process in the Community will gather further momentum and will be longer lasting. The outlook for developing country exports to the Community should improve appreciably in 1986. In addition, further headway in reducing inflation is expected in Member States, and this will not fail to have its effect on interest-rate trends.

Furthermore, a European Monetary System strengthened by the convergence of economic policies is having a stabilizing effect on international monetary relations. It was also pointed out in the Committee that capital markets in most Member States are making an essential contribution to the refinancing of international financing organizations.

During the Committee's deliberations, special emphasis was placed on the need for the Community to ensure, during the forthcoming GATT negotiations, that tangible progress is made possible on international trade. In other related areas, too, solid progress should be made as swiftly as possible. Some members suggested that the Economics and Finance Ministers should take more vigorous action at European and national levels to counter special sectoral interests.

The Committee also discussed whether supervisory regulations and tax rules in individual countries represent an obstacle to participation by European banks in tackling the debt problems. Generally speaking, this does not appear to be the case in the Community countries, but these matters are still being examined in detail by the Commission on the basis of work by existing expert committees. For this reason, a conclusive assessment of this matter is not yet possible.

In the Committee's discussions the importance of a positive signal by the Community countries in the area of export credit was mentioned. It was proposed that for debtor countries whose external debt has been rescheduled, which are undertaking the proper policy adjustments, thereby improving their economic prospects, and for which commercial banks are prepared to provide fresh money, industrial countries should resume or increase export credit cover, subject to their standard national policies.

The specific difficulties and needs of Africa were underscored once again by the Committee. The Community countries should be aware of their special responsibility for this region. They have already demonstrated their responsibility by participating in the World Bank's special sub-Saharan facility and by helping the particularly needy countries of Africa in other ways.

Finally, the Monetary Committee would like to make it clear that the European countries as a group have made a comparatively large contribution to resolving debt problems and that, in so doing, they have, in a special way, lived up to their international economic responsibility. For example, European countries accounted for over half of the total reschedulings of official credits in the framework of the Paris Club (around USD 19 000 million in 1985 alone).

V. SUMMARY

1. All in all, the problems of international indebtedness have not fundamentally altered as a result of the recent movements in oil prices and in exchange-rate

relationships between the industrialized countries. Although the prospects for the world economy in general, and for most developing countries, have improved, the difficulties of a number of major debtors have been seriously exacerbated, at least in the short term. The dangers for the international financial system still exist.

2. The very different situations of debtor countries underline the need for a continuation of the 'case-by-case' approach. All those concerned must continue to make their contribution to resolving the complex debt problem. This is true, first and foremost, for the debtor countries but also for the industrialized countries, the international organizations and the commercial banks.
3. Since the causes of the debt problem are to be found primarily in the economic and financial sphere, it is there that the solutions must continue to be sought. As before, the Bretton Woods institutions and the Paris Club provide the appropriate institutional framework.

Gleneagles, 15 September 1986

A PROGRAMME FOR STRENGTHENING THE EMS

(Written report by the Chairman of the Monetary Committee)

At their informal meeting in Palermo the Ministers for Finance asked the Monetary Committee to prepare proposals for strengthening the EMS. The Committee has already presented a detailed report, in June 1985, on the long-term goals of the EMS and the fields of action in a medium-term outlook. The written report put forward today gives an overview of developments since Palermo, deals briefly with the present situation of the EMS and sets out lines of action for a programme of EMS reinforcement.

1. DEVELOPMENTS SINCE PALERMO

By amendment of the Treaty of Rome three important reference points were established for monetary policy in the Community: first, economic and monetary union as well as the necessary convergence of economic and monetary policies were built into the Treaty as objectives. Secondly, the path of pragmatic cooperation was confirmed as the one to be followed by the EMS, while respecting existing powers in this field. Thirdly, it was made clear that, insofar as further development in the field of economic and monetary policy necessitates institutional changes, the provisions of Article 236 shall be applicable.

In the past year the Monetary Committee has, after a thorough consideration of the long-term goals of the EMS, examined in particular the question as to whether, and if so in what measure, the growing use of the private ecu has effects on monetary developments and on the exchange-rate policies of member countries. The Committee has also actively supported the preparatory work on a new directive on the liberalization of capital movements. Finally, the Monetary Committee has identified some lessons which can be drawn from recent adjustments of central rates within the EMS. With the aim of improving convergence among member countries, the Committee has worked towards a deeper understanding of the necessity for economic policy to be conducted in a way which fully reflects the requirements of the EMS. These discussions will be taken further.

2. THE PRESENT SITUATION IN THE EMS

As a whole, key economic data show that convergence is proceeding. In spite of the progress made in convergence, some changes in central rates became necessary during the last few months.

Several member countries have introduced measures to open up their capital markets in recent years (Denmark, France and Italy); the result has been to consolidate the desired progress in the matter of convergence, inspiring confidence for the future. In addition, the degree of indexation of incomes and pay has been further reduced in some countries (Belgium, Italy, Denmark).

The present situation within the EMS should be used to strengthen the system, not least through the correction of internal policy deficiencies.

3. PROGRAMME FOR STRENGTHENING THE EMS

3.1. Convergence

Thanks to the progress made in bringing economic policy orientations closer together in the member countries, the EMS has so far weathered a period of often very large dollar fluctuations without excessive disturbance. However, the relatively satisfactory degree of convergence will be under threat unless there is success in overcoming policy deficiencies remaining in some countries, particularly in the area of public finance. If these deficiencies are not made good, an excessive burden may be put on monetary policy, or else there may be consequences for the stability of central rates.

In order to correct the present lack of convergence in the area of public finance, the Committee considers it to be essential that the excessive deficits still prevailing in some countries should be reduced to a level which can be sustained over a long period. Although for some countries this reduction may need to be phased over several years, it is nevertheless important that this process should be started without delay and should be convincing.

Moreover, the growing mobility of capital flows means that the need for convergence in the EMS will become even greater.

3.2. The liberalization of capital movements

The liberalization of capital movements is primarily an obligation which flows from the EC Treaty and is thus independent of the EMS; it is also a central component in the creation of the single internal market.

For these reasons the dismantling of the remaining exchange controls should be pushed forward speedily. An important step would be to adopt soon the new liberalization directive. In order to achieve a full and lasting opening of capital markets, the Committee recalls the importance of the Council's intention to decide on complete liberalization in 1987. Against the background of this second directive the Committee will examine some of the important implications: the consequences of

full liberalization for monetary policy and its instruments, the problem of the safeguard clauses and the need to ensure an adequate framework for market supervision. In addition, care should be taken that the effects of dismantling controls on capital movements are not reversed or weakened by new administrative intervention.

For the EMS itself, the liberalization of the whole range of capital movements will bring about some important changes: in economic policy the EMS countries must come together much more closely; corrective measures must be taken more promptly, and the disappearance of an instrument which potentially influences the exchange rate calls for a more balanced policy mix. This increased pressure for convergence will in the end reinforce the economic strength of all participating countries and will thus in the end favourably influence the stability of exchange rates.

In order to strengthen their economic fundamentals, it is equally important that new Member States — in addition to their legal obligations — take steps to liberalize capital movements.

3.3. The ecu

As far as the private ecu is concerned, the Committee has examined closely whether its increased use would have disturbing effects for monetary policy: under present conditions, while there are limited monetary effects, there are no grave problems. From the monetary point of view, therefore, the maintenance of limitations on the use of the private ecu does not seem necessary. On the other hand it seems to be appropriate that the further development of the private ecu be determined by market forces. That does not preclude an institution such as the Monetary Committee from following its further development closely.

As to the official ecu, several important improvements have been introduced since Palermo by the Central Banks, whose effects in practice are as yet only partly discernible. These questions are being dealt with more particularly by the Committee of Central Bank Governors. For its part, the Monetary Committee will consider at the appropriate time whether to make suggestions on the official ecu.

Recently consideration has also been given to a possible link between the private ecu circuit and the official ecu circuit, which is of a completely different nature. The Committee has not yet been able to examine this question thoroughly. While some Members take a favourable view of this idea, others point out that bringing the two ecu circuits closer or actually joining them would have important monetary effects as well as important consequences for institutional checks and balances. The Monetary Committee will continue to examine these questions.

As to the potential role of the ecu as a reserve asset in the wider international context, the Committee's discussions have not yet come to a final conclusion. While it

was stated by some members that this development could be promoted by a further extension of the role of the official ecu and by the abolition of restrictions on the private ecu, other members expressed the view that a reserve currency cannot be artificially created.

3.4. Special rules

One step towards reinforcing the EMS would be the dismantling of existing special rules, and in particular the creation of uniform conditions in the exchange-rate mechanism.

The question of full participation is naturally in the first place a decision for each of the member countries concerned. In order to avoid further differentiation it would be useful to have the same conditions for all members.

Different conditions still apply at present with regard to the band width; the wider band used by one country was envisaged as a transitional solution and has not in fact been used to its full extent for a long time.

Finally, the Committee has considered the dual exchange market existing in two Member States. This special rule, which results in different exchange rates for different types of payment, would not be fully in accordance with the objective of integration, which is also pursued through the full liberalization of capital movements.

4. FUTURE WORK

The Monetary Committee regards this document as a progress report on its work. Additional work seems to be necessary, especially in the following fields:

- (a) further liberalization of capital movements;
- (b) further development of the role of the ecu;
- (c) re-examination of the application of special rules.

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Twenty-eighth activity report

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