EUROPEAN ECONOMIC COMMUNITY

EIGHTH REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

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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.

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(1) Merchandise, services, public and private transfers.

Direct American investment abroad increased again, and net exports of long-term capital amounted to about \$4400m., compared with sums of \$2500 to \$3000m. during 1962 and 1963. The deficit on the US basic balance was \$2000m.

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 \$2000m. 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.