EUROPEAN ECONOMIC COMMUNITY

EIGHTH REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

Blank pages not reproduced: 2, 4

Brussels, 15 April 1966

INTRODUCTION

The purpose of this report is to give a general picture of the activities of the Monetary Committee of the European Economic Community during 1965.

In the course of the year the Committee held eleven meetings under the chairmanship of Jonkheer E. van Lennep, and working parties met on many occasions. A list of the members of the Committee is appended.

The report was completed on 4 April 1966, and so takes no account of economic developments since the end of February, whether within the Community or outside it.

Chapter I

1. In 1965 the Monetary Committee continued the work allotted to it under the Treaty of Rome. As in previous years, it studied the economic and financial situation in the member countries, and the conclusions it reached are set out in Chapter II.

2. In its last report, the Committee analysed the problems raised by the growing interpenetration of the Member States' economies. It noted that the measures adopted by the authorities of any given country to influence the economic trend within that country were felt more and more rapidly throughout the Community. The need for closer co-ordination of the economic policies followed by the Member States is therefore all the stronger. As in the past, the Committee examined these questions in detail, watching in particular the policy mix that can best be used to maintain the balance of the economy or, if necessary, to restore it.

3. Even more than in previous years, the Committee has studied international monetary problems, which in 1965 assumed particular importance. The Council's decision of 8 May 1964 provided for consultations within the Committee on any decision or any important statement by Member States in the field of international monetary relations, in particular with regard to the general functioning of the international monetary system or where one or more Member States participate in major support operations aimed at helping non-member countries.

Consequently these topics were discussed in the Committee before they came up in the other bodies and institutions within which the Member States have been very active. In addition, the Committee has set up a working party whose task it is to confront and seek a common denominator for the points of view of the Member States so as to facilitate the work being done in the same field by these other bodies, notably by the Group of Ten.

The Committee has also held discussions prior to the renewal of the EMA, to the increase in the IMF quotas and to the extension of the General Arrangements to Borrow.

4. The trend of their external payments accounts in 1964 and 1965 led the United Kingdom and the United States to adopt measures designed to eliminate their deficits; it also led to international support operations which, in the case of the United Kingdom, were carried out at exceptionally short notice and on a large scale. The measures adopted by these two countries, notably those taken by the United States with regard to capital movements, have enabled some progress to be made towards the re-establishment of international equilibrium.

5. Together with the reduction in the payments deficits of the USA and the UK there has been a contraction in the Community surplus, a larger

surplus on current account being more than outweighed by the decline in the net capital inflow. The external payments position of certain other European countries and of certain countries that produce mainly raw materials has also deteriorated, but in most of the developing countries it has improved slightly.

I

6. In the various countries of the European Economic Community developments have followed markedly divergent lines. The previous slowdown in the economic growth of Italy and France was reversed at the end of 1964 in Italy and in France from the spring of 1965 onward. In Germany and the Netherlands excess demand persisted, making the labour shortage more acute and speeding the upward thrust of prices; in Belgium and Luxembourg economic expansion remained modest. The increase in the real gross Community product was 3.5% for 1965, compared with 5.6% for 1964.

The recovery in France and Italy may be expected to continue in 1966. The expansion of economic activity tended during the last few months of 1965 to slow down in Germany — where there was a shortage of production factors and the growth of demand was inclined to lose momentum — and this tendency will presumably persist.

7. The current accounts in the member countries reflected these divergent trends. While France and Italy recorded very heavy surpluses in 1965 — in the case of Italy, more than $1 500m. — the surplus continued to contract in the Federal Republic of Germany and in the Netherlands; in Germany it even became a substantial deficit.

8. The upward price movement remained unduly rapid, with the annual increases in consumer prices ranging from 2.5% in France and Italy to 5% in the Netherlands. According to the economic budgets, prices will rise at much the same tempo during 1966. In its Recommendations of April 1964 and April 1965, the Council gave absolute priority to the stabilization of prices; this objective has been far from fully attained.

A more detailed examination of trends in the member countries leads to the following general conclusions.

9. The divergent and even conflicting trends in 1965 in the member countries helped to limit inflationary strain in the countries most severely affected and to assist economic recovery elsewhere. In Germany, for example, the effects of surplus demand were tempered by a substantial increase in imports from other member countries, while the economic recovery in Italy benefited considerably from the additional demand from Germany. For 1965, exports from Italy to Germany increased by 47% and from the other member countries by 26%, whereas the corresponding figure for the rest of the world was below 20%.

10. Although the divergent trends in the economic situation of the various countries tended to compensate each other, they made no substantial contribution to restoring price stability. The upward movement continued even in those countries where the pace of economic growth slackened. It should however be noted that this upward movement can in part be put down to increases in the rates charged by public utilities, in rents and in indirect taxes; and once again it has been shown that a reversal in the trend of business activity affects the trend of wage costs only with a certain time lag. At all events, the re-establishment or the maintenance of more or less stable prices must continue to be a major policy objective in all the member countries. Consequently, the various measures to get the economy under way again have had to be carefully balanced in Italy and in France to prevent the recovery getting out of control. The evidence available in early 1966 suggests that, when allowance is made for the measures already taken, the current trend is satisfactory and that no further incentive measures are needed.

11. In this situation the establishment of a genuine incomes policy is still fraught with difficulty. Such a policy can in any case not replace monetary and budgetary policies in their own field, i.e. in the control of overall demand, and past experience has shown that it is of little use in periods of severe strain. It should none the less make it possible to avoid situations in which the authorities are obliged to resort to restrictive credit policy or to heavier taxes at a time when production factors which would enable expansion to continue at a firm rate are still available : in cases in which inflationary pressure stems mainly from an autonomous increase in incomes and prices, these instruments can be brought to bear only indirectly on the causes of disequilibrium and their application is therefore bound to harm the economy.

12. Budgetary policy has in fact played its proper role in few of the member countries. The stimulus to economic activity due to official spending went beyond the bounds set by the Council in its 1964 and 1965 Recommendations. This was most marked in Germany, the Netherlands and Belgium, and in these countries it helped to force prices up.

The rapid expansion of public expenditure in recent years, which is mainly due to the expansion of consumption expenditure and, even more, of transfer expenditure, has quite definitely helped to increase strain. However, this does not mean that the problems raised by the need to improve structures in the member countries have not remained of vital importance. This objective necessarily entails a steady increase in expenditure, notably on education, equipment and infrastructure generally. This trend is coming increasingly to the fore and as a result Governments are being faced with difficult decisions. Where investment expenditure has been postponed in view of the economic situation, the problem is likely to become all the more difficult in the years ahead.

This makes it more than ever necessary to reconcile economic policy objectives with the need to maintain a balanced development in the national economies. It would in this connection be desirable to facilitate the establishment of the annual budgets by making available longer-term forecasts covering those classes of expenditure for which such forecasts are feasible. Furthermore, central government action to curb the expansion of public expenditure ought to be backed up by local and regional authorities and by semi-public institutions and companies; in recent years the rapid expansion of expenditure by these authorities often added to inflationary pressures. Finally there is a danger that with the passage of time a number of transfer expenditure items may acquire a permanent status : action should be taken as far as possible to avoid this. With these adjustments, fiscal policy would thus acquire a flexibility that would make it easier for the authorities in each country to establish a better « policy mix ».

13. In 1965 the financial difficulties besetting almost all the member countries forced the authorities to lean too heavily on monetary policy as a means of maintaining internal equilibrium. The Committee has repeatedly drawn attention to the consequences of such a policy. The use of monetary policy alone to eliminate excess demand might well entail unduly heavy pressure on industrial investment and on construction. The measures being taken to improve the working of the national capital markets could also be weakened and international capital movements disturbed. Such a policy in one Community country could hamper the work of the monetary authorities in others.

14. Growing economic integration within the Community also means that the effectiveness of monetary measures taken at national level is declining. The more numerous forms of contact between member countries are enabling firms to avoid some of the effects aimed at when the authorities in their own country pursue a restrictive monetary policy. The difficulties the German authorities encountered in applying a restrictive credit policy in 1965 bear witness to this fact. In the past only the big companies were able to finance activities with money raised abroad, but now the growing interpenetration of commercial and banking relations in the EEC is making it possible for smaller firms to borrow abroad. This trend highlights the need for close international co-ordination if the effectiveness of credit policies applied is to be improved.

15. Co-ordination could cover, for example, interest rates and official regulations concerning the granting of credit. It might very well take the form of consultations between the responsible authorities in the Member States; an essential point in these consultations would be to show how decisions taken in the light of the situation in one country might affect the markets of other countries. Those member countries not yet possessing the means — such as those tried out in the Netherlands and France — of directly controlling the volume of credit might be wise to study the feasibility of instituting the necessary machinery for use should the circumstances require it.

16. All this highlights the importance of improving the economic « policy mix » in the member countries. The need for such action is becoming

increasingly evident as the impact of certain instruments weakens with the progressive integration of the economies. Member States must therefore aim at taking measures which will obviate the difficulties set in motion by internal imbalance. Action in good time should, in particular, make it possible to prevent a recurrence of price increases as heavy as those recorded in recent years and to prevent their being « exported » to the other countries of the Community.

17. The Committee again stresses, in this connection, the need for the Member States to do everything possible to follow the Council's Recommendations in the fight against inflation. For prices to rise as rapidly as they have done in the last few years not only conflicts with one of the major objectives of the Rome Treaty (Article 104), it could eventually undermine the competitiveness of exports from the Community and thus jeopardize the stability of the various currencies.

II

18. Balance-of-payments trends in recent years have not yet reflected this danger. The latest figures — which are still provisional — give the following picture.

The tendency for the EEC current account [1] surpluses with the rest of the world to contract in 1962 and in 1963 was reversed early in 1964 and the new trend gathered strength in 1965. The surplus on current account, which was about \$650m. in 1964, was more than \$1 500m. in 1965. However, the tendency for surpluses to grow seems of late to have lost something of its momentum.

Long-term capital exports as aid to the developing countries, and, more generally, exports of long-term public capital, have been more than offset by net imports of long-term private capital, so that the surplus under this heading was more than \$500m., although it fell appreciably short of the figure achieved in 1964 (\$1 400m.). The surplus on the basic balance was, at about \$2 000m., much the same as for 1964. Including all other items — advance debt redemption, short-term capital movements, errors and omissions — the overall surplus on the balance of payments (change in net official holdings and in position with the IMF) was \$1 500m., compared with \$1 900m. in 1964.

19. The most important external counterpart of the payments surpluses registered by the Community is to be found in the United States, where the payments accounts closed, on the basis of official settlements, with an overall deficit of about \$1 300m; the balance on visible trade deteriorated by nearly \$2 000m. and the surplus on goods and services fell to about \$7 000m. — still a handsome figure, but well below the \$8 600m. achieved in 1964.

---

[1] Merchandise, services, public and private transfers.

Direct American investment abroad increased again, and net exports of long-term capital amounted to about $4 400m., compared with sums of $2 500 to $3 000m. during 1962 and 1963. The deficit on the US basic balance was $2 000m.

Measures by the US Government to curtail capital exports, which were stepped up towards the end of 1965, have as yet had no noteworthy effect on long-term capital movements. On the other hand, movements of short-term funds showed a radical change : an outflow of about $2 000m. in 1964 gave way in 1965 to net imports of about $850m.

III

20. The trends described above cannot be properly assessed unless due consideration is given both to the financial relations between the United States and EEC countries and to the financial relations — which are in need of improvement — between industrialized countries and developing countries. The industrialized countries have set themselves the objective of stepping up aid to the developing countries to a level of at least 1% of their national incomes; this presupposes a balance-of-payments pattern with an adequate surplus on current account. If the heavy flow of capital from the United States towards Europe since most European currencies have once again been convertible is left out of account, it will be found that the composition of the US balance of payments is compatible with this objective, but that the same cannot yet be said for all the member countries of the EEC.

21. However this may be, the member countries should endeavour to increase their capital exports to the rest of the world. The Monetary Committee has accordingly embarked on studies to find out how capital exports towards the highly developed countries can be facilitated, and also to developing countries, especially through international institutions for financing development.

22. Direct American investment has unquestionably contributed to economic growth in Europe, especially where accompanied by the transfer of advanced industrial techniques. But the flow of capital in all forms to the EEC has none the less become excessive, jeopardizing, at least for a time, the equilibrium of international payments and hampering the European countries in their fight against inflation.

23. Consequently, the measures designed to curb exports of American capital to the Community certainly appear necessary if the objectives set forth above are to be achieved, though it is still too soon to say just what their impact on the European capital markets will be. While strains have increased in severity on some of these markets, this has been due rather to the inability of long-term saving to keep pace with the heavy demand for capital than to the inadequacy of overall saving, which is running at a

high level in all member countries. Strains on the capital markets of certain member countries have also been aggravated recently by developments in budgetary policy, which have entailed heavier borrowing by public authorities.

24. The problems posed by the need to reform the machinery of certain European capital markets and by their relative tightness assume special importance now that Community exports to non-member countries are mounting and the movement of American capital to Europe is likely to be smaller. At all events, as the development of the capital markets is vital to the harmonious economic development of the member countries and of the Community as a whole, these matters are being examined with care in a number of member countries and within the Monetary Committee itself.

25. Once again the Committee has had to note that the liberalization of long-term capital movements between the Member States, which is necessary to the attainment of the objectives laid down in the Treaty of Rome, has made no appreciable progress.

It is admittedly impossible to create at short notice an integrated capital market in Europe. Many obstacles, such as structural and institutional disparities, insufficiently co-ordinated economic policies, and the existence of six different currencies, stand in the way of spectacular successes in this field. These problems must of course be studied concurrently with the question of the further liberalization of capital movements inside the Community, so that any progress in one field can be turned to good account for harmonization in other fields, a process which will gradually lead to the establishment of a stable and homogeneous money and capital market, which is the final objective.

26. The Committee has therefore sought for ways and means of further liberalizing capital movements. Such further liberalization, even if it were of only limited scope, would enable the Council to resume negotiations on the third directive. This directive, which is designed to remove administrative obstacles to capital movements, varies very widely in value to the different countries, depending on the scale of surviving currency restrictions in each case. If it is really to attain its objective, something should be done at the same time to relax exchange controls. The Committee is studying this question, and hopes to be in a position to present concrete proposals shortly.

IV

27. A large part of the work carried out by the Committee has been devoted to an attempt to co-ordinate the member countries' views and policies on the negotiations for a reform of the international monetary system. These negotiations moved into a new phase when the ministers and governors of the central banks of the Group of Ten charged their representatives

on 28 September 1965 "to determine and report to Ministers what basis of agreement can be reached on improvements needed in the international monetary system, including arrangements for the future creation of reserve assets, as and when needed, so as to permit adequate provision for the reserve needs of the world economy".

28. This examination has revealed that there is an area of common agreement on a number of important questions of principle. Since, however, the negotiations are continuing in the Group of Ten, the Committee has preferred not to give fuller details at the present stage.

Chapter II

THE INTERNAL AND EXTERNAL SITUATION OF THE MEMBER STATES AND MAIN FINDINGS OF THE COMMITTEE

FEDERAL REPUBLIC OF GERMANY

In 1965 expansion continued in Germany and gross national product in real terms rose by close to 4.4%, compared with 6.6% in 1964. The main growth factor was domestic demand, which was swelled both by a considerable expansion of fixed investment and by a sharp increase in public and private consumption; the latter buoyed up by rapidly rising wages and salaries.

The growth of production was held back by the increasing labour shortage. At the end of the summer there were 700 000 unfilled vacancies, and the unemployment rate had dwindled to 0.4%. Domestic supply was unable to meet the higher demand, and merchandise imports rose by almost 20%. Although merchandise exports in their turn increased by about 10%, the balance on services deteriorated so sharply and the deficit on unrequited payments became so much heavier that the current balance of payments as a whole closed with a deficit of about DM 6 000 million, compared with a current surplus of around DM 1 000 million in 1964. However, the deficit on overall payments was much smaller than that, because of a heavy inflow of short-term capital. The gold and foreign exchange reserves of the Bundesbank dropped by DM 1 500 million in 1965, while the net balance of the commercial banks' foreign exchange assets and liabilities improved by DM 200 million.

In spite of the increase in imports, the gap between money demand and real supply widened and consequently the rise in consumer prices gathered speed in the course of the year; their 1965 average was 3.4% above the preceding year's level.

So far from inhibiting growth, public finance had a distinctly expansionary impact in 1965, so that it fell to monetary policy alone to combat the inflationary pressures. The Bundesbank last year maintained and indeed tightened the restrictive credit policy it had introduced as far back as the spring of 1964; bank rate was raised from 3 to 4% in two stages, and with effect from 1 October 1965 the ceiling of the Bundesbank's rediscounting facilities for commercial banks was lowered by about 10%.

However, this policy was slow to take effect. The expansion of commercial bank credits did not begin to lose momentum until the second half of 1965, and even then the last six months of the year still showed a rise of 6.3% compared with 7% in the second half of 1964. The delay is attributable to high bank liquidity when the restrictions were introduced, as well as to the offsetting effects of public finance operations. Furthermore, the monetary authorities' restrictions led the banks to cut down on security purchases and thereby hit the capital market. In these circumstances the Committee, when at the end of 1965 it reviewed the monetary and financial situation of the Federal Republic of Germany, suggested that there was a case for considering direct measures by the Bundesbank to restrict the banking system's credit expansion.

In addition, the Committee expressed the view that quite special importance would attach to budgetary policy in the effort to restore economic equilibrium in 1966. It welcomed the measures already taken or proposed with a view to containing the increase in federal expenditure. The Government's decision to fix a figure of DM 69 100 million for the budget estimates ought to limit the increment of federal expenditure to 5% in excess of the 1965 outturn. However, the Committee realized that the effectiveness of the Federal Government's budgetary policy depended largely upon the readiness of the Länder and municipalities to follow suit, for there is still a danger of expansionary pressure from the aggregate of public budgets in 1966. In the Committee's opinion, therefore, the current policy of credit restriction should be continued.

Although economic expansion is expected to slow down in 1966, the Committee is doubtful whether — if the steep climb of wages and salaries continues — the efforts of the authorities responsible for monetary policy and the budget will succeed in sufficiently reducing the imbalance between total demand and domestic supply this year. There is the additional danger that in the event of costs per unit of output continuing to go up at the present rate, the resulting price rise may not only jeopardize the return to internal equilibrium, but in the longer run may impair the German economy's competitive strength. In these circumstances it appears desirable for the federal authorities to use their full influence in bringing home to employers and employed alike how important it is at this precise juncture to contain the expansion of wages and salaries.

In more general terms, the Committee took the view that German short-term economic policy should be re-appraised with a view to arriving at a more effective policy mix by a better distribution of the parts allotted to monetary and to budgetary policy. The Committee is of course aware that, because of the federal structure of this member country, no quick results can be expected from such efforts to improve the set of instruments available to short-term policy. For this very reason it would be well to step up these efforts forthwith and to direct them in the first place at strengthening co-ordination among the various authorities which are in a position to influence economic developments. In this connection the Committee welcomed the progress made in plans to prepare budget estimates for several years ahead and expressed the hope that this work might soon be brought to a successful conclusion.

The downswing beginning during the second half of 1964 gave way in the spring of 1965 to a gradual recovery, which consolidated in the autumn and gained impetus toward the end of the year. In these circumstances, gross national product at constant prices rose in 1965 by a little more than 3% in the annual average, compared with 5.4% in 1964.

The recovery is not attributable entirely to the constant buoyancy of foreign demand, which was 11% above the figure for 1964; domestic demand, too, picked up increasingly as the year went on.

Private consumption expanded in step with gross national product. During the second half of the year there was a revival of demand for certain consumer durables. The satisfactory rate of increase in fixed capital formation is mainly attributable to public investment and residential construction.

The recovery of industrial production was at first held back by reduction of stocks, which in many cases had reached unduly high levels by the end of 1964. Toward the spring, production began to pick up in several consumer goods industries, but in the capital goods sector the pace of expansion remained very slow. Building activity was brisk throughout the year, though the rate of increase slackened somewhat during the last few months of 1965. Agricultural production exceeded the preceding year's total, which was already a high one.

Although imports rose appreciably during the second half of the year under the impact of the domestic recovery, the decline during the early months of 1965 held the increase in the volume of imports back to 2% for the full year, compared with 13% in 1964.

Thanks to the slower rate of expansion in 1964 and during the early months of 1965, the strain eased in most sectors, but nevertheless consumer prices (retail price index) still rose by 2.7% in the annual average, compared with 3.2% in 1964. The increase was mainly due to the slow but steady rise of food prices and to the continuing rapid advance of the price of services, which was only in part due to an upward adjustment of certain public charges.

The sustained export expansion and the stagnation of imports during a large part of the year combined to raise last year's external surplus on goods and services well above its 1964 level. In that year the surplus on current account was very small; in 1965 it amounted to something like FF 3 000 million. Notwithstanding a decline in the net inflow of private capital and an increase in public capital exports (mainly advance debt redemption) the overall balance of payments therefore closed with a surplus of FF 4 470 million, more than FF 500 million in excess of the 1964 surplus. Official gold and foreign exchange reserves, however, rose by only FF 1 750 million, compared with the preceding year's increase of

FF 3 200 million; assets with the International Monetary Fund rose sharply and the net foreign exchange position of the commercial banks improved.

The payments surplus again contributed to the expansion of domestic liquidity. The Treasury's cash transactions, on the other hand, over the year as a whole once more had the effect of scaling down the Treasury debt to the banking system. Lending to commerce and industry expanded at a slower rate during the first half of 1965, but because of the subsequent economic revival, and the need to finance agricultural stocks and building, the year's increase — 12% — was nearly as high as for 1964.

The Committee reviewed the monetary and financial situation of France in March 1965, and on that occasion expressed the view that there was no need for general measures to revive economic expansion. Price stabilization was the primary objective of French policy, and the Committee felt that restrictive policies should be relaxed with caution, and that there was a case only for selective incentives, especially in the field of credit, with a view to encouraging firms to invest. When economic activity picked up again spontaneously in the early spring and gradually gathered strength, the effectiveness of the French Government's policy was confirmed.

In the course of the year a number of measures were taken to ease restrictions. Bank rate was cut in April from 4 to 3.5% and the quantitative restrictions on the expansion of bank credit were lifted on 1 July. Finally, measures were introduced to encourage the formation and consolidation of saving and to channel more of it into productive investment, e.g. long-term saving commitments, saving for housing purposes, harmonization of rates of interest on various forms of investment according to maturities, tax reliefs on equity dividends and on interest from fixed-interest securities.

All this was part of a general policy line designed, as the Committee had recommended, to revive a wide-ranging capital market capable not only of meeting the economy's domestic requirements and thus reducing its use of foreign finance funds, but also of facilitating larger exports of long-term capital.

As regards internal equilibrium, the most important of a number of reforms was the introduction of changes in the system of turnover tax. The new provisions mark the beginning of the structural changes needed to streamline production and distribution and to eliminate the basic factors responsible for the rise in costs and prices.

ITALY

The marked recession of 1964 gave way last year to a revival of economic growth which steadily gathered momentum. This sharp reversal of fortunes in the course of the year does not, however, show up in the average annual changes in the economic aggregates, since economic activity was still slack at the beginning of the year. Gross national product in real terms went up by about 3.4%, i.e. by about as much as in 1964.

Foreign demand was again the most dynamic element in the Italian economy, witness last year's 19-20% expansion in exports of goods and services. Domestic demand, on the other hand, progressed at a relatively slow pace. In spite of measures to inject new life into the economy applied from March last year onward, fixed investment fell about 7.4% short of the 1964 figure, mostly because of the sharp decline in residential construction. The decline in investment in plant and equipment, though, came to a halt during the third quarter of 1965. Both public and private consumption recovered in the course of the year, but a comparison of annual figures shows the rate of increase last year to have been only moderately faster than in 1964.

Domestic supply expanded thanks to a considerable increase in agricultural production and a sustained recovery of industrial production, which gained speed during the last few months of the year. Imports of goods and services had an upward trend, but over the year as a whole barely exceeded those of 1964.

The upward movement of costs and prices slowed down again, mainly thanks to considerable improvements in productivity per person employed and to the distinctly slower pace of wage and salary rises in comparison with 1964. While the index of wholesale prices toward the end of the year was only 1.5% higher than twelve months earlier, retail prices rose over the same period by about 3%.

Thanks largely to an appreciable improvement in the trade balance, the current account closed with a surplus of more than Lit. 1 300 000 million. In contrast with the trend in 1964, capital movements showed a net deficit, but even so the surplus on the overall balance of payments reached about Lit. 1000 billion, compared with Lit. 474 000 million in 1964. The commercial banks continued to scale down their net indebtedness vis-à-vis abroad to such an extent that it virtually disappeared: repayments during the year amounted to Lit. 385 000 million. In these circumstances net official reserves rose by Lit. 510 000 million.

Balance-of-payments developments and Treasury transactions resulted in a further and considerable increase in bank liquidity. Business demand for bank credit was still slack, though it picked up somewhat toward the end of 1965; over the year as a whole bank lending expanded by only about 4%. The Treasury had no difficulty in financing its greatly increased cash deficit by the issue of Treasury Bills.

The Committee's review of the monetary and financial situation of Italy took place in the spring of 1965, and on that occasion the Committee found itself in general agreement with the measures the Italian authorities had adopted to infuse fresh vigour into economic activity. It did suggest, however, that this policy, which was greatly facilitated by the relatively high elasticity of production and a large external surplus, should be implemented with some caution, lest too vigorous an upswing jeopardize the attempt to contain the rise in costs and prices. The Committee's main recommendation was that selective measures should be taken to revive public and above all private investment. It attached particular importance to the requirement that wages should not rise faster than productivity, so that firms might restore their internal balance. The Committee furthermore considered it desirable that firms should have easier access to the capital market. However, the maintenance of a more receptive mood on the capital market can only be combined with a lasting recovery of investment if there is a revival of the propensity to save, which has declined sharply in recent years.

The Committee also felt that the Italian authorities' efforts could be expected to be successful only if a comprehensive incomes policy were introduced and the current system of sliding wage scales radically revised.

In view of the extent of economic recovery in Italy during the last few months, the Committee wishes to stress, in this report, how important it is that improvements in wages and salaries should not outstrip those in productivity. Great caution is also required in budget administration, so as to avoid the danger that public expenditure does not expand so fast as to revive toward the end of 1966 those same inflationary pressures which in recent years have threatened economic equilibrium. The Committee suggests that any proposed increase in public expenditure should be channelled to investment rather than to transfer payments and consumption.

NETHERLANDS

The Dutch economy again expanded in 1965, though less fast than in 1964. The real rise in gross national product was 5%, as against 8.5% in 1964.

This loss of momentum is attributable to a smaller number of working days and to weather conditions, which were much less favourable than in 1964, a year of exceptional increase in agricultural production. Elimination of these random factors shows that, if anything, the pace of economic expansion quickened rather than slackened last year. Labour shortages remained as severe as ever and the unemployment index showed virtually no change. The brisk growth of domestic demand in 1964 proceeded in 1965 at a more moderate pace, mainly because demand for capital goods dropped off somewhat; gross fixed capital formation in real terms increased by only 5.5% compared with 17% in 1964, and there was much less stockbuilding. Private consumers' expenditure, on the other hand, which had expanded by 5.5% in 1964, went ahead still faster last year, even though wages and salaries rose slightly less (14%, compared with 19% in 1964). To some extent, this spurt reflects large-scale purchases in anticipation of the rise in indirect taxes on 1 January 1966.

Prices rose fairly sharply, mainly under the impact of higher labour costs. Consumer prices went up by 6.5% in 1964 and by another 4.5% last year — with the result that the increases in this country were for two years running the highest in the Community.

The trade deficit fell from Fl. 4 500 million in 1964 to Fl. 3 900 million last year, mainly because of lower merchandise imports reflecting the slackening in stockbuilding, with the result that the current account (on a transactions basis) closed with a small surplus of Fl. 50 million (provisional figure), compared with a deficit of Fl. 713 million in 1964. Since, however, the balance of capital movements switched from surplus in 1964 to deficit in 1965, the overall balance of payments closed with a deficit of Fl. 714 million, compared with a surplus of Fl. 213 million in 1964. The bulk of the deficit was accounted for by the expansion of the commercial banks' lending to abroad (an increment of Fl. 527 million), an item that had shown virtually no change in 1964.

The Central Bank's gold and foreign exchange reserves declined by Fl. 71 million, while the net position of the Netherlands with the International Monetary Fund improved by Fl. 338 million. Over the same period, the foreign exchange position of the commercial banks deteriorated by Fl. 974 million.

Short-term bank lending, which is subject to control by the Central Bank, expanded in the course of the year by 10% and so remained within the prescribed limits. Medium-term credits and portfolio investments by the banks increased more than the banks' medium- and long-term resources, especially during the first part of the year. In an attempt to make credit control more effective, the Central Bank has secured the banks' informal agreement to halt this development. The initial results of the new arrangement are satisfactory.

The national budget last year had a distinctly more expansionary effect than was originally estimated; the budget deficit amounted to about Fl. 1 500 million (or Fl. 1 800 million if certain extraordinary receipts are left out of account), compared with initial estimates of Fl. 900 million. The 1966 budget again provides for a considerable growth of expenditure, which is expected to be 11% higher than the probable outturn of 1965. However, revenue is to increase even more, as a result of new tax measures, so that the deficit is now estimated at around Fl. 1100 million.

At the beginning of last summer, when the Committee reviewed the situation of the Netherlands, the Committee found that the figures then available made it appear unlikely that equilibrium would be restored in the Dutch economy before 1966, although in the previous report it had been thought possible that normal conditions would be achieved in 1965. Given that budgetary expenditure was still rising at a rate far in excess of the 5% limit fixed by the EEC Council in its recommendation of 14 April 1965, the Committee stressed the need for closer adherence to the Council's recommendations. In this connection it reminded the Government of the need to keep a close watch on local authorities, which are apparently very apt to overspend original estimates. For the moment, it was suggested, the main restrictive influence needed to achieve this purpose must be exerted by monetary — especially credit — policy. The Committee noted with satisfaction that short-term credit control had been tightened up by the agreement on medium-term lending and portfolio investment by the banking system. Nevertheless, the Committee pointed out that it was impossible to rely in the long run on monetary policy alone to contain inflationary pressures, and that budgetary policy would have to play an increasing part in re-establishing internal equilibrium.

Even so, the equilibrium that should emerge at the end of the re-adjustment phase cannot be expected to last unless the Dutch authorities succeed in applying an effective incomes policy.

BELGIUM

After a period of sharp inflationary pressure, the Belgian economy began to regain its equilibrium in the autumn of 1964 and continued on this course last year.

The real growth of gross national product amounted to about 3% in 1965, compared with more than 5% in 1964. The reasons for this slower rate of increase in economic activity were a sharp deceleration in the expansion of production, as a result of weaker demand for capital goods and certain other items, including textiles and coal, coupled with a fall in agricultural production and a decline of building activity, both due to weather conditions. Certain labour shortages were a contributing factor.

In 1964 a policy was introduced which aimed at reducing the strains on the economy, and this affected all the components of domestic demand except public consumption, which rose appreciably. Gross fixed capital formation in real terms showed to all intents and purposes no change, while private consumption rose by 7.5% in value and by 3% in volume. Foreign demand expanded by 10.5%, compared with 16.4% in 1964.

The trends of merchandise and services trade kept the current account in substantial surplus from the end of the third quarter of 1964 on. For the full year 1965, the B.L.E.U. current account showed a surplus of about Bfrs. 7 500 million. The net foreign assets of the National Bank (including the net position with the International Monetary Fund) increased by Bfrs. 8 000 million.

Nevertheless, internal balance is not yet fully re-established. Wholesale prices for manufactures stopped climbing, but retail prices continued to mount. The retail price index, which in the last quarter of 1964 stood 4.3% above its level 12 months earlier, showed another year-to-year increase of nearly 4% in the last quarter of 1965. This increase has brought the sliding scale into action three times since the middle of 1964. Allowing also for contractual wage increases and for higher social charges payable by employers, the index of hourly wage costs in manufacturing industry went up by nearly 12% between June 1963 and June 1964, and by another 12.6% in the 12 months ending June 1965. In these conditions, the rise in wage costs per unit of output between the first half of 1964 and the first half of 1965 must have been approximately 6%.

With economic expansion losing momentum, the monetary authorities relaxed in July 1965 the credit restrictions they had introduced in 1964. The precise quantitative limits recommended to banks have been suspended until further notice. Since 15 July 1965 the provision introducing the reserve ratio has not had its validity extended. Nevertheless, the principle of restraint in the granting of credit remains intact.

The growth of public expenditure was a matter of particular concern to the Committee when it reviewed the monetary and financial situation of Belgium last autumn. The previous surplus of current revenue over current expenditure gave way to a considerable deficit in 1965, expenditure having grown well beyond the limits recommended by the EEC Council. In addition, part of the deficit was financed by recourse to the money market. The Committee therefore considered it indispensable that the Belgian authorities renew their effort to curtail as fully as possible the growth of expenditure by government and semi-public institutions and also try to reduce short-term indebtedness.

In the longer run, the structural reform of the Belgian economy will certainly require heavier investment expenditure if the medium-term target of a 4% growth in GNP is to be achieved in conditions of satisfactory external and internal equilibrium. For this reason the Committee recalled the recommendation made in the Seventh Report, to the effect that the Belgian authorities should budget for a current surplus in the years to come, so as to have at hand resources with which to finance a growing portion of public investment expenditure. For the rest, the Committee took the view that developments during the period under review confirmed its repeated and insistent recommendations on the need for structural reform and revision of the methods used to finance public expenditure.

LUXEMBOURG

Economic expansion slowed down markedly in Luxembourg last year. Gross national product in real terms rose by only 1.5%, compared with 6.5% in 1964. Contributing factors were the distinctly slower growth of exports (4.5% as against 13%), especially of iron and steel products, the decline of public investment and the restrictive credit policy of the Government's Caisse d'épargne (savings bank), the effects of the latter being most in evidence in the private building sector. Furthermore, it so happened that traditional industries were cutting down on investment just at a time when a few new firms which had settled in the Grand Duchy came to the end of their investment programmes. These developments also affected household incomes and thereby depressed demand for consumer goods, especially durables. Prices continued to rise, partly because of a general increase in costs and partly because food prices went up in consequence of the reduction in subsidies to farmers. As in 1964, rising prices twice brought the clauses of the sliding scale into play last year, once in July and once in December.

The Government had budgeted for lower expenditures in 1965 than the 1964 outturn, but in the event spent more even than the exceptionally large amounts disbursed that year, which themselves were 20% higher than in 1963. Notwithstanding the lull in business activity in 1965, revenue also exceeded estimates, mainly because of the higher yields from certain taxes and because of tariff increases introduced in 1964.

Last year there was no difficulty in financing the budget deficit, first by drawing on Treasury assets and more recently by turning to the capital market; but in 1966 the situation may well be less propitious. Current expenditure can probably be covered by revenue, but if public investment is to expand according to plan, the overall deficit will no doubt turn out to be even larger than in 1965. The obvious answer seems to be to float more public loans, but this would constitute an additional burden on a capital market already suffering from the heavy demands made upon it by the private sector, especially the new companies previously financed by foreign funds. In addition, the Luxembourg public displays a preference for investing its savings abroad, largely because rates of interest at home are relatively low.

In the light of these difficulties the Committee, when it reviewed the monetary and financial situation of Luxembourg last autumn, expressed the view that every effort should be made to reduce the budget deficit in 1966 to the greatest extent possible. Any shortfall that still remained should in any event be financed by long-term borrowing.

Finally, the Committee felt that some revision of interest policy was called for if the money and capital markets were to become more flexible and the financing problems which might arise in 1966 made easier to solve.

ANNEX

THE COMMITTEE MEMBERS AND ALTERNATES

Chairman:

Jonkheer Mr. E. van LENNEP	Thesaurier-generaal bij het Ministerie van Financiën (The Hague)

Vice-Chairman:

M. B. CLAPPIER	Sous-gouverneur de la Banque de France (Paris)
Dr. O. EMMINGER	Mitglied des Direktoriums der Deutschen Bundesbank (Frankfurt/Main)

Members:

M. P. BASTIAN	Commissaire du gouvernement (Luxembourg)
Dott. F. BOBBA	Director-General for Economic and Financial Affairs in the EEC Commission (Brussels)
M. A. de LATTRE *(until 27 April 1965)*	Directeur des finances extérieures (Paris)
M. F. DE VOGHEL	Vice-gouverneur de la Banque Nationale de Belgique (Brussels)
M. T. de VRIES	Director in the Directorate-General for Economic and Financial Affairs in the EEC Commission (Brussels)
M. M. D'HAEZE	Directeur général de l'administration de la trésorerie et de la dette publique, Ministère des finances (Brussels)
Dr. R. GOCHT	Ministerialdirektor, Bundesministerium für Wirtschaft (Bonn)
M. J. HEINEN	Conseiller de direction à la Caisse d'épargne de l'Etat (Luxembourg)
Dott. R. OSSOLA	Capo del servizio studi di economia internazionale della Banca d'Italia (Rome)
M. M. PEROUSE *(from 27 April 1965)*	Directeur du Trésor, Ministère de l'économie et des finances (Paris)

Prof. G. STAMMATI	Direttore generale del tesoro, Ministero del Tesoro (Rome)
Mr. J.H.O. graaf van den BOSCH	Directeur der Nederlandsche Bank N.V. (Amsterdam)

Chairman of the Alternates :

Mr. A.W.R. Baron MACKAY	Onderdirecteur der Nederlandsche Bank N.V. (Amsterdam)

Alternates :

Dr. H. BONUS *(until 12 March 1965)*	Ministerialdirigent, Bundesministerium der Finanzen (Bonn)
M. F. BOYER de la GIRODAY	Head of Division in the Directorate-General for Economic and Financial Affairs in the EEC Commission (Brussels)
Dott. M. CARDINALI	Ispettore generale delle valute, Ministero del commercio estero (Rome)
Drs. S.N. EISMA *(until 15 October 1965)*	Ministerie van Financiën (The Hague)
M. H. FOURNIER *(until 27 April 1965)*	Directeur général des études et du crédit de la Banque de France (Paris)
Dott. L. FRONZONI	Delegato della Banca d'Italia per Benelux (Brussels)
M. H. KOCH *(from 27 April 1965)*	Directeur du service des études à la Banque de France (Paris)
M. R. LOMBA *(until 7 December 1965)*	Directeur général à l'administration de la trésorerie et de la dette publique, Ministère des Finances (Brussels)
H. MARETSCH *(from 30 March 1965)*	Ministerialrat, Bundesministerium der Finanzen (Bonn)
Prof. J. MERTENS de WILMARS	Onderdirecteur der Nationale Bank van België (Brussels)
M. MEULEMANS *(from 7 December 1965)*	Ministère des finances (Brussels)
M. C. PIERRE-BROSSOLETTE	Directeur-adjoint à la direction du trésor, Ministère de l'Economie et des finances (Paris)
Dr. G. SCHLEIMINGER	Bankdirektor, Abteilungsleiter in der Deutschen Bundesbank (Frankfurt/Main)

M. M. SCHMIT	Chef du service du budget (Luxembourg)
Dr. H. STEFFE	Director in the Directorate-General for Economic and Financial Affairs in the EEC Commission (Brussels)
M. R. WEBER	Membre du Comité de direction de la Caisse d'épargne de l'Etat (Luxembourg)
Drs. D.M.N. van WENSVEEN *(from 15 October 1965)*	Ministerie van Financiën (The Hague)

Secretariat:

M. R. de KERGORLAY
M. G. LERMEN

PUBLICATIONS SERVICES OF THE EUROPEAN COMMUNITIES
1024/5/IV/1966/5