EUROPEAN COMMUNITIES

MONETARY COMMITTEE

TWELFTH REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

Brussels, 30 June 1970

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INTRODUCTION

The purpose of this report is to give a brief account of the activities of the Monetary Committee during the period from 15 May 1969 to 30 June 1970.

During this period, the Committee held nineteen meetings and its working parties met on many occasions.

Following the departure of Jonkheer Mr. E. van Lennep, appointed Secretary-General of OECD, the Committee, at its meeting of 9 and 10 January 1970, unanimously elected as Chairman M. B. Clappier, Deputy Governor of the Banque de France, for the remainder of M. van Lennep's term of office, and as Vice-Chairman Professor W. Drees, Treasurer-General in the Netherlands Ministry of Finance, for the remainder of M. Clappier's term. A list of the members of the Committee is annexed.

The report was adopted on 30 June 1970. It takes no account of subsequent monetary and financial trends or measures in or outside the Community.

1. In the period reviewed in this report, the inflationary tendencies discernible in the Community since 1968 persisted and indeed strengthened in varying degree, while the balance of payments disequilibrium deteriorated, leading to exchange rate adjustments in France and Germany. These developments and the various measures taken by the member coutries to cope with them largely determined the nature of the tasks carried out by the Committee, which on several occasions held prior consultation meetings in conformity with current Community rules.

The Committee also continued its work on fuller co-ordination of economic and monetary policy within the Community. In particular, it had occasion to render Opinions on the appropriate prior consultation procedures, in line with the Council decision of 17 July 1969 on the co-ordination of short-term economic policies of the Member States, and on the implementing procedures for a Community system of medium-term financial aid.

In the field of international monetary relations, a number of important decisions were taken; here, the Committee helped to harmonize the positions to be adopted by the Six in more general international negotiations; the subjects dealt with in consultations included the creation of special drawing rights and the five-yearly revision of the quotas in the International Monetary Fund.

2. The pressure of work on current problems and the allocation of additional tasks forced the Committee to spend less time on the periodical examination of the monetary and financial situation of the member countries. Regular reviews and special examinations at consultation meetings replaced in some measure the traditional systematic studies. It is also clear that in future the Committee will have to devote more and more of its time to international monetary policies of the member countries. This is in line with the objectives set out in the Hague communiqué concerning the establishment by stages of an economic and monetary union among the Six.

I – GENERAL SURVEY OF ECONOMIC AND MONETARY DEVELOPMENTS IN THE COMMUNITY AND MAJOR NON-MEMBER COUNTRIES

3. The period of boom business conditions which had started in the Community in 1968 continued throughout 1969, and in most member countries, indeed, there were unmistakable signs of strain. Real gross Community product rose by 7·1% in 1969, a record since the inception of the Common Market. Growth was particularly rapid in Germany, France and Luxembourg. It was also lively in Belgium and satisfactory, though a little slower than in 1968, in Italy and the Netherlands.

4. This development was, however, accompanied by inflationary pressures which strengthened in most member countries in the period under review. Although production again showed a surprising degree of elasticity, particularly in the first half of 1969, potential overall demand gradually moved ahead of overall supply and cost increases outstripped productivity gains, mainly because various raw materials were in short supply and because there was an increasing number of bottlenecks on the labour markets of most member countries. In the course of the year, the price trend in the Community was, in general, mounting vigorously both at the production stage and at the various stages of distribution; consumer prices rose by 4·8%, the sharpest increase since the Common Market was set up.

The following table shows clearly how the inflationary process gathered speed.

Growth of GNP in the member countries and the Community in 1968 and 1969

(% change on preceding year)

	Value		Prices		Volume	
	1968	1969	1968	1969	1968	1969
Germany	8.9	11.6	1.6	3.3	7.2	8.0
Italy	7.6	9.2	1.5	4.0	6.0	5.0
Netherlands	10.1	11.7	3.7	6.3	6.2	5.0
Belgium	6.3	10.4	2.4	4.0	3.8	6.2
Luxembourg	7.1	15.0	3.0	7.5	4.0	7.0
EEC[1]	8.7	11.4	2.8	4.0	5.7	7.1

[1] Value : calculated on the basis of the official exchange rates, account being taken of the parity changes made in 1969 in France and Germany.

Volume: calculated on the basis of the official exchange rates in force in 1963.

5. In the Community, faster growth in 1969 was the result of an expansion of external and internal demand. The strength of Community exports remained satisfactory. In terms of value, visible exports to non-member countries were 11% higher than in the previous year. There was also a very distinct rise in internal demand. Gross fixed asset formation expanded sharply while private consumers' expenditure gathered momentum under the influence of a rapid rise in disposable incomes of households. The very lively upswing in internal demand was matched by exceptionally vigorous expansion in the field of intra-Community trade and imports from non-member countries. In terms of value, visible trade between the member countries went up by almost 30% while visible imports by the Community from non-member countries were 17% higher than in 1968.

6. In 1969, member countries' imports from the United States and, to a lesser degree, from the developing countries mounted sharply and the surplus on the Community's balance of trade ($1 200m. as against $3 200m. in 1968) therefore contracted. As the increase in the surplus on services was almost completely offset by a heavier deficit on transfer payments, the surplus on current account fell sharply ($1 600m. as against $3 500m. in 1968). There were also heavy net outflows of long-term capital, especially private capital, and the Community's basic balance therefore closed with a deficit of the order of $7 000m. (as against $1 700m. in 1968). Including all other items (short-term capital movements, errors and omissions), the total payments deficit was $6 700m. Of this, $4 450m. was financed by a reduction in net official gold and foreign exchange reserves (including the net position with the IMF) and $2 260m. by a deterioration in the net short-term external position of the banking sector.

7. In Germany, demand built up vigorously in 1969. There was a particularly rapid rise in investment and exports, but from the autumn onwards, private consumers' expenditure was also gathering distinct momentum.

The labour market came under increasing strain. Production expanded considerably, thanks to a fresh and significant improvement in productivity and the recruitment of more foreign workers. In terms of volume, GNP was 8% higher than in 1968 while industrial production advanced by about 13%.

The upward thrust of prices gathered distinct momentum from the autumn onwards, notably as a result of major wage awards in a large number of industries.

On current account, the balance of payments showed a heavy surplus, but long-term capital exports easily offset this. Until the autumn, inflows of speculative short-term capital boosted gold and foreign exchange reserves. The period of relative calm which followed the wave of speculation of May 1969 was of short duration. During September 1969, inflows of short-term capital reached alarming proportions and forced the Bundesbank to intervene on a very large scale. In the circumstances, the Government decided to close the foreign exchange markets in Germany from 24 September 1969. On 30 September, immediately following the elections, the authorities decided to allow the mark to float, i.e. to discontinue, until further notice, intervention on the exchange market to keep the exchange rate within the limits fixed under the Bretton Woods agreements.

This measure and even more the decision to revalue the mark by 9·29%, taken on 27 October 1969, triggered off a rapid outflow of short-term capital, so that the situation on the exchange markets reverted to normal. The reserves of various countries which had run into difficulties because of the speculation on the mark now built up again.

Although at the beginning of 1970 exports returned to a more normal level, overall demand in Germany is still very buoyant. Production rose again considerably, but there was also a very appreciable rise in prices.

8. In France, the internal and external disequilibria which had developed after the strikes of May and June 1968 persisted and indeed grew worse during the greater part of 1969. The uncertainties connected with political or social deadlines and the international monetary situation influenced the behaviour of producers, dealers and consumers. As a result, the restrictive measures adopted at the end of 1968, including the credit restrictions, which were intensified the following spring, took longer to "bite" than would

otherwise have been the case. For a fairly long period demand outstripped production capacities, curbing exports and entailing a sharp rise in imports. The cost of living continued to increase, the annual rate being about 6%. Maintenance of the exchange controls made it possible to avoid very heavy outflows of capital of the scale registered in May and November 1968. Nevertheless, in the first half of 1969 the balance of payments deficit, which had already touched $3 200m. in 1968, was close on $1 700m., partly because of a "leads and lags" effect.

At the beginning of August 1969, the Government decided to devalue the franc by 11·11%. This measure was to have an important psychological impact but this did not affect the need for a rigorous recovery programme in support. Fresh moves were made to eliminate the budget deficit gradually and ensure that in 1970 revenue and expenditure would be back in equilibrium. The limits placed on the expansion of credit to trade and industry were tightened and Bank rate was raised to 8%. Internal liquidity creation slowed down sharply and the rate of expansion of the money supply (including near-money) dropped to 6% from 11% in 1968 while the money supply in the narrow definition hardly increased at all.

From the autumn onwards the pressure of domestic demand gradually slackened, particularly in respect of private consumption. As there was first a reversal in the "leads and lags" effect and subsequently an improvement in the trade account, heavy surpluses replaced the previous deficits on foreign trade and payments; in the end, the payments deficit for the year as a whole was no heavier than it had been at the end of the first half of the year. In the spring of 1970, France was able to pay off the balance of its short-term debts contracted abroad while increasing its gross foreign exchange holdings.

Supported by a strong wave of investment and exports and by the drive to replenish stocks, growth remained very dynamic, both during the closing months of 1969 and in the early months of 1970. GNP for 1969 expanded by some 8% in volume terms and forecasts under the economic budget for 1970 have been revised upwards very appreciably. Although prices are still rising too rapidly, strain has eased in most industries.

9. In Italy, the phase of rapid expansion that began in the summer of 1968 came to an abrupt end in the last four months of 1969 because of a wave of strikes of unusual proportions. They cut back the growth of GNP at constant prices to 5% while there had been good reason to expect an expansion of 7% before the social disturbances started. For the year as a whole, however, all components of domestic demand gathered slight momentum, reflected in an extremely rapid expansion of imports.

At the beginning of 1970, the Italian economy entered a phase in which the economy was making good previous production losses, but this trend was hampered by further strikes. In the first quarter, industrial production was about 5% up on the level of a year earlier.

On the labour market, unemployment fell sharply and there was a shortage of skilled labour in some areas.

The upward thrust of prices gathered momentum throughout 1969, and in the first quarter of 1970 consumer prices were almost 5% higher than a year earlier, compared with an average increase of 2·8% in 1969. As for the balance of payments, there was a slight decline in the surplus on current account and a considerable rise in outflows of capital.

The overall deficit reached \$1 400m., compared with a surplus of \$600m. in 1968. Despite this deterioration, the net official gold and foreign exchange reserves fell only slightly, mainly because of heavy imports of short-term funds by the banks.

10. In the Netherlands, economic expansion remained rapid in 1969. The lively growth of overall demand was supported by faster export growth. The expansion of fixed investment, by contrast, slowed down and the growth of private consumers' expenditure slackened distinctly in terms of volume. Although the growth of world trade has tended to weaken since the beginning of 1970, there are no important signs of the business trend in the Netherlands weakening.

Under the persistent pressure of demand and despite mounting strains on the labour market, domestic supply was remarquably elastic. Industrial production rose by 12·5%, as against 11% in 1968, while GNP in real terms expanded by 5%, following a rise of 6·2% in 1968.

In the early months of 1969, the price climate deteriorated appreciably, not only because factors in the business trend forcing up prices were strengthening but also because of the repercussions of the introduction of VAT. In 1969, consumer prices went up by 7·5%, the sharpest increase since 1951. In the first quarter of 1970, the year-to-year rise was only 3·4%.

The current account deteriorated in 1969. However, if stocks are included, the external position is seen to have improved appreciably.

With funds flowing in from abroad, particularly after revaluation of the mark, and the authorities making considerable use of the money market because tax receipts fell short of estimates, the tightening of liquidity was not as pronounced as had been expected. For these reasons the restrictive policy was reinforced to some extent in 1970.

11. In Belgium the rising phase of the trend, which began about the end of 1967, continued throughout 1969, and it was not until the beginning of 1970 that it showed signs of slackening. The vigorous contributions came from the usually rapid expansion of export demand as the other member countries purchased much more and from the strong recovery in gross fixed asset formation. Private consumers' expenditure also rose sharply.

The rise in production gathered appreciable momentum: at constant prices, value added by industry went up by 9·5% in 1969, as against 5·6% the previous year. With activity in the other sectors also expanding appreciably, GNP at constant prices rose by 6·2%, as against 3·8% in 1968.

As a result of the slowdown in productivity gains, there was a tendency for the improvement in the employment situation become more marked. The decline in unemployment continued and even gathered momentum at the beginning of 1970, leading to general strains on the labour market.

The business upswing entailed increasing pressure on the level of domestic prices. The rise in consumer prices was 3·75% in 1969 and rose to 4·3% in January-April 1970 above the price level for January-April 1969.

While the overall balance of payments for the first nine months of 1969 closed with a deficit of BF400m., it produced a surplus of BF23 000m. in the period October 1969-

February 1970, this being mainly a matter of "leads and lags" after the revaluation of the mark.

12. In Luxembourg, the economic upswing strengthened significantly in 1969, borne up mainly by exports and fixed investment. In terms of volume, the growth of GNP in 1969 may be estimated at 7%, as against 4% in 1968. Since the beginning of 1970 the pace of growth has, however, slowed down because export demand for iron and steel products has advanced at a less lively pace and several industries have been running at capacity.

The faster expansion of production is due not only to major productivity gains but also to a significant rise in the numbers in paid employment. Strain on the labour market grew in the course of the year.

Until the summer, the price trend was calm; in the second half of the year, prices were rising somewhat more rapidly, particularly because the cost of imported manufactures and services went up. For the full year, the consumer price index went up by 2·3%. At the beginning of 1970, the index rose appreciably because of the switch to the VAT. The policy pursued by the Government, however, helped to avoid excessive increases such as could have resulted from the reform in a period of boom business conditions.

13. The economic trend in the Community in 1969 differed appreciably from the trend in the United States, where expansion slackened sharply during this period without, however, there being any easing in the pressure on prices. The trend in the Community also contrasts with the rather sluggish revival of economic activity in the United Kingdom.

Under the contraints imposed in monetary and budget matters, the American economy tended to mark time. From August onwards, the index of industrial production declined. Inflation none the less remained very rapid throughout the year (about 5·8% in annual average terms), especially under the pressure of private investment and an increase in costs, due largely to wage increases running well ahead of productivity gains.

14. On a liquidity basis, the United States balance of payments for 1969 closed with the record deficit of about $7 000m. By contrast, the balance on an official reserve transactions basis showed the heaviest surplus in many years ($2 700m.). [1]

The very sharp deterioration in the liquidity balance, which in 1968 was still virtually in equilibrium, is mainly due to a trend reversal for special financial transactions (a deficit of $900m. compared to a surplus of $2 300m.) and to a major increase in non-recorded exports of capital, reflected in a swollen "errors and omissions" item. Net exports of private long-term capital accounted for $1 600m. of the deterioration in the external position, this being partly due to a relaxation of the Johnson programme on capital exports. There was no major change in the current account from one year to the other, despite an appreciable slackening of economic expansion and despite the anti-inflationary policy of the American authorities.

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[1] The US balance of payments is defined in a number of different ways and this gives rise to some problems of interpretation. It should be noted that none of the concepts used by the American authorities matches the definition of the overall balance of payments used in the Community.

Given the role played by the dollar in the international monetary system, it is clear that the persistence of a heavy deficit on the US balance of payments is liable to disrupt the international monetary order.

15. During 1969 the United Kingdom made considerable progress on the road to stabilizing its external position, while the state of internal equilibrium deteriorated.

The restrictive measures taken under the budget bit into consumer demand and enabled some real resources to be switched to exports. Compared with the previous year, the growth of gross domestic product slackened distinctly and was down to 2%, after 3·5% in 1968. Although economic activity was thus not very dynamic, the rise in prices persisted and indeed gathered momentum.

16. The balance of payments staged a remarkable recovery in 1969. United Kingdom exports, favoured by the slackening of domestic demand and the extremely lively expansion of world trade, grew appreciably faster than imports (14% in terms of value as against 5%). In the circumstances, the trade deficit fell sharply, from £643m. in 1968 to £158m. in 1969.

The surplus on services also rose further so that the current account produced a surplus of £415m. The basic balance showed a surplus of £398m., the best performance in many years. The changes in its external position enabled the United Kingdom to repay, sometimes ahead of schedule, a substantial part of its external debts.

17. During 1969, interest rates were rising throughout the world and movements of short-term capital expanded at an unusual pace.

Inflationary pressure, varying in strength from country to country in the Community, led the national monetary authorities to tighten restrictions and this made a progressive contribution to the rise in interest rates.

This tendency was strengthened by the monetary policy pursued by the US authorities. As credit demand remained strong, official policy entailed a distinct rise in interest rates, first on the American market and then for Eurodollars when American banks turned to the Eurodollar market. The interest rates prevailing in the Community were inevitably affected; some Member States were forced to follow the trend on the Eurodollar market in order to avoid very heavy outflows of capital.

In the closing months of the year, short-term interest rates, which are particularly sensitive to credit policy, reached their highest point in most member countries and have since been running at very high levels although there have been signs of a decline in the United States and on the Eurodollar market. Long-term interest rates, by contrast, appear to be still rising in many countries. The policies pursued to restore equilibrium have failed to prevent private individuals from acting on the assumption that the inflationary process would continue: this has made the demand for credit very inflexible, so that inflation has itself become an inflationary factor.

Although in this period there was no conflict between outside influences and the requirements arising from the internal situation in the Community, it is not certain that this pattern will last or will again emerge in the future. Member countries therefore examined ways of preventing US monetary policy hampering their own policies. In this context, the Committee discussed the trend of interest rates on several occasions. These discussions enabled a large measure of agreement to be reached among the Six and this harmonized attitude played an important role in discussions held at other levels.

18. The exceptional scale of short-term capital movements is mainly attributable to two factors: firstly, there was the disparity which developed for a time between interest rates on the national money markets and interest rates on the Eurodollar market and, secondly, there was the prospect of parity changes, mainly for the French franc and the mark.

For a time, interest rate escalation in the United States and also on the Eurodollar market entailed major disparities between the yields on these markets and yields on the markets of most other industrialized countries. This induced the banks and private individuals in Europe to step up their holdings of securities denominated in dollars. To meet their finance and liquidity needs, the satisfaction of which was hampered by the restrictive monetary policy adopted by the United States, American companies and banks had to repatriate a large part of the funds held with their subsidiaries abroad. These two factors led in some cases to a heavy drain on the reserves of certain member countries, which were consequently compelled to take safeguard measures by raising their Bank rates and/or imposing requirements with respect to the external position of their commercial banks.

The effects which the likelihood of parity changes had on movements of short-term capital were referred to in Sections 7 and 8 above.

II – PARITY CHANGES: CONSULTATIONS IN THE COMMITTEE

19. In accordance with the rules, prior consultations were held within the Committee on the parity changes made in the Community in 1969. Before an outline is given of the conditions in which these consultations were held, it may be useful to recapitulate the provisions which are the institutional basis of the consultations.

In accordance with Article 107 of the Treaty of Rome, which provides that "each Member State shall treat its policy with regard to exchange rates as a matter of common interest", the representatives of the Governments of the Member States meeting in the Council adopted, on 8 May 1964, a declaration confirming their intention to consult each other prior to any change in the parities of their currencies. In conformity with instructions received pursuant to this declaration, the Committee worked out the procedure for these consultations.

20. Council Regulation No. 129 of 23 October 1962 requires that the common agricultural prices are to be expressed in units of account, and Council Regulation No. 653/68/CEE of May 1968 lays down the rules governing changes in the value of the unit of account as used for this purpose. So as to facilitate the preparation of the decisions to be taken by the Council in the event of a change in a Member State's parity, the Committee has to render an opinion on the desirability of changing the value of the unit of account and/or certain agricultural prices. Where such changes are made it is also incumbent on the Committee to examine the situation created in the relevant fields, render an opinion on the economic and monetary implications of the automatic adjustment of the prices expressed in national currencies and state its views as to whether it is desirable for the Member State concerned to make arrangements temporarily mitigating the impact of these automatic adjustments.

21. These rules were applied for the first time when Community countries decided to change their parities in 1969: in connection with the devaluation of the French franc, prior consultations were held during the meeting of the Committee of 10 August 1969, while in respect of the revaluation of the mark the rules were applied in two stages:

(i) The decision by the German Government to allow the rate of exchange of the mark to float led, on the occasion of the annual IMF meeting in Washington, to a meeting of the Committee and a meeting of the Ministers of Finance of the Six on 29 September;

(ii) Prior consultations were held on the definitive fixing of the new parity for the mark at the meetings of the Committee of 8 October and 24 and 25 October 1969.

These consultations enabled the other Member States to obtain detailed information on the measures envisaged and to express their views. Experience has shown, however, that this procedure could be improved: it is important to ensure that the consultations are held **before** any important measure, for their efficacy is largely a function of their timing.

22. The meetings of the Committee on 10 August and 24 and 25 October were devoted mainly to an examination of the impact of the parity changes on the functioning of the common market in agriculture: despite the unit-of-account technique adopted, a change in exchange rates is necessarily a threat to price uniformity for farm products in the common market. The Committee had to express its views on the advisability of changing the value of the unit of account or the agricultural prices. In both cases, i.e. on the occasion of the devaluation of the French franc and the revaluation of the mark, the Committee came out against changes of this kind.

Normal application of the unit of account would have meant that when the French franc was devalued, the agricultural prices expressed in French francs would have gone up automatically in proportion to the rate of devaluation. The success of the devaluation would therefore have been jeopardized from the outset because higher farm prices would strengthen inflationary tendencies in France.

Conversely, the revaluation of the mark would have entailed an automatic cut in agricultural prices when expressed in marks. Unless modified, this arrangement would have entailed an immediate and appreciable fall in farm incomes in Germany.

These considerations led the Committee to express the view that the two governments should be able to take temporary and degressive measures to cushion the impact of an automatic adjustment of the agricultural prices in terms of national currencies, it being understood that these measures should comprise no impediments to free trade in the Community.

III – CONSULTATIONS ON INTERNATIONAL MONETARY PROBLEMS

23. In the period under review, two important decisions were taken in this field. At the general meeting of 3 October 1969, the Board of Governors of the IMF decided to create special drawing rights (SDRs). At the beginning of 1970 it was decided, in accordance with the Articles of Agreement of the IMF under which the quotas of the members are