EUROPEAN COMMUNITIES

MONETARY COMMITTEE

THIRTEENTH REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

Brussels, 16 February 1972

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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 1 July 1970 to the end of 1971.

During these 18 months, the Committee held 15 sessions and the working parties drawn from its own members or set up at its suggestion met on many occasions.

The Committee's officers were re-elected for a period of 2 years starting on 1 June 1970. Following the departure of Professor W. Drees, Treasurer-General in the Netherlands Ministry of Finance, the Committee elected Professor C.J. Oort, on 23 June 1971, as vice-chairman for the remainder of Professor Drees' term. Professor Oort is also the new Netherlands Treasurer-General. A list of the Committee members is annexed.

The report was adopted as at 31 December 1971. It takes no account of subsequent monetary and financial trends or of measures adopted since, in or outside the Community.

1. Trends during the period under review were heavily influenced by the difficulties besetting the working of the international monetary system, which culminated in a monetary crisis in August 1971, when dollar convertibility was discontinued.

These developments affected the Community in two ways: firstly, with regard to business activity, by stimulating, initially, inflationary trends, and then by posing a threat to orderly growth of the economy, they raised difficult problems for the member countries, for which they were unable to find coordinated solutions; secondly, in respect of the institutions, they slowed down the alignment of the economic and monetary policies of the member countries and impaired the normal working of the agricultural market by compelling the Community to introduce compensatory arrangements at the frontiers.

In view of their importance, the international monetary developments are described in the first chapter of this Report. The second chapter covers economic trends in the Community countries and in leading non-member countries, mainly during 1971, and the third the Committee's own work, which was chiefly concerned with consultations on current problems and with action contemplated to implement the Council of Ministers' plan for achieving economic and monetary union.

CHAPTER I

THE MONETARY CRISIS

Events preceding the crisis

2. The immediate causes of the monetary crisis cannot be isolated without referring to developments at the beginning of 1970: the varying economic trends at that time in the United States, the Community and Japan, and the belated and often injudicious deployment of monetary policy instruments on both sides of the Atlantic in attempts to restore domestic equilibrium largely account for the steady deterioration over the months of the United States balance of payments and for the corresponding growth in other countries' monetary reserves.

3. In the United States, with private consumers' expenditure flagging and investment losing momentum, economic activity declined in 1970. In an effort to curb growing underemployment, the Administration allowed the budget deficit to expand and at the beginning of 1970 the monetary authorities eased previous restrictions, although prices and wages were still rising.

4. On the other hand, in most of the member countries, at least during the first half of 1970, as in 1969, the growth of production was brisk, with inflationary strain spreading to an increasingly disturbing extent. In order to bring the upward price movement to a halt, these countries maintained or actually tightened up the restrictions - especially credit restrictions - introduced in 1969. The steady slow-down in economic activity from the second half of 1970 onwards prompted the authorities in the Member States to withdraw or relax some of the controls.

5. The new trend in United States monetary policy is the key to the spectacular deterioration in this country's external situation in 1970: with borrowing terms substantially more favourable to the lender in Europe than across the Atlantic, there were heavy movements of short term capital particularly to the Euro-dollar market.

Even if the general economic trend had not affected the overall payments balance, there would have been a deficit in 1970 anyway because of the unfavourable swing of the basic balance: since the end of the 'fifties, the traditional deficit on long-term transactions has no longer been offset by current-account surpluses. This change became more marked from the autumn of 1970 onwards: improvements in the competitive situation of the main industrialized countries, especially Japan and Canada, brought a sharp increase in United States imports and entailed an appreciable deterioration in the United States commodity trade balance.

So much so that in 1970 the United States payments balance (official settlements) closed with a deficit of $ 10 700 million, comparing with a surplus of $ 2 700 million for 1969 (1). The counterpart of the United States external deficit was a heavy accumulation of dollar assets in the central banks of the Community countries and more generally in Europe, Japan and Canada. Consequently the European central banks acted to stem the inflow of foreign exchange and neutralize its impact on domestic liquidity; the various bank rates were lowered on several occasions. The United States authorities made a number of attempts to curtail capital exports, achieving, however, only a temporary lull on the exchange markets.

May 1971

6. The increase in the monetary reserves held by the European countries helped to bring about a gradual change in the *motives* underlying the capital inflows. From April 1971 onwards, more and more speculative capital was being attracted by the likelihood of currency revaluations in Europe.

Given the helathy situation of the German economy, the German mark was the main target of speculation, the scale of which is brought out by the following figures. From January to the end of March 1971, the inflow of short-term capital into Germany was DM 7 600 million. In April alone, when the trend started, the sum involved was DM 1 900 million, to which should be added about DM 7 000 million in forward purchases by the Bundesbank. From 3 to 5 May, about DM 8 000 million in foreign capital was placed at short-term in Germany. By the end of May, Germany's monetary reserves stood at about DM 69 000 million of which DM 17 000 million were accounted for by the inflow of short-term capital since the beginning of 1971, mainly accumulated through a "leads and lags" affect and through bank loans contracted abroad by resident firms.

(1) Not including allocation of SDRs.

The expansion of domestic liquidity generated by these inflows largely neutralized the monetary policies pursued by the Community member countries, which were endeavouring to counteract the growth of inflationary strain. For example, the formidable inflow of foreign exchange was the main reason why the money supply (M 1) (1) increased by about 11.4 % in Germany from April 1970 to April 1971, despite restrictions.

7. In these circumstances, several Community countries adopted appropriate external and internal monetary policy measures in May. On 9 May, Germany and the Netherlands decided to float their currencies. Germany also prohibited the remuneration of non-residents' deposits and imposed prior authorization for purchases of short-term negotiable securities by non-residents. France amended exchange controls to tighten up restrictions on inflowing capital. The Belgo-Luxembourg Economic Union adjusted its two-tier exchange system to curb the inflow of foreign capital; for this purpose, transactors were deprived of the option, when selling foreign exchange needed for capital transfers to the BLEU, between the free market and the controlled market (on which rates cannot fluctuate beyond certain limits). The payments must now be made through the free market, on which, by definition, rates are unrestricted. Action to contain domestic liquidity was strengthened, particularly in Germany and in France. Among the Community's neighbours, Switzerland and Austria revalued their currencies.

The crisis of August 1971

8. These changes failed to dispel uncertainty as to the stability of international monetary relations; indeed they tended to highlight the gravity of the United States external account situation. The disequilibrium on this account assumed alarming proportions in the first half of 1971, the external payments deficit having reached a figure of about $ 11 000 million (official settlement) during this period (2). The emergence of a heavy trade balance deficit from April 1971 onwards, after a long series of surpluses, was the main cause of a crisis of confidence in the dollar. Speculative capital movements then took the form of a flight from the dollar, a development which lent increasing credibility to the prospect of a dollar devaluation; the result was a further deterioration in the external position of the United States. The outflow of funds became exceptionally heavy, despite official action in a number of other countries to combat the trend. In the first quarter of 1971 alone, the United States balance of payments showed a deficit of about $ 12 000 million (official settlements), the bulk of which had been incurred before the middle of August.

9. The United States Administration was also anxious to speed up the rather sluggish business recovery, and in these circumstances it adopted exceptional measures. On 15 August, the convertibility of the dollar into gold and into other reserve instruments was suspended and a 10% surcharge was imposed on dutiable imports. At the same time, with a view to encouraging business activity, taxes were eased and investment incentives announced, including the introduction of a tax credit for which imported capital goods would not qualify.

10. The member countries reacted in differing ways to the situation created by the United States decisions, particularly the decision to suspend dollar convertibility. The Bene-

(1) Notes, coins and sight deposits.
(2) Including allocations of SDRs.

lux countries decided to apply as between themselves the arrangement they had proposed to the other Community member countries at the Council Meeting of 19 August. These included:

(i) Limiting fluctuations between Benelux countries to 1.5% above and below respective parities. For this purpose, the Belgian and Netherlands central banks intervene exclusively in their partner's currency.

(ii) Suspending the fluctuation limits of the other currency rates, including the dollar.

In September the Netherlands Government also introduced a "closed circuit" for non-resident purchases of bonds denominated in florins.

The French Government introduced a two-tier foreign exchange market system and strengthened exchange controls, particularly with regard to the net external position of the banks and to rules concerning payments for imports. Under these arrangements, settlements for merchandise and certain related services were to be made on the official market on which the limits on exchange rate fluctuations around parity would still be enforced; all other authorized operations, except transactions in foreign securities settled through the security foreign exchange market (1), were to go through the financial franc market.

The German authorities maintained the arrangements introduced on 9 May, whilst Italy decided that the lira should be allowed to rise or fall above or below the limits previously observed.

Outside the Community, the United Kingdom introduced arrangements similar to those in Italy, and Japan adopted a fluctuation system for its exchange rates. However, in these countries and in most of the Member States, actual rate variations were controlled - though to varying degrees of strictness - in order to prevent undue appreciation of the relevant currency.

11. In addition, like France, several other Member States strengthened or amplified arrangements to discourage imports of capital (exchange controls, regulation of the banks' external holdings, suspension of remuneration of foreign deposits, higher reserve coefficients on liabilities to non-residents, direct rules concerning the timing of settlements). Speculation on the future realignment of parities nonetheless generated a further inflow of foreign exchange, to Europe and Japan in particular. This led to a gradual - though uneven - revaluation of a number of currencies and increases in the exchange reserves in the relevant central banks in the third quarter of 1971.

Overcoming the crisis

12. Agreements concluded within the Group of Ten and decisions adopted by the Executive Directors of the International Monetary Fund on 18 December 1971 in Washington led to a new exchange rate pattern as between the IMF Member countries changing their parities or adopting "central rates". They also allow member countries, for the time being, to float their exchange rates within 2.25 % either side of the dollar par value or central rate.

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(1) The security foreign exchange market (*marché de la devise-titre*) was discontinued on 21 October 1971.

Further to these decisions, all the Community countries except France (which maintained its old gold parity) notified the IMF of the "central rates". In relation with the previous gold basis, the new rates entail a 4.61% revaluation of the mark, a 2.76% revaluation of the Benelux currencies and a 1% devaluation of the lira. All the Community countries also decided to exercise their right to float their exchange rates within the broader limits authorized by the IMF. However, the Benelux countries agreed not to use this wider arrangement as between each other.

The decisions taken in Washington are only the first step towards international monetary reform, the need for which has been highlighted by recent evènts. Realignment of exchange relations dispelled uncertainties occasioned by the floating of the currencies, which had already begun to impair growth and trade in a number of countries. However, machinery better adapted to current requirements cannot be implemented unless a number of other problems - including future convertibility arrangements, the role of gold, of the reserve currencies and of the SDRs, an adequate supply of reserve instruments, the degree of flexibility of exchange rates and the control of undesirable capital movements have first been solved.

It is obvious that any contribution the Community can make to such a reform largely depends on the degree of harmonization which the member countries will have reached in defining their positions on the various closely interrelated problems arising (see sec.30).

13. A number of conclusions can already be drawn from the monetary developments of 1971. The difficulties were caused by the spread of inflationary strain - varying in intensity from country to country - and the failure to ensure mutual consistency, either within the countries or between them, in the measures taken to counter this trend. The present increase in strain in a number of countries is all the more disturbing because it is occurring at a time when economic activity is losing momentum almost everywhere. This situation underlines more strongly the importance of national equilibrium policies based on the right combination of economic policy instruments; the effectiveness of the policies largely depends on effective coordination at international level and, in particular, Community level. Such coordination is needed in particular because of the very heavy volume of liquid funds which has built up on international capital markets in recent years and because of the greater mobility which improvements in international credit machinery have made possible: successive monetary crises have shown that international capital movements can distort national economic policies and indeed constitute a threat to the working of the entire monetary system.

CHAPTER II

ECONOMIC AND MONETARY TRENDS IN THE COMMUNITY AND THE MAJOR NON-MEMBER COUNTRIES

14. The crisis occurred at a time when economic activity in the Community was already tending to slow down. The psychological and direct physical effects of the United States measures had not substantial effect on trends in the member countries but did affect the general economic climate, which suffered from an appreciable decline in the growth of domestic demand, due mainly to retrenchment in investment schedules by private firms

as profits fell sharply. On the other hand, private consumers' expenditure was, taken as a whole, still expanding relatively briskly. Lastly, sales abroad faltered in the last months of 1971 because of the uncertainty as to future currency parities.

At the same time, conditions on the labour market tended to ease: unemployment increased slightly in all member countries and the number of foreign workers recruited declined, with the number of unfilled vacancies also falling.

For the full year 1971, the gross Community product was only about 3·4% up in volume on the 1970 figure, compared with a growth figure of 6·3% for 1970. But this overall figure covers widely varying trends in the various countries. The slowdown was particularly sharp in Italy and in Luxembourg, where GNP growth rates fell well short of the 1970 figures. In Belgium, the Netherlands and Germany, on the other hand, real growth was still running at 3 to 4%, while in France, the rate was very nearly 5·5%.

Slower growth failed, however, to curb inflation, which persisted in 1971; wage increases once again far outstripped productivity gains and helped to force up prices, which rose fast for the third year running.

15. In general, persisting inflationary strain was accompanied throughout the year by a rapid increase in the money and near-money supply. In most of the member countries, transactions with abroad initially dominated this trend, leading certain central banks to tighten up restrictions. However, as the growth outlook became less favourable, the authorities in all the member countries gradually relaxed restrictions, though not to the same extent in each country. The central banks relaxed the restraints imposed on the banks and Bank rate was reduced, sometimes more than once. This also helped to render the member countries' markets rather less attractive to foreign capital. In these conditions, the growth of the money supply was, from the autumn onwards, mainly accounted for by an increase in lending to commerce and industry, with the financing of Treasury operations also adding to the money stock in certain countries. By the end of the year, monetary policies had been relaxed virtually everywhere in the Community.

16. In 1971, two factors determined the state of the Community's trade balance (cif-fob, on the basis of customs returns): firstly, the slowdown in business activity weakened the propensity to import, and secondly, the member countries which floated their currencies enjoyed an improvement in the terms of trade. This led to a surplus of about \$ 1 000 million, against a deficit of \$ 400 million for 1970. However, since the deficit on services and unilateral transfers was heavier, the current-account surplus did not increase to the same degree. On the other hand, the surplus on the basic balance climbed steeply (about \$ 5 000 million, compared with \$ 2200 million in 1970), owing to very heavy net imports of long-term capital. Since there was also a fairly heavy inflow of short-term capital (though less, for the full year, than that for 1970), the surplus on the overall balance of payments increased from \$ 7300 million in 1970 to about \$ 8 000 million in 1971. This surplus was reflected in an increase in the external holdings of the monetary authorities (net gold and foreign exchange reserves, IMF position, SDRs) of more than \$ 9 000 million, while the net short-term external position of the banking sector deteriorated by more than \$ 1 000 million.

17. The underlying trend of economic activity in Germany lost momentum in the second half of 1970. Early in 1971 the slowdown was halted. Thereafter, however, and especially after the external and domestic stabilization measures were adopted in May, growth again slackened.

Once the DM was floated, export demand weakened and the investment trend, particularly in capital goods, faltered. Nonetheless, inflationary trends, which had grown much stronger in 1970, mainly because of the considerable increase in wage costs, persisted in 1971. In December 1971, the cost-of-living index for households showed a 5.8% increase over the December 1970 figure. Expansion of the gross national product, which had been 5.3% in volume and 13% value in 1970, was 2.9% and 10.9% respectively in 1971.

In 1971 there was a surplus of DM 500 million on the current account, comparing with a surplus of DM 2500 million in 1970. Until May, there were heavy inflows of short-term capital from abroad, while the total net gold and foreign exchange reserves of the Bundesbank increased by DM 19600 million in the first five months, not including heavy purchases on the forward market maturing at later dates. In June, net reserves declined by DM 7800 million, to increase again in the second half of the year by DM 5100 million. Thus, from the end of May to the end of the year, the reserves contracted by DM 2700 million (without adjustment to take account of the DM revaluation).

The stabilization drive was maintained. In May 1971 the Federal Government adopted a number of budgetary measures designed to curb the increase in the expenditure of public authorities and to freeze tax revenues exceeding estimates in a "business activity equalization fund". Similar measures were adopted by the Länder authorities, Money supply and credit policy, hamstrung in the period up to May by very heavy borrowing abroad by the banks and industry, began to bite from June onwards and the expansion of the money supply lost momentum. The increase in the DM exchange rate in the autumn led the Bundesbank, however, to relax its credit policy to some extent. A further step along this road was taken at the end of December, in order to narrow the gap between domestic and external interest rates and thus consolidate the re-alignment of the exchange rates.

18. In France, the relatively brisk growth rate achieved in 1970 continued in 1971 till the end of the summer. Since then, there have been signs that growth has been slowing down, particularly in the output of capital goods, although the level of industrial production is not unduly affected: the growth rate of industrial production has continued at a rate near to 6 % per year, though it slowed down a little in the third quarter. The consumption of households staged a fairly strong recovery as compared with 1970, so that the consumer goods industries are once again working at full capacity. The spurt in the expansion of household demand largely offset the slowdown in the growth of investment and exports. The result was a real growth rate in gross national product of nearly 5.5%, compared with 6% in 1970.

The upward wage and price movement was substantially more vigorous than predicted at the beginning of the year. On the price side, this was partly due to special factors (substantial increase in oil prices, adjustment of agricultural and other prices subsequent to the 1969 devaluation). With regard to wages, it was probably due to the shortage of skilled labour, which remained severe during most of the year. In addition, the higher prices that had to be paid for certain imported items because the currencies of several countries were dearer acted as a shield against international competition, which was therefore unable to act fully to moderate domestic prices. In the course of the year, consumer prices rose by 6% and wages in industry by nearly 11% (annual average).

The improvement in the trade balance recorded in 1970 continued in 1971. For the full year, the surplus of exports over imports totalled FF 4500 million (including the franc area), although business activity had been slowing down in a number of the countries trading on an appreciable scale with France. For 1970, the surplus had not exceeded FF 700 million. With a deficit on current account (transactions), the overall payments balance showed a heavy surplus (1) due to long-term capital transactions but especially to short-term capital movements and to change in the timing of settlements ("leads and lags").

When direct restrictions on the expansion of credit were lifted at the end of October 1970, the money supply swelled rapidly. Faced with persisting and heavy inflationary strain, the authorities, wishing also to neutralize the effect of heavy inflows of capital, imposed restrictive measures from the second half of 1971 onwards. On 1 April, a new minimum reserves system for distributed credits was introduced, reserve coefficients on credits and on deposits were raised several times in the subsequent months, and Bank rate was raised from 6.5% to 6.75%. Measures were also taken from August onwards to combat the inflow of foreign exchange (see sec 10).

In the later months of 1971, money-supply and credit policy were relaxed a little to maintain economic growth. The reserve ratios were lowered and Bank rate cut back to 6.5% in October. It should be noted, however, that Bank rate has a less important role than before and that the money market rates, now more important, were running well below the official discount rate. The central government budget was designed to sustain economic activity, although the equilibrium aimed at in the current Finance Act was in fact not affected to any substantial extent.

19. In Italy, the direct and indirect effects of the current social disturbances, which began in the autumn of 1969, are still weighing heavily on the trend of economic activity. After a distinct loss of momentum in 1970, a growing number of industries (particularly building and construction) suffered in 1971, from the symptoms of recession. At the present time there is plenty of slack in the economy, both on the labour market and in the area of technical production capacity.

The key to these difficulties is a slowdown in demand, particularly in the capital goods sector, due mainly to the sharp reduction in profits squeezed by the rapid rise in wage costs and the decline in productivity. It is also due, though to a lesser extent, to certain difficulties - strikes, absenteeism, etc. - affecting the factors of production. Despite some increase in consumption and particularly in exports, the gross national product in real terms grew by only 1.2% in 1971 (compared with 5.1% in 1970).

The upward price movement was very rapid; on the basis of the implicit SNP index, the price index for the private sector was up about 6% in 1971 (6.5% in 1970). The figures do show, however, a tendency for the trend to slow down despite the continuing sharp disequilibrium between costs and prices.

Benefiting from the decline in domestic demand, the surplus on goods and services rose sharply to Lit. 1000000 million, against Lit. 388000 million in 1970. Net gold and foreign exchange reserves rose by Lit. 590000 million in 1971.

From the middle of 1970 onwards, the monetary authorities sought to increase opportunities for obtaining credit and, from 1971 onwards, to cut the cost of borrowing. In the first nine months of 1971, the money supply exceeded by about 20% the level recorded for

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(1) Estimated at nearly $ 1700 million from December 1970 to November 1971.

the corresponding period of 1970. In the area of budgetary policy, efforts to restimulate demand, mainly by encouraging investment, generated a substantial increase in public expenditure, with a consequent increase in the budget deficit. However, this public expenditure was not as effective as had been hoped.

20. In the Netherlands, disequilibria - already very marked in 1970 - grew worse in 1971, and economic activity tended to lose momentum. While fixed investment and, after the summer, export demand lost vigour, the expansion of private consumers' expenditure remained brisk. Although production capacity and manpower shortages were handicapping production expansion less and less, the real growth of gross national product did not exceed 4% in 1971, against an increase of more than 5.5% for 1970.

Spurred on by the sharp upward movement in wage costs, inflationary strain continued to increase, and remained a source of concern. Consumer prices, up by 3.8% in 1970, rose by a further 7.2% in 1971.

Thanks to the recovery in the trade balance from the autumn onwards, the deficit on current account contracted; it was about Fl. 600 million in 1971. as against Fl. 1700 million in 1970. A heavy net inflow of private capital and other factors ensured that the overall balance of payments still showed a heavy surplus. This trend was reflected in a further increase in net gold and foreign exchange reserves (Fl. 2550 million in 1970, Fl. 800 million from January to November 1971). In contrast with the trend in 1970, the net external position of the commercial banks improved in 1971, at least during the period up to the autumn.

In view of the intensity of inflationary strain, the monetary authorities maintained restrictions. However, to curtail the creation of liquidity generated by the inflow of foreign capital, Bank rate was cut (in two stages) from 6 to 5% in 1971. The authorities also acted to curb capital inflows, and one of their measures was a "closed circuit" for non-residents' purchases of bonds denominated in florins.

21. In Belgium, growth lost more momentum in 1971, inhibited by a slowdown in the expansion of overall demand. Although consumption value again increased appreciably, the growth of export demand was less brisk. In addition, investment, which had accelerated in 1970, tended to weaken more and more. Real GNP growth fell to about 4 % in 1971 from 6.1% in 1970. In these conditions, the increase in employment became distinctly slower and unemployment tended to rise in the second half of the year.

Although it remained less pronounced than in any of the competing countries, the upward price movement was fairly vigorous. Consumer prices, forced up by production costs and the introduction of the value added tax, increased by 5.6% in 1971 (3.1% in 1970).

Mainly because of the change in the timing of settlements, but also probably because the Belgian economy was in a stonger competitive position, the current account again achieved heavy surpluses in 1970 to 1971. Thus, despite the heavy deficit on capital movements, the overall balance of payments of the BLEU closed with a substantial surplus: Bfrs. 20000 million in 1970 and Bfrs. 22200 million in 1971. In the later year, the Banque Nationale's foreign exchange reserves increased by Bfrs. 13600 million (1), while in the first nine months of the year the commercial banks' external position improved by Bfrs. 6300 million.

Economic and monetary restrictions were appreciably eaed after the suspension in August 1971 of the fluctuation margins for the Belgian franc vis-à-vis currencies other than the

(1) Not including allocation of SDRs.

florin. As economic conditions gradually reverted to normal, the authorities, faced with more than ample liquidity and a persistent downward trend of interest rates, discontinued bank credit controls and, for the fourth time since October 1970, cut Bank rate from a high point of 7.5% (October 1970) to 5.5%.

22. After reaching a peak in the first half of 1970, production in Luxembourg, inhibited by changes in the world demand for steel products, dropped in the second half of 1970, and then rallied in the period up to the autumn of 1971. In annual average terms, the real rate of growth of the gross national product was, however, substantially lower: it was only 0.5 % in 1971, comparing with 3.5 % in 1970. Inflationary strain persisted and was reflected in a substantial increase in consumer prices (4.7% in 1971, compared with 4.6% in 1970).

23. For most of the period under review, trends in the Community were again in marked contrast with those in major non-member countries. For example, in the United States, the tendency for business activity to decline continued in 1970. Nor did the recovery in the first half of 1971 match official forecasts made at the beginning of the year. However, from the second half of the year onwards, growth, stimulated by public expenditure and a recovery in private consumers' expenditure, was fairly brisk. Under these conditions, real GNP growth totalled 3% for the full year. The rate of price increases was much slower in the later months, but by the end of 1971, 6% of the labour force was still unemployed, although unemployment had been declining since June.

The deterioration in the external situation of the United States, which had already been pronounced in 1970 became much more severe in 1971. The balance of payments deficit (official settlements) rose from $ 10600 million (1) in 1970 to about $ 30000 million in 1971. The increase in the deficit was partly due to the trend on the trade balance, which, from one year to the next, deteriorated by about $ 5000 million, moving from a surplus of $ 2100 million in 1970 to a deficit of $ 2900 million in 1971. The main factor, however, was the exceptionally heavy outflow of capital.

24. In the United Kingdom, growth was slow in 1970 and prices came under severe pressure from the sharp increase in production costs. In the first quarter of 1971 there was, indeed, an actual decline in activity due to the steady fall of profits, to low rates of production capacity utilization in most industries, to the poor outlook for demand and to strikes, and this slowdown was not fully offset in the following quarter. The official programme designed to sustain domestic demand implemented in the summer, following separate measures announced in the autumn of 1970, did in fact spur on growth so that for the full year the gross national product expanded by 1.5% in real terms. However, the tendency for unemployment to increase persisted, although the upward price movement lost a little momentum.

The improvement in the external situation continued. The record balance of payments surplus achieved in 1970 (£ 1 287 million (1)) was easily exceeded in 1971. Since the spring, the trade balance has again shown a distinct improvement, and the surplus on invisibles has been maintained at a high level. The surplus on current account has exceeded £ 900 million. Moreover, there have been very heavy inflows of capital into the United Kingdom, largely from the sterling area, attracted, at least at first, by high interest rates on the London market. This trend in the external account has enabled the United Kingdom to step up its monetary reserves and cut back external indebtedness for the second year in succession.

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(1) Not including allocation of SDRs.

CHAPTER III

THE ACTIVITIES OF THE MONETARY COMMITTEE

25. In 1970 the Committee was already concentrating mainly on international monetary problems. The 1971 crisis merely strengthened this tendency. It also delayed the stage-by-stage implementation of the economic and monetary union, which, in other circumstances, would have been given priority by the Committee.

The international monetary problems

26. Well before the crisis, the Committee had devoted many of its sessions to problems connected with the wider fluctuation margins within the IMF, to sliding parities and to the temporary floating of exchange rates. It adopted no final position, although the studies put in hand did bring out areas of near-agreement before the annual IMF meeting in September 1970 and also enabled progress to be made in analysis of the machinery which the international agencies have yet to discuss in an effort to find a lasting solution to the present situation. Until May 1971, the Committee discussed the problem raised by the plan to establish narrower margins between the currencies of the Six. Events then forced the Committee to review the entire structure of the international monetary systems.

27. The Committee was called upon to participate actively in Community consultations organized on several occasions during the events of May and August 1971. Preparing the Council's session of 8 and 9 May, it held, on 6 May, a prior consultation on the monetary measures adopted by the German authorities to restore satisfactory conditions on their exchange market, namely:

(i) the introduction of a control system for imports of foreign capital (implementation of section 23 of the *Aussenwirtschaftsgesetz);*

(ii) temporary floating of exchange rates.

The Committee acknowledged that the exceptional situation in the Federal Republic demanded emergency action. It expressed the hope that, as far as possible, Community arrangements would be adopted by the Council. In view of the role played by international capital movements in the crisis, the Committee also suggested that study should be made as to how monetary flows could be better controlled.

At the end of the consultation, held on 8 and 9 May, the Council adopted a resolution in which it stressed that a system of floating exchange rates between Community currencies was, in normal circumstances, incompatible with the proper working of the Community. However, where excessive capital inflows were taking place in certain member countries, it "expressed its understanding" that in certain cases these countries might widen, for a limited period, the fluctuation margins or exchange rates of their currencies around the current parity; it added that such action should be strengthened by measures designed to discourage excess inflows of capital and neutralize their impact on the domestic monetary situation.

Following this consultation, the German and Netherlands authorities announced the decision to float the DM and the Florin (cf. sec. 7).

28. As agreed at its meeting held on 6 May, the Committee carried out a survey, in association with the Committee of Governors of the central banks, of facilities available for the control of domestic liquidity and of capital transactions with abroad. Using the material provided by the two committees, the Commission drafted a proposed directive for the control of international financial flows and the neutralization of any undesirable impact they may have on domestic liquidity. This proposal recommends the control of investments on the money market and of the remuneration of non-residents'deposits; the control of loans and credits contracted abroad by residents, where such loans or credits are not linked with commercial transactions or with the provision of services; the control of the net external position of credit institutions; and the use of compulsory reserve ratios, especially for non-residents' balances. The Council gave this proposal a first reading on 2 July 1971 and general agreement on its content was reached.

In this connection, it may be noted that the decision taken by the central bank governors on 13 June to discontinue official investments on the Eurocurrency market was already in line with these proposals. In addition, certain Member States, lacking full facilities in this field, have introduced or prepared new deterrents (cf. 10 *in fine*). In Germany, in particular, a law entering into force at the end of 1971, empowers the authorities to require residents to make a compulsory interest-free deposit with the Bundesbank ("*Bardepot*") against financial commitments contracted by them with non-residents.

29. As part of the consultation work organized following the United States decisions of 15 August (cf. 9), the Committee met promptly to prepare for the Council meeting of 19 August. Its agenda included an examination in the Community context of the short-term problems raised by these measures for the Member States. It felt that concerted action with regard to financial transactions would be very difficult in view of the likelihood that differing exchange systems would be introduced in the Community countries, at least temporarily. Concerted action with regard to current transactions, however, seemed feasible, provided certain conditions were fulfilled:

(i) that the Six review the exchange relationships between their currencies, it being understood that adaptations could well be small, but should be realistic;

(ii) that the Member countries re-establish, as between their currencies, the fluctuation margins operative until 9 May 1971;

(iii) that from time to time they should fix limits on the fluctuation of the United States dollar as against their currencies, an arrangement under which each of the countries would need to dispose of facilities to combat speculative capital movements.

At its session of August, the Council noted that no specifically Community exchange could be agreed upon at once. Accordingly, it accepted that pending a reform of the international monetary system, the rates for the United States dollar could be reached freely in certain Community countries on single markets and would be fixed in other countries on two-tier markets. Consequently, the member countries implemented the differing exchange arrangements described in sec. 10.

30. Following the events of August 1971, the Committee was instructed to carry out, for the Council, preparatory work jointly with the Committee of Governors of the central banks with a view to the establishment of a joint position to be maintained at the meetings of the Group of Ten and of the Annual Meeting of the IMF.

Advised by the two Committees, the Council agreed, on 13 September 1971, on the main points of a common attitude to be maintained by the Six within the international bodies:

(a) any reforms to the international monetary system must comply with the principle of fixed parities, to be changed as soon as they become unrealistic. The restoration of satisfactory equilibrium in international payments relations entails differing degrees of realignment in the parity relationships between the currencies of the industrialized countries. Such readjustment should include the currencies of all the countries concerned, including the dollar;

(b) a reformed international monetary system cannot work properly unless measures are taken to control international capital movements. Such measures could usefully include the widening, to a limited extent, of the exchange fluctuation margin so as to temper the impact of interest rate differentials, and measures to discourage movements of short-term capital liable to engender disequilibria;

(c) the basis of international liquidity will remain gold, and to a growing extent, reserve instruments created and administered collectively at international level; the special drawing rights arrangement should be adapted and developed as the role of national currencies as a reserve instrument gradually declines;

(d) the new international payments equilibrium cannot be maintained unless all the countries or organized groupings of countries comply without exception with the obligations and constraints imposed by the adjustment of payments balances, and implement appropriate domestic policies;

(e) within the framework of the reformed monetary system, the IMF's authority and scope for action must be strengthened in all fields in which it works; the EEC Member States must endeavour to establish joint positions within this institution.

These principles were defended by the representatives of the Member States and of the Commission participating in successive meetings of the Group of Ten; they were also endorsed virtually in their entirety in the resolution adopted by the annual meeting of the IMF in September 1971 and underlie the agreements concluded in Washington on 17 and 18 December (sec. 12). Thoughout the negotiations, the United Kingdom representatives supported the position adopted by the Six.

Economic and monetary union

31. Implementing instructions agreed at the Conference of heads of states or governments in the Hague on 1 and 2 December 1969, the Council had, on 6 March 1970, instructed a Working Party, the Chairman of which was Mr Werner, Luxembourg Prime Minister and Finance Minister, to draft a report indicating the main policy choices to be made for the achievement by stages of an economic and monetary union. In May the Working Party filed an interim report and in October 1970 a final report was produced, to which were annexed the findings of an expert group convened by the Committee of Governors to study certain technical and economic problems to be solved before the Community could have its own exchange system.

At its session on 8 and 9 February 1971, the Council, having considered the final report of the Werner Working Party and the Commission's proposals, adopted a resolution in which the representatives of the governments expressed their intention to establish over the next ten years an economic and monetary union according to a stage-by-stage plan, beginning on 1 Janauary 1971. With this in view, the Council and the representatives of the Member States' Governments agreed to put in hand a set of measures to be implemented during the first stage, which would last three years and end on 31 December 1973.

At the same meeting, the Council adopted a set of decisions (1) related to this project. The decisions provide for:

(i) more extensive coordination of the Member States' short-term economic policies; this decision included a rule that the Council will meet three times a year to examine the economic situation in the Community;

(ii) fuller cooperation between the Member States' central banks, which will coordinate the monetary and credit policies in compliance with general economic guidance given by the Council;

(iii) the introduction on 1 January 1972 (1) of the medium-term financial assitance arrangements previously planned; under this decision, a Member State facing payments difficulties or severe threat of such difficulties can use the Community mutual assistance machinery; it was also agreed that the Committee must be consulted whenever a Member State uses medium-term credit resources, of whatever origin, and particularly when mutual assistance machinery is used, and whenever a Member State requests exemption from contributing to the financing of such an operation;

(iv) the adoption of the third medium-term economic policy programme for the period 1971/75; this programme contains target figures and forms the framework in which the coordination of economic policies can contribute to fuller convergence of economic trends in the member countries.

32. This set of decisions was the first part of the programme of measures recommended for the first stage. The second part relates to the strengthening of the coordination of short-term economic policies, including monetary and credit policy, the gradual harmonization of economic and policy instruments, measures to encourage tax harmonization and the free movement of capital, the easing of strain in regional and structural areas, the gradual adoption of joint positions in monetary relations with non-member countries and the international organizations and, in particular, a commitment, not to invoke, in exchange relations between Member States, any rules allowing a relaxation of the international exchange system.

As immediate and practical evidence of its desire to achieve coordination and as a first step towards the establishment of the Community's own exchange system, the Council invited the central banks, as a tentative measure, to hold exchange rate fluctuations of the Member States' currencies within narrower limits than those imposed by the margins in force for the US dollar. They were to do this by concerted intervention in dollars on the exchanges. The Monetary Committee and the Committee of Governors were also asked to draft, by June 1972, a report on the organization, functions and governing instruments of a European monetary cooperation fund. The report should take account of experience gained with regard to narrower exchange margins and the alignment of economic policies.

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(1) The parliamentary ratification procedures had not yet been completed in all the member countries at the date of publication of this report.

Taken as a whole these arrangements meant that the Monetary Committee had to step up work to which it was already giving a great deal of attention and embark upon new work, the execution of which was delayed by the monetary crisis.

33. Although the Committee was mainly concerned with international monetary problems, it still assigned great importance to the regular reviews of the monetary and financial situations of the Member States. These reviews provided an opportunity for the Committee to carry out, in accordance with the Council decision of 17 July 1969, prior consultations on economic or monetary measures contemplated by the Member States. The scrutiny procedure will, however, have to be better adapted to the stricter requirements of economic and monetary unification.

34. The Committee completed the updating of its study, originally made in 1962, of the "Instruments of Monetary Policy in the EEC countries", which will be published shortly. Completely rewritten, it gives an overall view of the institutional and structural aspects of the national financial systems and a comparative analysis of monetary policy and objectives in each member country. The Working Party set up by the Monetary Committee and the Committee of Governors to harmonize monetary and credit policy instruments in the Member States will be able to use this study as a working document.

35. Under the broader terms of reference received from the Committee, the Working Party on securities markets held a periodic review of trends on the member countries' captal markets and on the international markets and of official policies in this area. It reported to the Committee, which approved the findings. (1).

With regard to the free movement of capital, specific measures of protection adopted by certain Member States during the world monetary crisis deviated from commitments made under the directives for the implementation of Article 67 of the EEC Treaty. The result was greater "compartmentation" between the national capital markets within the Community. However, the serious disturbances in monetary relations and their impact on domestic liquidity justified the use made by the States of the control instruments available. The conclusion of the work on establishing a monetary personality of its own for the Community will provide an opportunity to study ways and means of achieving further progress in the liberalization of capital movements within the Community.

36. In line with the Council's wishes, the Committee of Governors of Central Banks had decided to make a first experimental reduction, from 15 June 1971 onwards, in the margins of fluctuation of exchange rates between the Community currencies. Under the pressure of events, this experiment had to be deferred. Because of the decisions since taken in Washington, the exchange rates of the Member States' currencies may now show disparities, in the short-term, of up to 4.5% and theoretically over a period of time, up to 9%. This wider range has serious disadvantages, not only for the agricultural price system but also for the proper working of the Common Market as a whole. In fact, the decisions have not only made possible but also necessitated the revival of efforts to give the Community its own monetary personality while ensuring effective coordination of the short-term economic policies.

(1) This report is annexed.

ANNEX I

THE COMMITTEE : MEMBERS AND ALTERNATES

Chairman

B. Clappier	Sous-Gouverneur de la Banque de France (Paris)

Vice-Chairmen

Prof. W. Drees (until 5 February 1971)	Thesaurier-generaal bij het Ministerie van Financiën (The Hague)
Dr. O. Emminger	Vizepräsident der Deutschen Bundesbank (Frankfurt/Main)
Prof. C.J. Oort (from 23 June 1971)	Thesaurier-generaal bij het Ministerie van Financiën (The Hague)

Members

F. Boyer de la Giroday	Director in the Directorate-General for Economic and Financial Affairs - Commission of the European Communities (Brussels)
M. D'Haeze	Directeur-général de l'administration de la trésorerie et de la dette publique - Ministère des finances (Brussels)
C. de Strycker	Vice-Gouverneur de la Banque nationale de Belgique (Brussels)
Dr. W. Hankel	Ministerialdirektor - Bundesministerium für Wirtschaft und Finanzen (Bonn)
C. Lamboray (from 1 June 1971)	Directeur adjoint de la Caisse d'épargne de l'Etat (Luxembourg)
R. Larre (until 11 June 1971)	Directeur du Trésor - Ministère de l'économie et des finances (Paris)
A.W.R. Baron Mackay	Directeur der Nederlandsche Bank N.V. (Amsterdam)
Prof. G. Miconi (from 30 November 1970)	Direttore generale del Tesoro - Ministero del Tesoro (Rome)

Dr. U. Mosca	Director-General for Economic and Financial Affairs - Commission of the European Communities (Brussels)
Dr. R. Ossola	V. Direttore generale della Banca d'Italia (Rome)
C. Pierre-Brossolette (from 11 June 1971)	Directeur du trésor au Ministère de l'économie et des finances (Paris)
J. Schmitz	Conseiller de gouvernement au ministère des finances (Luxembourg)
Prof. G. Stammati (until 30 November 1970)	Ragioniere generale dello Stato - Ministero del Tesoro (Rome)
R. Weber (until 1 June 1971)	Membre du Comité de direction de la Caisse d'épargne de l'Etat (Luxembourg)

Chairman of the alternates

Prof. J. Mertens de Wilmars	Conseiller économique de la Banque nationale de Belgique (Brussels)

Alternates

D. Deguen (until 11 June 1971)	Directeur adjoint à la direction du trésor - Ministère de l'économie et des finances (Paris)
J. de Larosière (from 11 June 1971)	Chef du service des affaires internationales à la direction du trésor - Ministère de l'économie et des finances (Paris)
Drs. G. de Man (from 1 November 1971)	Ministerie van Financiën (The Hague)
A. Dondelinger (from 1 June 1971)	Commissaire au contrôle des banques (Luxembourg)
Dr. L. Fronzoni	SADIBA (Perugia)
Dr. D. Gagliardi	Espettore - Ministero del Commercio Estero (Rome)
Drs. R.L. Haan (from 1 January 1971 until 1 March 1971)	Ministerie van Financiën (The Hague)
G. Jennemann	Bankdirektor - Deutsche Bundesbank (Frankfurt/Main)
H. Koch	Directeur-général des études à la Banque de France (Paris)
M. Meulemans	Conseiller à l'administration de la trésorerie et de la dette publique - Ministère des Finances (Brussels)

Dr. B. Molitor	Director in the Directorate-General for Economic and Financial Affairs - Commission of the European Communities (Brussels)
N. Rollmann (until 11 June 1971)	Conseiller de direction à la Caisse d'épargne de l'Etat (Luxembourg)
Dr. M.O.C.R. Ruding (until 1 June 1971)	Ministerie van Financiën (The Hague)
M. Schmit	Inspecteur des finances (Luxembourg)
Drs. A. Szasz	Onderdirecteur van de Nederlandsche Bank N.V. (Amsterdam)
Dr. G. Willmann	Regierungsdirektorin - Bundesministerium für Wirtschaft und Finanzen (Bonn)
G. Wissels	Director in the Directorate-General for Economic and Financial Affairs - Commission of the European Communities (Brussels)

Secretariat

G. Morelli
G. Lermen

ANNEX II

REPORT OF THE WORKING PARTY ON SECURITIES MARKETS

Foreword

1. When it was set up by the Monetary Committee on 30 October 1967, the Working Party, comprising experts appointed by the Member States and the Commission, was instructed to assess how equilibrium is reached on the bond markets in each of the member countries.

Accordingly, it began by listing the procedures and instruments used to ensure the proper working of the national markets; it then analysed the policies pursued by the Member States in this area from 1966 to 1969. Its report was entitled: "Bond market policy in the countries of the EEC (current instruments and the use made of them from 1966 to 1969)".[1]

The work done highlighted the value of regular exchanges of information and closer cooperation in the implementation of the Member States' policies and in the preparation of structural reform in the capital market field. The Committee therefore decided in April 1970 to maintain the Working Party and to extend its terms of reference to cover all capital market problems.

The new terms of reference include:

(a) the provision of such advice for the Committee as may be requested;

(b) regular discussions on Community market trends and their relationship with the international markets;

(c) an examination of all aspects of the policies pursued by the Member States with regard to the capital markets and of the practical scope for promoting and facilitating their gradual integration.

2. The Working Party began by organizing regular discussions on trends in the Member States' markets and the relationships of these markets with the international markets. It decided to devote one meeting a quarter to this question. Meeting as often as this enables it to follow fairly closely capital market trends and official policies and to compare prospective trends for the following quarter. The Working Party also agreed to carry out a comparative analysis at the beginning of each year of certain annual forecasts relating to the national markets.

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(1) Published by the Office for Official Publications of the European Communities, Luxembourg 1970 (Doc.8320).

Secondly, on the question of its examination of the Member States' capital market policies and practical ways and means of promoting and facilitating their gradual integration, the Working Party felt that it should begin by concentrating on topical problems arising both on the domestic markets and on the international markets, endeavouring to throw light on divergent or convergent factors.

The purpose of the present report is to relate briefly the activities of the Working Party on the securities markets from the second half of 1970 until October 1971.

Trends on the capital markets of the Member States and on the international markets : key trends

3. Taking the Community as a whole, the bond markets were working fairly satisfactorily. Apart from temporary suspensions of issues in almost all the countries at different times, designed to overcome temporary congestion, the bond markets developed fairly steadily.

The volume of issues of fixed interest securities increased appreciably in all the member countries, though in Italy only from 1971 onwards. This was mainly due to the relatively high and stable rate of household saving and above all to the preference of investors for long-term fixed interest securities, a preference due to the maintenance of interest rates at levels attractive to subscribers.

It may be recalled in this connection that in countries like France and Italy, the authorities discontinued in 1968 or 1969 their consistent cheap money policy and allowed market forces to work more freely. Convergent upward interest rate movements were then recorded from 1969 onwards on the Member States' long-term markets, not only under the impact of conditions on the international capital market but also because of internal factors: high interest rates are regarded as necessary in periods of inflationary strain to offset the loss of value of money; they are also an important factor in policies to encourage household saving and to attract it to the right areas.

Although no joint action among the Six was agreed, the tendency for interest rate policies to come closer together was confirmed in 1970 and the first part of 1971. In all member countries, the authorities endeavoured to arrest or control the downward movement in rates which started in United States and spread through the international market. Finding this trend too rapid given the domestic situations, they were able to maintain the rates on their markets or curb the downward trend mostly by generating a heavy volume of issues, for example by encouraging public loans or bringing forward issue dates. However, because the short-term and long-term markets are not related to the same extent in each country, the downward movement progressed at different speeds in the Member States and by the beginning of 1971 some disparities were discernible between the various capital market rates.

At the end of the period under review, the interest rate pattern was varying even more widely, for reasons connected with economic trends and also because of the prospects of realignment of currency parities and because of certain measures taken in this context. Long-term interest rates dropped sharply in Belgium, less sharply in Germany, the Netherlands and Italy, but continued at their old level in France.

With regard to the control of the markets, facilities for varying capital supply or demand were amplified in Germany, the Netherlands and Italy. In addition, these instruments were also used to react more promptly to changes in the market trend, so that policies are now more similar throughout the Community than they were before.

The pattern of issuers (central authorities, local authorities, public credit institutions, mortgage banks, public nationalized undertakings, private-sector companies) continued to vary widely from country to country, despite a general feeling that the private sector should have fuller access to the bond markets. The situation reflects the disparities in the structure of financing channels from country to country in the Community.

Constrasting with the situation on the fixed interest markets, the volume of issues in the period under review on the equity markets was irregular and was thought inadequate in most of the countries. Moreover, in 1971, quotations fell, often heavily. The trend may be partly due to uncertainty as to the international monetary situation but it is also partly due to lower - sometimes much lower - corporate profits. The fact that institutions and households have been showing more interest in bonds has also to some extent worked to the detriment of investments in variable yield securities.

4. On the international markets, the volume of issues remained heavy ($ 3400 million in 1970 and about $ 4600 million for the first eleven months of 1971, compared with $ 3900 million in 1969 and $ 5100 million in 1968), although the monetary situation inhibited the working of the markets throughout the period.

However, there were frequent changes in the currencies used in the period under review, and issuers adapted rapidly to the currency in which investment opportunities seemed most favourable, having due regard to subscribers' preferences.

The market in issues denominated in dollars remained very active despite increased instability. The disturbances which occurred were largely offset by progress in issues denominated in other currencies.

The more flexible official attitude in Switzerland to Swiss-franc loans, following the revaluation of the Swiss franc, made possible an increase in the amount of public issues and particularly in private placings made in this currency on behalf of foreign borrowers.

Speculative capital movements affected directly the member countries' bond markets less than might have been feared because of the prompt adaptation of exchange arrangements. The mark and the florin were still in heavy demand as a vehicle for international issues, while issuers used the currencies of other member countries more frequently than in the past.

Germany's role on the international market has changed: this country has moved from the position of net long-term capital exporter to that of a transit market - since 1971 loans issued by foreign borrowers have been taken up more and more by non-residents who now account for virtually all this type of lending. Moreover, in 1971, other member countries, notably Belgium and Luxembourg, adopted a more liberal attitude than in the past with regard to the admission of foreign issues on their markets. However, on other markets, especially France, high interest rates and issue costs proved an obstacle to foreign issues. Lastly, some member countries have recently withdrawn altogether from the international markets for balance-of-payments reasons and because more funds are available domestically.

Capital market trends in the member countries and national policies

5. In Germany, after a difficult period extending into the second half of 1970, the capital market began to develop favourably. Its capacity to absorb issues was satisfactory, mainly because private individuals have been taking over from the financial institutions as purchasers of fixed income securities, thus offsetting the reserved attitude adopted by these institutions as a result of the restrictive policy pursued in 1970 and at other times by the Deutsche Bundesbank. Official German policy and interest rate trends in other major countries, particularly the United States, were largely responsible for the trend of interest rates in Germany, which maintained a stable and high level until the beginning of December. However, at the turn of the year, they fell sharply, to rise again in the second quarter of 1971, though without reaching the previous level.

After ceasing altogether, in the first quarter of 1970, issues of foreign loans on the German market were once again brisk by the second quarter of 1970. Indeed, the heavy demand for funds created by these issues generated strain, particularly in February and March 1971. However, as noted above, the loans were being taken up more and more by non-residents, so that in 1971, for the first time since 1965, capital imports exceeded capital exports in Germany, if all operations made on international loans in DM are included in the figures (i.e. including transactions on international DM loans issued in the past).

In the early part of the period under review, there were very heavy placings, mainly by the Bundesbank and the Bundespost. The resulting strain - which did not last - led the authorities to improve the concertation procedure within the "Konjunkturrat" (Economic Council).

By and large, the authorities avoided intervention on the market. However, early in 1971, they pursued a policy designed to slow down any too rapid decline in rates, which was undesirable from the point of view of domestic economic activity and the future trend of the market. In May, they also adopted, on the basis of the "Stabilitätsgesetz", an arrangement restricting official indebtedness. This move eased strain on the capital market.

Bundesbank intervention on the bond market on behalf of issuers was very limited, partly because its fixed income security portfolio available for the purpose was too small. However, in order to ensure a portfolio wide enough to be used as a "buffer stock", the Bundesbank, by agreement with issuers and the placing syndicate, has, since 1970, reserved a certain percentage (at present 10%) of the new Bund and Bundespost loans. It has power to deploy these securities on the market whenever appropriate. The public borrower does not receive the funds corresponding to the reserved share of the loan. It is only as and when the Bundesbank sells the securities on the market that the borrower receives the corresponding funds. This technique is quite different from open-market operations, the result of which is the creation or destruction of liquidity by the central bank.

6. In France, thoughout the period under review the volume of issues increased very aprreciably; the key to this trend was the demand situation associated with a high level of interest rates. Most of the increased borrowing was, initially, by private-sector companies and to a lesser extent, by the public sector. Generally speaking, the issues were effected without special difficulty. Although the public sector endeavoured to leave enough room for private sector issues, the placing of private bonds sometimes raised problems because of the scale of long-term financing needs.

The main aim of official policy was to maintain rates assuring an attractive yield, despite the decline of the value of money. Throughout the period they varied only very little. The authorities wished not only to protect household investment against monetary erosion and thus encourage the formation of private saving but also to encourage a shift of the saving of individuals from liquid investment to longer-term investments.

Early in 1971, the Issues Committee, within which the authorities and the banks work together, decided, although the market was particularly relaxed, not to change the nominal rates and to provide new securities in sufficient quantities to restore yields, which were tending to decline, to a level close to the nominal rates. This decision, accompanying a credit policy which was necessarily vigilant because of the domestic economic outlook, shielded the French market from the switch in the interest rates trend which occurred some months later on many other markets.

The increase in the supply of capital on the bond market was due to more household saving and a shift in this category of saving through long-term investments, but also to efforts made by the banks to sell their security quotas to the public, and to the success of the unit trusts specializing in bonds. Purchases of bonds by life assurance companies also increased sharply. Another factor was the disappointing trend in equities, which led institutional investors and households to give pride of place in their investing to fixed income securities.

Foreign issues were few in number and small in scale. As the external payments situation improved, a more liberal attitude took the place of the restrictive policy previously pursued because of the payments problem. However, with the level of interest rates and issue costs higher than that on the international market, the French market was not particularly attractive for foreign borrowers.

7. There were two separate trends on the Italian capital market during the period under review. In 1970, the bond market contracted appreciably: following a gradual but fairly rapid alignment from the second half of 1969 onward of domestic rates on international rates and the concomitant decline of prices on the secondary market, a climate of uncertainty developed on the bond market so that private investors adopted a definitive attitude of "wait and see" towards new issues. Accordingly, although the Banca d'Italia moved in as subscriber on a generous scale, replacing the banks and private investors, the volume of issues steadily declined. On the other hand, in 1971, bond issues gradually recovered and exceeded the figures for 1970 by a wide margin. At the same time the pattern of supply on the market reverted to normal in that the share accounted for by households increased sharply and the purchases of the Banca d'Italia were scaled down.

In 1970, in contrast with the trend on the bond market, there was a very heavy volume of new issues on the equity market (in connection with tax rules), while in 1971 the market contracted once again.

Until recently, use of foreign markets has been very heavy and has more than offset the temporary contraction of domestic markets. Official policy has aimed at restimulating issues and at an alignment of domestic yield rates on those of the foreign markets. Early in 1970 the authorities had already raised the yield rate on mortgage securities in circulation by one point; thereafter, they adjusted the compulsory reserve rules for banks on several occasions.

With a view to encouraging purchases of securities by private investors, they also encouraged the conclusion of an inter-bank agreement aimed at lowering the level of interest rates paid on bank deposits. The purpose of this agreement is to increase the discrepancy between the remuneration of relatively liquid savings and the yield on securities. Pursuant to this agreement, which entered into force in January 1971, the maximum credit rate payable on large bank deposits was lowered on several occasions; it is now 5.5%.

8. In the Netherlands, where strain on the capital market increased in the first half of 1970, with a sharp and continuing upward movement in yields, rates began to move down steadily in the second half of the year but began to rise once again in the second quarter of 1971.

Market trends were strongly influenced by the heavy purchases of bonds denominated in florins by foreigners. Large-scale purchases by non-residents - on the secondary market as well as on the primary market - often ran against the trend of the monetary policy of the Nederlandsche Bank, which, because of strain in economic conditions, had been attempting to reduce the liquidity of the econmoy. With a view to neutralizing, at least in part, the inflow of funds from abroad, the authorities authorized domestic and foreign borrowers to place abroad short-term notes denominated in florins, provided the funds thus raised were used solely abroad. A long-term loan in florins was also issued on the international market. On the domestic market the central banks' delaying policy was applied less firmly. Lastly, foreign borrowers were authorized to place bond loans, the State having issued two consolidation loans.

The persistent and increasingly speculative inflow of foreign capital was tending to distort the formation of the fluctuating florin rate on the exchanges, and at the beginning of September 1971 the authorities therefore introduced temporarily a "bond-florin".

In December 1970, the centralized financing arrangement for local authorities was renewed for 1971.

In the Netherlands, where private loans ("Onderhandse leningen") are particularly prominent in borrowing activity, the authorities are drafting a bill requiring that major loans of this kind must be notified to the Nederlandsche Bank.

9. Broadly speaking, conditions were very relaxed on the Belgian capital market, so that the public sector was easily able to account for its borrowing requirements. The ample supply of funds also enabled the central government to reimburse large amounts of short-term debt denominated in foreign currency and to consolidate certain other short-term debts, thus improving the pattern of its liabilities. The private sector also took advantage of the favourable situation by making a number of major issues, although the total sum involved was still small compared with that of public-sector borrowing. In this connection, it should be recalled that Belgian private-sector companies traditionally cover financing needs by borrowing from the banks and by issuing shares. Share issues rose sharply because Belgian companies were seeking to improve their financial structure by strengthening their equity.

Official interest rate policy was dictated mainly by the economic trend, but it also provided a sharp incentive to the formation of saving for financing purposes. During the period under review, interest rates followed two separate trends. In the second half of 1970 they levelled out at a high point, but early in 1971, they began to fall and continued to do so throughout the year.

10. There was very little pressure on the Luxembourg capital market in 1970, mainly because the boom in the steel industry generated ample tax revenue for the central authority.

Domestic saving accrued mainly in the form of bank deposits and on the Euro-issue market. The market trend was steady; however, at the end of 1970, the Bank Control Commissioner was compelled to intervene to prevent two foreign issues reaching the market at the same time.

The Government floated a major loan in 1971 and non-residents issued Luxembourg-franc loans which were placed on the international market. For three years Government loans have been exempt from withholding tax so that issuers are not being compelled to increase issue rates too sharply.

The list of foreign loans publicly issued in Luxembourg includes a large number of loans denominated in units of account and some loans denominated in ECU(1), as the banks domiciled in the Grand Duchy and the Luxembourg Government have encouraged these techniques since they were devised.

11. According to its terms of reference, the Working Party has conducted regular examinations of trends on the international bond markets. International bond issues lost momentum in the first half of 1970 but staged a recovery from the third quarter onwards. In the early months of 1971 the volume involved touched a new record. However, from March onwards, the market once again showed signs of weakness, due to some overcrowding: too many borrowers had been attracted by interest rates which had been falling since the end of 1970. From 5 May 1971 onwards, the monetary developments which brought out into the open the weakness of the dollar also affected the market climate; however, the volume of issues did not vary widely and the trend of interest rates remained relatively stable.

The dollar Euro-issue market suffered most from the monetary crisis and from the action taken by the United States and the European authorities. Its share, which had been running at about two-thirds of total international loans for 1970 and the first quarter of 1971, subsequently fell to less than 50%. However, this type of issue rallied strongly from October 1971 onwards.

The volume of DM international issues reached a new record in 1971, with yields equal or even rather below those for domestic issues. Despite the monetary crisis and the complete suspension of issues between 26 May and 28 June because of a ZKMA (2) decision, foreign DM issues developed steadily, especially as a cautious approval policy in respect of domestic issues prevented a "glut" on the market.

The market in medium-term notes denominated in florins expanded very appreciably in 1970 and in the early months of 1971. In 1970, these issues, which are very similar to private loans ("Onderhandse leningen") issued under certain conditions, accounted by themsleves for from 10 to 15% of the absorption capacity of the international markets. However, after the events of May 1971, the scale of these issues contracted sharply.

The market in bond issues in currencies other than the dollar or the DM or the florin developed appreciably from the last quarter of 1970 onwards. This trend gathered further momentum in the second and third quarters of 1971. In this context, the Swiss franc played a preponderant role after the policy change at the time of its revaluation; in the third quarter of this year SF issues alone matched in scale Euro-dollar issues and international DM issues. An extremely large volume of medium-term credit was recorded (estimated at more than SF 2000 million in the first nine months).

(1) E.C.U. European Currency Units.

(2) ZKMA: Central Capital Market Committee.

Broadly speaking, the international Euro-issue market for bonds was remarkably flexible throughout the period under review: economic and monetary events entailed no serious disturbance in its working; occasional temporary overcrowding or weakness in one or another area were offset and indeed even more than offset by an increased volume of issues in other areas of the international market.

As part of its study of the international markets, the Working Party also discussed issues in units of account and in ECU. These issue techniques could, members of the Working Party feel, be of special value in connection with the establishment of a European capital market and with a view to the further coordination of economic and monetary policies of the Member States.

The Working Party has also found that special financing devices such as, for example, variable rate loans and, in particular, renewed credits, have gained some importance. Insofar as these techniques entail some kind of indexation or constitute the financing of long-term investment from short-term resources, they may raise certain problems. The Working Party believes that the further development of these techniques requires special consideration.

Having regard to the quantity of Community capital flowing on to the international markets, the Working Party has felt that it would be desirable to obtain more information about the supply of funds reaching these markets. It has suggested that efforts should be made by the Member States to improve available statistics.

The Member States capital market policies and the scope for promoting and facilitating progressive integration

12. The quarterly examinations organized by the Working Party have already been largely devoted to scrutinies of the Member States' policies with regard to the capital markets. Another aspect of this item in the terms of reference covers action recommended with regard to capital by the Council resolution concerning the achievement of economic and monetary unions. Because of the monetary events which have since intervened, the Working Party decided to postpone to a latter date its examination of the scope for further progress in the liberalization of capital movements.

On the other hand, it discussed on several occasions adjustments to taxation arrangements liable to influence capital movements. This question is of special relevance to the more extensive interpenetration of the capital markets of the Member States.

13. With regard to the taxation of bonds, the Working Party stresses the value of harmonization in this area, in view of its importance for the smooth working of the Community's capital markets. Most of the members felt that the member countries should discontinue altogether the use of withholding taxes treated as a first tax installment. The reason for this is that there are international markets on which no such withholding tax is levied and also that it is advisable to avoid increasing borrowing costs in the Community as compared with such costs in other industrialized countries.

Leaving aside considerations for which the Working Party is not competent (particularly with regard to supervision and tax revenues), it would be appropriate to approach the problem by stages. The first task would be to ensure that in no case is actual taxation increased. Tax concessions in favour of bond holders could usually be maintained (sum withheld freeing income receiver from any further liability, flat-rate tax in Italy, etc.), provided that all measures of discrimination from country to country within the Community are gradually eliminated. In the long run, the problem of harmonizing these concessions would have to be solved. Differences of treatment from group to group of borrowers should be eliminated in order to ensure tax neutrality.

14. As for the taxation of equities, the Working Party believes that if the capital markets are to be merged, the problem of the double taxation of dividends should be solved. An acceptable solution would be to make any tax withheld in one of the Member States claimable in the country of domicile.

Because of the tax systems in force, income from equities is also subject to double "economic" taxation in degrees varying from country to country and this is a handicap which should, in the Working Party's opinion, be reduced. As it is also desirable to improve the working of the equity markets and the methods used to finance companies, most of the Working Party would recommend general use of a system of easing double economic taxation of dividends by the tax credit method already used in France and in Belgium and contemplated in Germany.

On the other hand, the Working Party feels that equal tax treatment for bonds and equities is an objective which cannot easily be achieved.

NOTE ON STOCK MARKET YIELDS GRAPH

Securities chosen for the calculation of Eurobond yields;

Euro DM			**Euro dollars (until the end of 1970)**		
Australia	1967	6.5 %	Australia	1967	6.5 %
BP	1965	5.5 %	B.P.	1966	6.75%
Eurofina	1967	6.5 %	Eurofina	1967	6.5 %
E.I.B.	1968	6.5 %	E.I.B.	1968	6.75%
Highveld Steel (without option)	1966	6.5 %	Highveld Steel	1967	6.5 %
Mexico	1968	7 %	Mexico	1967	7 %
E.C.S.C.	1965	5.5 %	E.C.S.C.	1967	6.5 %
New Zealand	1968	7 %	New Zealand	1966	7 %
Oslo	1967	7 %	Oslo	1968	7.25%
French State Railways	1968	6.5 %	French State Railways	1967	6.5 %

From January 1971 onwards, the figures are for all $ Eurobonds officially quoted.

For the Member States, the reference is to the rates considered as the most representative on the market. In the absence of series for the entire market, there are those of the issuers operating most frequently on the relevant market.

Germany : all fixed interest securities

France : stock market yield on bonds issued or guaranteed by the State and bonds having the same status

Belgium : stock market yield on State loans maturing in more than five years

Italy : stock market yields on bonds issued by credit institutions (credit on movable property)

Netherlands : stock market yield of the 4.5% loan of the Bank voor Nederlandsche Gemeenten

Luxembourg : stock market yield of 13 state loan issues beginning 1955 (14 loans issues beginning October 1971). Data available only as of 1970.

ANNEX III

LIST OF MEMBERS OF THE WORKING PARTY ON SECURITIES MARKETS

Chairman	M.F. De Voghel, vice-gouverneur honoraire de la banque nationale de Belgique, Président de l'Institut de Réescompte et de Garantie, Brussels
Germany	Herr Dr. K. Andreas, Leiter der Hauptabteilung Kredit, Deutsche Bundesbank, Frankfurt
	Herr Borgböhmer, Regierungsdirektor, Bundesministerium für Wirtschaft und Finanzen, Bonn
	Herr H.G. Theisinger, Ministerialrat, Bundesministerium für Wirtschaft und Finanzen, Bonn
Belgium	M.M. D'Haeze, Directeur-général de l'Administration de la Trésorerie et de la Dette publique, Brussels
	M.F. Junius, Banque nationale de Belgique, Brussels
	M.E. Kestens, Inspecteur général au ministère des Finances, Brussels
France	M.Y. Berger, Conseiller auprès du gouverneur de la Banque de France, Paris
	M.Ph. Cosserat, Direction du Trésor, ministère de l'economie et des finances, Paris
	M.P. de Larosière, Sous-directeur des affaires internationales à la direction du Trésor, ministère de l'économie et des finances, Paris
	Mme. L. Beauvais, Banque de France, Paris
Italy	Dott. P. Battaglia, Condirettore centrale, Banca d'Italia, Rome
	Dott. G. Monterastelli, Condirettore centrale, Banca d'Italia, Rome
	Dott. M. Napolitano, Ispettore generale, Direzione generale del Tesoro, Ministero del Tesoro, Rome
Luxembourg	M.A. Dondelinger, Commissaire au Contrôle des Banques, Luxembourg
	M.E. Israel, Sous-directeur à la Banque internationale, Luxembourg

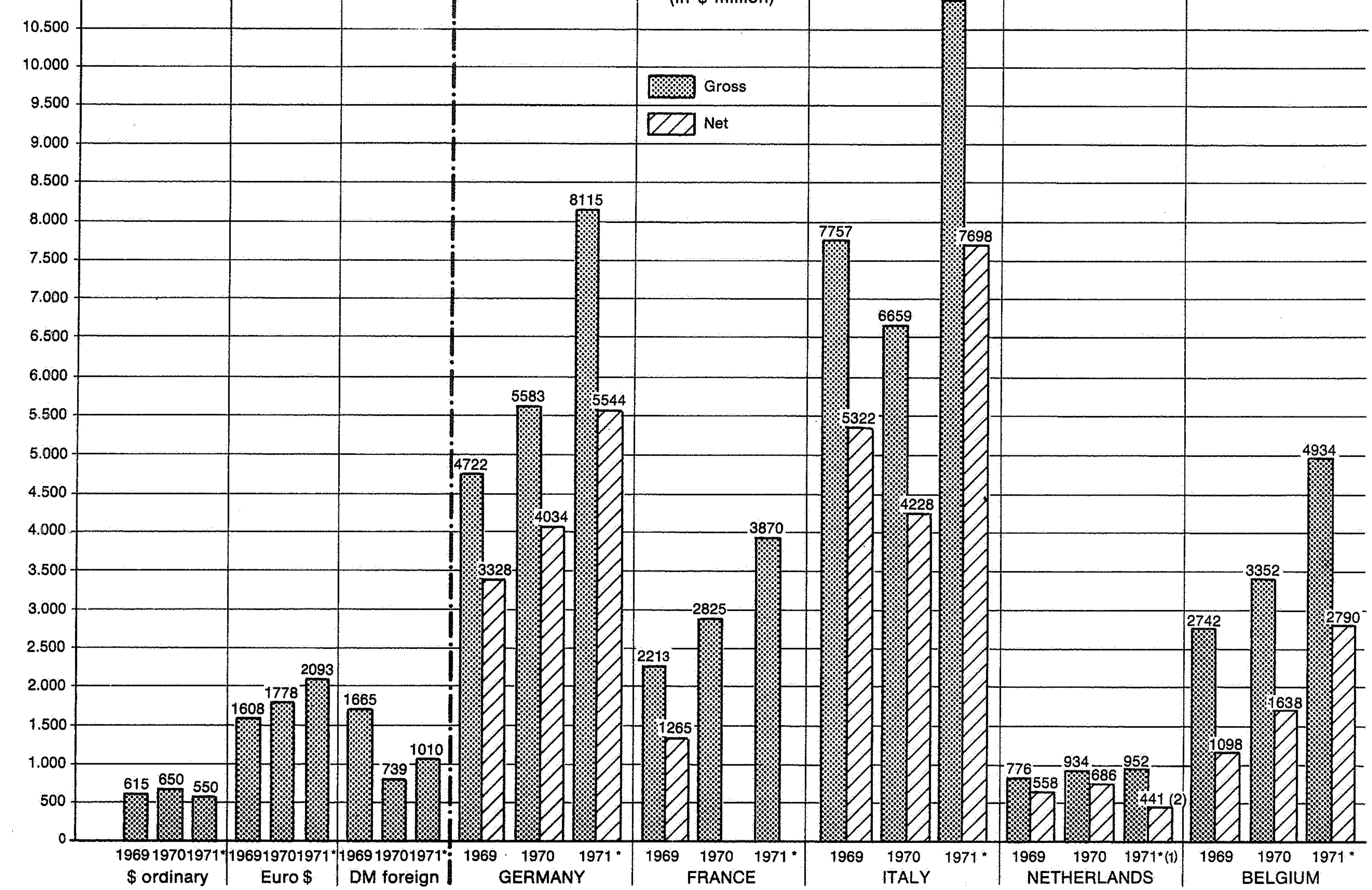
Netherlands	Drs. M.W. Keyzer, Nederlandsche Bank NV, Amsterdam
	Drs. P.C. Timmerman, Onderdirecteur der Nederlandsche Bank NV, Amsterdam
	Drs. D.J. Wolfson, Hoofd Afdeling nationale monetaire zaken, Directie binnenlands geldwezen, Ministerie van Financiën, The Hague

Commission of the European Communities

	M.F. Boyer de la Giroday, Directeur des affaires monétaires, Direction générale des affaires économiques et financières, Brussels
	M.M. Sarmet, Chef de la division des institutions financières et marchés des capitaux, direction générale des affaires économiques et financières, Brussels
	M.H. Stoller, Direction-générale des affaires économiques et financières, Brussels
Secretariat	M.G. Morelli, Secrétaire du Comité monétaire, Brussels
	M.G. Lermen, Brussels

VOLUME OF BOND ISSUES

(in $ million)

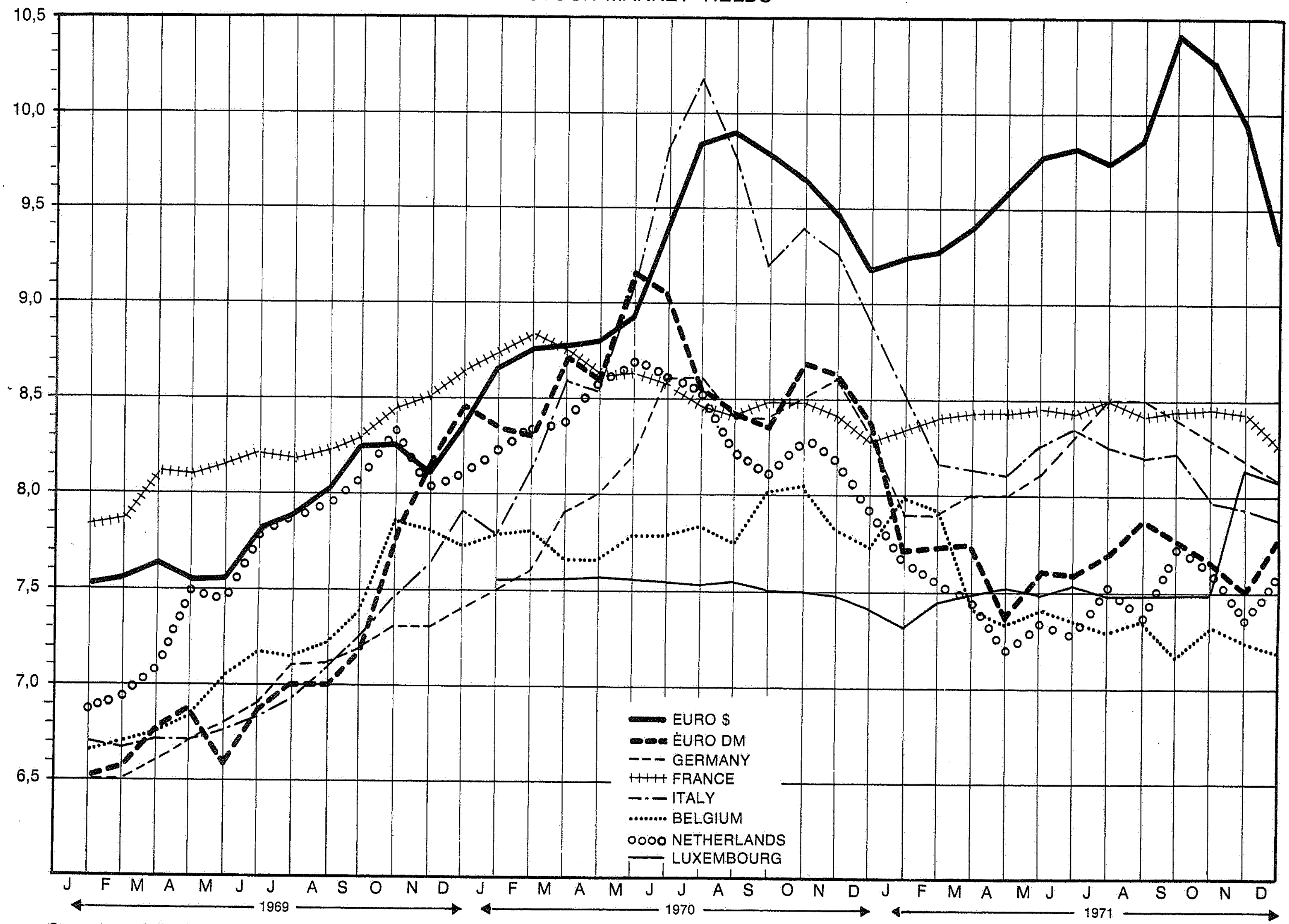


* Provisional figures

(1) Not including fourth-quarter tap issues

(2) Not including fourth-quarter net series issues of the central government

STOCK MARKET YIELDS



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