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COUNCIL AND COMMISSION

SEVENTEENTH REPORT ON THE ACTIVITIES OF THE MONETARY COMMITTEE

FOREWORD

The purpose of this report is to give a brief account of the activities of the Monetary Committee during 1975.

During the year, the Committee held 13 sessions and the working parties drawn from its own members or set up at its initiative met on many occasions. A list of members as at 31 December 1975 is annexed hereto.

The report was adopted as at 31 December 1975.

INTRODUCTION

1. 1975 was marked by an economic recession such as has not occurred since the 1930s. It affected all the industrialized countries and the non-oil-producing developing countries; its repercussions were reflected in international trade, which declined sharply in volume. The balance of payments situation in 1975 was characterized by a substantial reduction in the OPEC surplus, a considerable improvement for the major industrial countries as a group, and a deterioration for other groups of countries, the non-oil-producing developing countries, the smaller OECD members and the centrally planned economies.

2. Although the economic recession led to the restoration of a better balance on external accounts in all Community countries, it caused considerable unemployment in each of them and brought only partial relief from inflation. In these circumstances the Community authorities, as in the previous year, sought to help Member States in difficulty and, as a matter of priority, to safeguard the gains which the Community had made thus far and which might have been threatened in the difficult economic situation.

COMMUNITY ACTION AND THE ACTIVITIES OF THE COMMITTEE

3. At the beginning of 1975, five Community Member States were applying the Community arrangements of 10 April 1972 on the narrowing of intra-Community exchange rate margins (the snake). On 10 July, however, France, which had left the snake on 21 January 1974, announced that the French franc was officially rejoining the snake at its old central rate. At this time, the workings of the

system were modified: while the three-month extension under the very short-term financing mechanism had, until then, only been possible through agreement between the debtors and the creditors, henceforth it became automatically available to the debtor on request, subject to certain limits. With regard to settlement, the rules were adapted by excluding gold from the calculation of reserves and formally confirming its exclusion from the actual settlements themselves.

4. During the year, a solution was found, initially in the context of the European Development Fund, to the important problem of the European unit of account. At the Council session of 16 September 1974, the Monetary Committee had been instructed to start work on the problem of the units of account operating in various sectors and had already submitted two opinions before the end of 1974 (see paragraph 30 of the sixteenth annual report).

5. On the basis of a report prepared by the alternates, the Monetary Committee adopted a further opinion on this matter at its meeting of 4 March (Annex I), and on 18 March the Council adopted a new unit of account for the Lomé Convention transactions where the need was particularly urgent. This unit of account was a 'basket' type, equivalent in value to 1 SDR on 28 June 1974 and composed of the following amounts in the currencies of the Member States:

DM	0·828	(27·3 %)
£ sterling	0·0885	(17·5 %)
FF	1·15	(19·5 %)
Lit	109	(14·0 %)
Fl	0·286	(9·0 %)
Bfrs	3·66	(7·9 %)
Lfr	0·14	(0·3 %)
Dkr	0·217	(3·0 %)
Irish £	0·00759	(1·5 %)

The value of the unit of account in various currencies is calculated and published daily by the Commission departments. The same unit of account was subsequently applied by the European Investment Bank and also adopted by the European Coal and Steel Community. Moreover, at its meeting in Rome on 2 December, the European Council noted the Commission's intention to present proposals to the Council with regard to the application of the European unit of account to the Community budget as a further step.

6. International monetary matters, particularly the reform of the international monetary system, occupied much of the time of the Monetary Committee during the year. This arose from the quinquennial review of quotas in the International Monetary Fund, the need to make further progress in reform of the international monetary system and to amend the articles of agreement to reflect the reforms agreed.

7. The Monetary Committee played an important role in the process of arriving at a common Community position on these problems. Three aspects in particular were at the centre of negotiations: the distribution of the increases in IMF quotas, the problem of gold, and the question of the exchange rate system.

8. On quotas, against the background of agreement already reached in the IMF on the doubling of quota shares of OPEC countries and the maintenance of quota shares of developing countries, the essential features of the Committee's position were:

(a) agreement to generalize qualified majorities for voting on important issues in the IMF at 85 % instead of 80 %;

(b) agreement on a distribution of the quotas among industrialized countries on the basis of a modified application of the Bretton Woods formula.

9. In its report of 27 June (Annex II), the Committee endorsed proposals concerning the gold holdings of the IMF and worked out arrangements on gold transactions by monetary authorities reflecting the consensus reached between EEC finance ministers at Zeist on 22 and 23 April 1974 (see paragraph 27 of the sixteenth annual report), all of which were the basis for subsequent agreement at the IMF Interim Committee in August.

10. Later, the Committee agreed to press the need to maintain symmetry in the implementation of certain elements of the gold package, namely gold sales for the benefit of developing countries, gold restitution to member countries and freedom for monetary authorities to undertake transactions in gold.

11. In discussion of a clause on collaboration with the IMF in relation to gold policy, the Committee agreed that the IMF articles should promote the SDR as the principal reserve asset in the international monetary system and that any references to the reduction of the role of gold should be accompanied by references to the reduction in the role of reserve currencies.

12. Throughout the discussion, the Monetary Committee maintained the importance of a balanced package of new arrangements in the IMF, even when at the 31 August meeting of the Interim Committee no immediate progress proved possible on exchange rate arrangements. On the latter point, the Committee reached agreement on the framework of ultimate objectives as recorded in its report of 27 June. Later the Committee supported the agreement reached by the French and American authorities, which, in turn, provided the basis for the overall agreement at Jamaica in January 1976.

13. In accordance with the arrangements determined by the Council, particularly with regard to the economic policy conditions, on the granting of medium-term financial assistance of 1 159·2 million units of account to Italy in December 1974, the Committee kept under review the Italian economic and financial situation. For this purpose, a special working party was set up under the chairmanship of Mr de la Genière. Acting on a recommendation from the Commission and on the basis of an opinion of the Monetary Committee, the Council on 18 December 1975 adapted the economic policy conditions attached to the medium-term financial assistance to Italy for the following year.

14. In accordance with Article 4 of the Council Decision of 22 March 1971 on the medium-term financial assistance mechanism, a Monetary Committee working party under the chairmanship of Mr Andersen twice examined the balance of payments situation and reserves position of the United Kingdom which, though continuing to supply short-term assistance on a bilateral basis, had not participated in the medium-term financial assistance to Italy. At its meetings of 15 April and 28 November, the Monetary Committee approved the conclusions of its working party's reports, which, on both occasions, were that the United Kingdom's non-participation in the medium-term financing continued to be admissible.

15. In connection with possible borrowing by Italy and Ireland under the Community loan scheme, the Monetary Committee began examinations of the economic situation of both these countries.

16. The Committee gave special attention to its regular examinations of monetary and financial developments in Member States with particular emphasis on the monetary policy pursued, as well as on the problems of financing the budget deficits of the Member States.

17. The Committee also examined various other matters, including proposals for Community action, such as strengthening the role of the European monetary cooperation fund, and the issue of loans by Euratom for financing nuclear power stations, as well as arrangements for the preparation of Council sessions on economic and financial questions and proposals to change the conversion rates for national currencies into units of account for the purposes of the common agricultural policy.

WORKING PARTIES OF THE MONETARY COMMITTEE

18. The Working Party on Securities Markets continued to examine developments in the capital markets of the Member States and in the international capital markets and discussed capital market policies. It examined various aspects of the effect of inflation on financial assets and the possibilities of indexation. In particular it completed its report begun in 1974 on 'Methods of protecting the holder of bonds against inflation and their effects on intra-Community capital movements' (Annex III). The working party also continued its work on the regulation of issue conditions on the bond markets of the Member States. This is a continual process of up-dating and correction and is intended to supplement its 1970 report on 'Policy on the bond markets of the countries of the EEC'.

19. Following the request from the Council at its meeting of 16 September 1974 for the Monetary Committee and the Committee of Governors of the Central Banks to begin work as soon as possible on coordinated action on the euromarkets (see the sixteenth annual report), the Committees decided to entrust this task to the Working Party on Short-Term Capital Movements, which for this purpose was to become a joint working party of the Monetary Committee and the Committee of Governors. At its meeting of 12 February, the Monetary Committee accordingly amended the terms of reference of this working party. The working party began work on the Eurocurrency market and the regulation of international financial flows.

20. The Working Party on Harmonization of Monetary Policy Instruments set up jointly with the Committee of Governors in 1974 met several times during the year, in execution of its terms of reference. The working party intends to submit an interim report in early 1976.

LIST OF MEMBERS AND ALTERNATES OF THE MONETARY COMMITTEE

Chairman

Dr C. J. Oort	Thesaurier-generaal bij het Ministerie van Financiën (The Hague)

Vice-Chairman

Dr O. Emminger	Vizepräsident der Deutschen Bundesbank (Frankfurt-am-Main)
Mr C. de Strycker (until 24 March 1975)	Vice-gouverneur de la Banque nationale de Belgique (Brussels)

Members

Mr S. Andersen	Nationalbankdirektør (Copenhagen)
Mr M. J. Balfour	Bank of England (London)
Mr F. Boyer de la Giroday	Director in the Directorate-General for Economic and Financial Affairs — Commission of the European Communities (Brussels)
Mr B. J. Breen	Central Bank of Ireland (Dublin)
Mr R. de la Genière	Sous-gouverneur de la Banque de France (Paris)
Mr M. D'Haeze (until 23 May 1975)	Directeur général de l'administration de la trésorerie et de la dette publique — Ministère des finances (Brussels)
Mr A. Dondelinger (since 1 January 1975)	Commissaire au contrôle des banques (Luxembourg)
Mr C. W. Fogarty (until 31 December 1975)	H.M. Treasury (London)
Mr J.-Y. Haberer	Chef du service des affaires internationales à la direction du trésor — Ministère de l'économie et des finances (Paris)
Mr K. Hansen	Departementschef — Det Økonomiske Sekretariat (Copenhagen)
Mr G. Janson (since 23 May 1975)	Directeur de la Banque nationale de Belgique (Brussels)
Mr R. Kirsch (from 1 January 1975)	Conseiller de gouvernement — Ministère des finances (Luxembourg)
Prof. G. Magnifico (since 2 September 1975)	Banca d'Italia (Rome)
Prof. G. Miconi (until 2 September 1975)	Direttore generale del tesoro — Ministero del tesoro (Rome)
Dott. U. Mosca	Director-General for Economic and Financial Affairs — Commission of the European Communities (Brussels)
Mr T. O'Cofaigh	Department of Finance (Dublin)
Dott. R. Ossola (until 2 September 1975)	Vicedirettore generale della Banca d'Italia (Rome)
Dott. S. Palumbo (since 2 September 1975)	Dirigente generale al Ministero del Tesoro (Rome)
Drs. A. Szasz	Directeur van de Nederlandsche Bank NV (Amsterdam)
Mr J. van Ypersele de Strihou (since 23 May 1975)	Conseiller du ministre des finances (Brussels)
Dr H. H. Weber	Ministerialdirektor — Bundesministerium der Finanzen (Bonn)

Chairman of the alternates of the Monetary Committee

Mr J. G. Littler	H.M. Treasury (London)

Alternates

Dott. V. Barattieri di san Pietro (since 2 September 1975)	Banca d'Italia (Rome)
Mr J.-M. Bloch-Lainé	Sous-directeur à la direction du trésor — Ministère de l'économie et des finances (Paris)
Drs. D. H. Boot	Onderdirecteur van de Nederlandsche Bank NV (Amsterdam)
Mr C. F. Cavanagh (since 4 October 1975)	Department of Finance (Dublin)
Mr H. Dalgaard	Kontorchef — Danmarks Nationalbank (Copenhagen)
Dr W. Flandorffer	Ministerialrat — Bundesministerium für Wirtschaft (Bonn)
Mr F. L. Hall	Bank of England (London)
Mr P. Jaans (since 1 January 1975)	Secrétaire général au commissariat au contrôle des banques (Luxembourg)
Mr G. Jennemann	Bankdirektor — Deutsche Bundesbank (Frankfurt-am-Main)
Mr G. Lefort	Directeur général des services étrangers de la Banque de France (Paris)
Mr D. Lynch (until 3 October 1975)	Department of Finance (Dublin)
Mr D. McCormack	Central Bank of Ireland (Dublin)
Prof. G. Magnifico (until 2 September 1975)	Banca d'Italia (Rome)
Mr J. Mertens de Wilmars	Conseiller économiques de la Banque nationale de Belgique (Brussels)
Mr L. Meulemans (since 23 May 1975)	Inspecteur général à l'administration de la trésorerie (Brussels)
Dr B. Molitor (until 1 April 1975)	Director in the Directorate-General for Economic and Financial Affairs — Commission of the European Communities (Brussels)
Mr J. E. Nash	Director in the Directorate-General for Economic and Financial Affairs — Commission of the European Communities (Brussels)
Dott. S. Palumbo (until 2 September 1975)	Dirigente generale al Ministero del Tesoro (Rome)
Mr M. Schmit	Inspecteur des finances (Luxembourg)
Mr N. Ussing	Kommitteret — Det Økonomiske Sekretariat (Copenhagen)
Drs. R. Van Boven	Ministerie van Financiën (The Hague)
Mr J. van Ypersele de Strihou (until 23 May 1975)	Conseiller du ministre des finances (Brussels)
Dr M. Wegner (since 1 April 1975)	Director in the Directorate-General for Economic and Financial Affairs — Commission of the European Communities (Brussels)
Dott. A Zodda (since 2 September 1975)	Ministero del Tesoro (Rome)

Secretariat

Mr G. Morelli

Mr G. Lermen

Mr A. Chapman

ANNEX I

REPORT OF THE MONETARY COMMITTEE TO THE COUNCIL AND THE COMMISSION ON THE UNIT OF ACCOUNT

1. The Committee examined the problem of the definition of a new unit of account in the light of the report submitted by the alternates (text annexed) and of a simulation exercise submitted by the Commission.

2. Recent monetary events which have led to generalized floating of currencies are responsible for difficulties in the use of the unit of account in the EEC, based as they were on the concept of par values and defined by a weight of gold. The Committee recognized the need for the definition of a new unit of account better suited to the present circumstances and capable of being applied progressively in different sectors with the necessary adaptations in respect of conversion rules. In the case of the EMCF, however, where transactions are only between countries whose currencies maintain fixed relationships between themselves, the existing parity grid unit is the most satisfactory.

3. Apart from this the Committee felt that a unit of account based on a 'standard' basket of European currencies would be the most appropriate for Community purposes in general.

4. The Committee, having closely examined the arguments developed in the report of the alternates concerning the weights of component currencies in the basket, noted that even appreciable differences in the weights attributed to each currency would only make for minor differences in the behaviour of the unit of account as a whole. The Committee examined in detail the range of criteria which should be taken into account for the definition of an EEC basket; it feels that it has thus prepared the ground for the decisions to be taken.

5. The Committee felt that the new unit of account as defined under 3 above could be immediately adopted for use by the EDF. It suggested that this might provide a basis on which the authorities of the EIB could reach an interim decision on arrangements for conversions of currencies to be used in its accounts. It considered that further studies would be necessary before the unit could be adopted, with the necessary adaptations in respect of conversion rules, in other sectors of Community activity.

6. It took note of the intention of the Commission to submit proposals to the Council in this connection.

Appendix

Report of monetary committee alternates on European units of account

1. The Committee has studied, in collaboration with appropriate experts whose assistance is gratefully acknowledged, some of the practical problems in applying different types of units of account to a range of Community activities. The Committee has not had time to study the unit of account problems in all Community sectors, but has chosen for examination four important sectors involving a wide range of different operations.

2. This report:

— reviews the possible choices of units of account which have been considered;

— examines the appropriateness of different units of account to each of the activities which have been studied;

— sets out a number of general considerations; and

— indicates the points for political decision on the basis of technically acceptable ranges of choices.

Possible units of account

3. The existing Community units of account which are based on fixed par values and stable exchange rate relationships were all established in the context of the maintenance of par values of currencies in relation to a central *numéraire* of gold or gold-based dollars in the market. The fact that this context no longer exists has not only made the basis of the Community units of account out-of-date but has in many cases also introduced difficulties in their day-to-day operation or widespread dissatisfaction with the results. Provision was made in the case of all units to take account of changes

in par values but the present situation where par values formally remain unchanged but no longer correspond with market rates was not foreseen. *Ad hoc* solutions have therefore been necessary in many cases.

4. In current circumstances it is still possible within the Community to retain the concept of a fixed value relationship in the unit of account, but only among the 'snake' group of currencies which maintain fixed relationships between themselves. The unit of account which embodies this concept is the *parity grid* unit. The main feature of this unit as it is currently used in the European Monetary Cooperation Fund for intervention and settlement arrangements is that all 'snake' currencies have a stable value in it, subject to minor fluctuations within defined margins and to any deliberate central rate changes; in order to achieve a parallel realistic relationship between this unit and other currencies, these would have to be converted by reference to their fluctuating market relationship with the average of 'snake' currencies, as is done in the case of the present ECSC unit.

5. The alternative to the 'parity grid' approach is some composite unit based on a basket of currencies and reflecting the combined market values from moment to moment of all the constituent currencies. There is an important choice for the Community between a basket of world currencies and a basket of EEC currencies.

6. The feature of a world-wide basket of currencies is that it would be a measure of some average of values of all world currencies. The *SDR basket* adopted by the International Monetary Fund with effect from 1 July 1974 is the internationally accepted version of this concept and the only one worth consideration. The US dollar has a weight of nearly one-third in the SDR basket and those EEC currencies included in it have a weight of nearly one-half.

7. An *EEC basket* would represent similarly the concept of some average of values of all EEC currencies. The total number of EEC currencies is a manageable number for inclusion in a basket, and it seems desirable that all should be included. Since some have floating relationships with each other, the principles of construction and operation of the basket would have to be the same as those of the SDR: a standard basket in which the amount of each component currency would be maintained unchanged. A major problem is the choice of weightings of the nine currencies to achieve the desired average result, and this is discussed later.

8. The choices discussed below therefore are:

— the parity grid unit;

— the SDR;

— one or more versions of an EEC basket.

Conversion arrangements

9. It is important to recognize that in certain sectors some of the most serious problems in operating units of account at the present time arise over rates of conversion into national currencies which do not automatically follow, and have in practice diverged substantially from market rates. The definition of any new unit of account will not automatically resolve these problems, but in the interest of moving to more realistic conversion rates, it would be desirable to select a definition which would be well adapted to this process. Even so, special arrangements might be needed in some cases to maintain these conversion rates frozen for certain periods of time. Such special arrangements, however, need not detract from the objective of choosing a new and more appropriate definition of the unit of account.

The Main Activities Examined

10. The Committee has studied with the help of experts the implications of trying to operate the units of account discussed above in relation to four important activities of the Community: the European Monetary Cooperation Fund, the European Development Fund, the common agricultural policy, and the Community budget.

The following paragraphs highlight points of particular interest and importance.

11. The fundamental need for some unit of account for each of these activities rests generally on the technical requirement of a single denominator in each of them for accounting purposes; an additional reason in several cases is that aspects of the operations involve determination of values, claims and obligations according to a system of sharing among participating countries and the maintenance of equal shares and claims over time, when currencies move in relation to each other. Finally, the unit of account may be useful as a measure of the desired rates of increase in different sectors of activity.

12. There is only one case in the whole range of operations forming part of the four activities which have been studied in which it can be said that the choice of a particular unit of account automatically solves or eliminates technical problems, whereas any other unit of account would create such problems. This is the case of the European Monetary Cooperation Fund, where the unit currently in use — the parity grid unit — is the satisfactory one, exactly appropriate to the needs of the operations for which it is used. It is no accident that this operation is distinct from all other Community operations for which units of account are required in the important respect that it is by definition confined to dealings among 'snake' countries, i.e. those maintaining fixed exchange rate relationships between themselves. The Committee has not considered the quite different situation which would arise in the European Monetary Cooperation Fund if new arrangements (still not capable of being defined) were introduced to cover some intervention and settlement arrangements involving all

EEC currencies, not only those in the 'snake'. As far as the existing basis of operation is concerned, however, there seems to be strong technical justification for treating it as exceptional and, whatever might be decided elsewhere, confirming the use of the parity grid unit for this purpose.

13. In all the other Community operations which have been examined, there is need to cover all members of the Community, and therefore to accommodate currencies with floating value relationships. Here it is clear that the fundamental difficulties do not stem from the choice of unit of account and cannot be automatically solved by any particular choice. There is no sleight of hand by which the reconciliation of value relationships between all EEC currencies at the present time can be achieved simply through the definition of the unit of account. One unit of account may be more apt than another because the foreseeable trend of its value is more appropriately suited to maintenance of the desired value of particular operations; different units will tend to make for a larger or smaller need for adjustment to match market rate changes with particular different EEC currencies. Throughout, however, there are advantages and disadvantages to be noted and a judgment has to be made.

14. Many of the problems present themselves in very similar ways in relation to all activities which involve all EEC currencies. But before entering on general considerations, a few points which arise on particular activities are worth noting:

(a) *European Development Fund:* The choice of unit of account is a determinant of the trend of purchasing power and cost of the fund as a whole to both recipients and donors. The Committee considers that the value of 'snake' currencies is the least appropriate measure for this purpose. The world value measure of the SDR could be presented as a rational choice for an operation directly affecting many countries outside the Community, and would be familiar and readily comprehensible to them. From the viewpoint of the EEC countries it is more reasonable to guarantee the amount in an average of EEC currencies, and the fact that expenditure of the fund is entirely linked to supplies from EEC countries should make this acceptable also to the recipient countries.

(b) *Common agricultural policy (CAP):* Experts do not see any systematic relationship between prices of CAP products and any currency or group of currencies which would point to selection of a particular unit of account. Because of the effects on consumer prices and the incomes of farmers, no member country wishes to allow intervention prices and levy thresholds to follow changes in the value of its currency. To this end, rates of conversion between units of account and EEC currencies are only adjusted by deliberate decision and do not automatically follow market fluctuations or parity changes, at least in the short term. Discrepancies with market rates are made up by extra payments or deductions of monetary compensation amounts. There would be difficulty in abolishing these monetary compensation amounts, particularly on an automatic basis, due to their implications for price levels in different countries. In this connection it can be noted that:

(i) an average EEC basket would spread necessary adjustments among EEC currencies and minimize the risk of very large adustment being needed for one or two currencies. It would however also create a need for more adjustments or the application of monetary compensation amounts among all currencies in the case of changes of value of any currency. For 'stronger' currencies this would mean — because a reduction of farm prices would probably not be possible — a build-up of higher positive monetary compensation amounts, the abolition of which later on may create major difficulties;

(ii) the parity grid unit — assuming it would tend to be stronger than the average of EEC currencies — would involve for weaker currencies more and larger adjustments or negative monetary compensation amounts, additional to the general farm price increases to bring conversion rates into line with market rates; the larger, perhaps inflationary increases demanded of countries with weaker currencies in such a system would be a disadvantage;

(iii) the SDR basket involves a risk of the unit of account diverging significantly from all EEC currencies, which would be unwelcome.

(c) *Community budget:* here, as elsewhere, there is considerable advantage of convenience to any EEC country to maintain a fixed relationship between its own currency and the accounting unit, because of the automatic matching of provisions in its own currency in its domestic budget and payments and receipts denominated in units of account. This advantage might however mean — as is the case today — that this fixed relationship between currencies becomes completely unrealistic from the point of view of market relations. It seems nevertheless appropriate that the definition of the unit of account should in general facilitate a realistic relationship between currencies. Apart from this consideration the Committee could find no operational reason for preferring or rejecting any particular choice of unit, although it was generally felt that the SDR, inevitably introducing non-Community currencies into an essentially domestic Community operation, would be inappropriate. Two things are in any case evident: first, the problem of conversion — whether and with what degree of up-to-date accuracy and frequency of change market rate conversion should be used — has much more importance in practical effect than the choice of unit of account; secondly, the extent to which transactions through the budget are at values determined in units of account is expected to diminish, as the present member-share contributions give way to reliance on 'own resources' determined in domestic currencies, without a corresponding change in the pattern of valuation of expenditures.

15. Briefly summarizing the main implications of this examination of particular activities, therefore, we have the following pointers to choices of units of account:

(a) the European Monetary Cooperation Fund is a special case, in which there are particularly strong technical reasons for choosing the parity grid unit, and rejecting alternatives;

(b) there are no similarly strong technical arguments in relation to other activities;

(c) the parity grid unit is judged the least appropriate for the European Development Fund;

(d) the SDR is judged least appropriate for the Community budget and for the CAP.

16. The Committee has not discussed in detail the technical arrangements which may be necessary in the transition from the present system to a new unit of account in every sector. It will be particularly necessary to watch, in such future work, that technical arrangements are devised for the transition to a new unit of account, in such a way as not to give rise to serious economic and political problems for some member countries, for example in the agricultural sector.

General considerations

17. There are several considerations which apply, with varying importance, to all or most of the uses of units of account apart from the special case of the European Monetary Cooperation Fund.

18. The first is the relative trend of value of different units of account.

The Commission simulation exercise (text available if required) reveals several points of interest in the relative values of the different units:

(a) although the values diverge and converge at various points in time, the overall divergence is perhaps less than the background of very wide fluctuations in relative values of individual currencies would have suggested. This is because all the units represent in some sense average or middle positions, rather than extremes;

(b) there is nevertheless some systematic divergence, with the SDR weakening and the parity grid unit strengthening throughout, with the EEC basket generally falling between these two;

(c) the recent weakness of the SDR is a direct reflection of its large US dollar component. The experience of March 1973 to December 1974 cannot, of course, be assumed for the future. A future relative appreciation of the value of the US dollar would reverse the recent pattern;

(d) the relative strength which has in practice generally been experienced by the parity grid, at least in comparison with baskets of all EEC currencies.

19. A second aspect of the question of relative value is the relationship between each possible unit and each individual EEC currency. The main point at issue here is the convenience to any one EEC country of a relatively stable relationship between its currency and the unit of account. Where relationships between currencies are fluctuating, it is plainly impossible for all to enjoy a stable relationship with a common unit. In this respect, the parity grid unit confers great convenience on countries with fixed exchange rate relationships. Inevitably, however, this places the whole burden of adjustments which may be necessary on other currencies in the system, and the currencies which diverge most from the 'snake' group may have to undertake substantial adjustments. By comparison a basket which averages EEC currency values will call for adjustments in respect of all constituent currencies (inevitably a movement by any one currency will affect the value of the unit and hence its relationship with all other currencies), but the extremes of adjustment will tend to be moderated: the burden will be in some sense shared more widely and be less marked at the extremes.

20. The third general consideration is that of conversion arrangements. As already indicated, conversion problems do not arise on the parity grid unit in respect of snake currencies, except at any point of deliberate central rate change (it is assumed that the relatively minor fluctuations within margins in the EEC currency arrangements are so small that they could reasonably be ignored). In all other cases, problems arise over the extent to which arrangements should reflect day-to-day market rate changes. As indicated above, the 'averaging' effect of EEC baskets may moderate the extent of changes needed at the maximum for any one currency, but there is otherwise no particular technical advantage or disadvantage from this point of view in the choice of the unit of account. The extent of recourse to accurate market conversion will be a matter for decision in relation to the needs and conditions of each particular activity (e.g. the special considerations relating to the CAP, possibly the desirability of operating within an annual framework, or some other defined period, in relation to the Community budget etc.).

21. A fourth general consideration is the frequency of adjustment of units of account. In the case of the parity grid unit, there may be no need for adjustment at any time (but see paragraph 22). Any adjustment of the SDR basket will be a matter for decision in the International Monetary Fund, outside the Community framework. It is a matter for consideration — possibly in the light of future developments — whether any EEC basket would need adjustment from time to time or not.

22. A fifth consideration, linked with the foregoing comments, is the durability of different units of account. There can be no question about the durability of any EEC basket, subject to the possible need for adjustment of its construction which would be a matter for Community decision. Two reservations must be noted, however, in relation to the other two possible units:

(a) *Parity grid unit:* As was indicated at the outset, this unit depends upon the existence of a set of currencies within the Community maintaining fixed exchange rate relationships with each other. The group is unfortunately less representative than all would desire. Any further diminution in its size would not only diminish the importance of any arguments in favour of its continued use, but might reach a point at which the definition itself came under suspicion.

(b) *SDR:* When instituting the new definition of the SDR, the International Monetary Fund decided to review it in mid-1976. It can reasonably be assumed that an international decision on this matter will be designed to maintain the usability of the new SDR, but the fact that the decision will necessarily be taken outside the Community framework may give grounds for caution.

23. The final general consideration is political, rather than technical. Alongside their function on the technical level as common denominators for accounting and in some cases for valuation purposes, European units of account have some presentational importance as an indicator of the Community nature of activities. An extension of the same thought suggests that the chosen units should represent the Community as far as technical considerations permit. The parity grid unit is certainly the concept of definition which corresponds most to the long-term objective of stable exchange rate relationships between all EEC countries. In present conditions, however, technical considerations tend to point: first, in the direction of an EEC basket; secondly, in favour of the choice of a single EEC basket, rather than any variety of baskets with different weightings. The last point has particular force in the absence of any very great divergence in the performance of different EEC baskets (the two tested in the Commission simulation exercise were, within the range of any versions with reasonable justification, quite widely different from each other), and in the absence of specific operational reasons for choosing particular weightings in relation to any specific operation. It is also worth noting that, if an EEC basket were adopted, and fixed relationships between all EEC currencies were subsequently re-established, the EEC basket unit would at that stage itself attain a relatively stable relationship with all EEC currencies; it would then be a matter for decision whether to continue to define the unit as a basket, or to take the opportunity of redefining it on a parity grid basis.

Conclusions and recommendations

24. This is essentially a technical report, and the Committee recognizes that — particularly where the technical considerations do not point strongly to any one solution — formal recommendations would be inappropriate.

25. Nevertheless, it may assist the Council in reaching decisions to consider the following framework and sequence.

26. It is important to recognize that in certain sectors some of the most serious problems in operating units of account at the present time arise over rates of conversion into national currencies which do not automatically follow, and have in practice diverged substantially from market rates. The definition of any new unit of account will not automatically resolve these problems, but in the interest of moving to more realistic conversion rates, it would be desirable to select a definition which would be well adapted to this process. Even so special arrangements might be needed in some cases to maintain these conversion rates frozen for certain periods of time. Such special arrangements, however, need not detract from the objective of choosing a new and more appropriate definition of the unit of account.

27. *First question:* Is it essential, or desirable, that a single definition of the unit of account should be adopted throughout the Community? Setting aside presentational advantages, the Committee feels obliged to point out that there is at least one current Community activity of importance — the present intervention and settlement system of the European Monetary Cooperation Fund — where strong technical reasons exist for the choice of the existing parity grid unit; whereas the choice of that particular unit would seem to be less appropriate in other cases, and perhaps not the most attractive choice on general grounds.

28. *Second question:* Is it necessary to introduce a new unit simultaneously for all activities to which it can be applied? As far as technical considerations are concerned, there is certainly no necessity for simultaneous introduction — there are of course some inter-relationships and overlaps in the accounts of different operations, but these are not such as to make the use of the same unit imperative. Moreover, it appears that there is considerably more urgency in some cases than in others in settling a new definition.

29. *Third question:* If the immediate answer to the first two questions is negative, is it nevertheless desirable to try to establish a new unit of account which could

operate widely, even if not immediately or indeed ever applied to all Community activities? If the answer to this question is in the affirmative, it would seem from the technical point of view that the unit which would be capable of being applied with the least inconvenience over the widest range of activities would be a satisfactory EEC basket.

30. *Fourth question:* If it is thought desirable to adopt an EEC basket, what should its construction be?

31. *Fifth question:* Should any immediate decisions on units of account for particular operations be adopted? The Committee offers three suggestions:

(a) *European Monetary Cooperation Fund:* No decision is necessary, but the Council might wish to consider whether to confirm that, at least for the time being, the parity grid unit should continue to be used, without prejudice to decisions in relation to other activities.

(b) *European Development Fund:* The Committee understands that it is essential to settle a new unit of account for this fund before it commences operations in 1976, and that it is desirable for the assurance of all concerned to settle the matter as early as possible.

(c) *European Investment Bank:* There is particular urgency for the bank to adopt an interim measure that will enable it to apply realistic exchange rates in the presentation of its annual accounts for 1974. This need not prejudice subsequent decisions. If a decision on the European Development Fund was taken, however, this might assist the authorities of the EIB in deciding on a satisfactory interim measure.

(d) In relation to all other activities, the services of the Commission should be invited, in the light of convenience of timing and any special considerations of urgency, to continue its studies and make proposals as appropriate in conformity with the general direction of the Council decision in principle in reply to the third question above.

ANNEX II

REPORT TO THE COUNCIL AND THE COMMISSION ON THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

1. In accordance with the request made by the Council at its meeting of 16 June 1975, the Monetary Committee has reviewed the outcome of the Paris meeting of the IMF Interim Committee on 10 and 11 June 1975 and the prospects for future progress.

2. The Committee considers that agreement should be sought over the whole range of problems discussed at the Paris meeting of the Interim Committee and recorded in the press communiqué, as a package including the review of quotas. The following sections of this report consider the elements of a possible agreement, in a constructive spirit, and identify the outstanding points of contention and possible Community positions on them.

IMF gold

3. The Committee recommends endorsement of the proposals, which received wide acceptance in Paris, under which the stock of approximately 150 million ounces of gold held by the fund should be dealt with broadly as follows:

— two-thirds (100 million ounces) to be left with the fund, its future disposal would be decided by an 85 % majority of the executive board/governors; the articles of the fund should include enabling powers to permit a wide range of decisions, within the framework of the general purposes of the IMF and not excluding either further restitution or further sales;

— one-sixth (25 million ounces) to be refunded to existing members in proportion to quotas on (1 July 1975); recipients would be required to reimburse the IMF, in their own currencies, which they would not be obliged to repurchase, to an amount corresponding to the official SDR value of the refunded gold [1]; no other conditions would be attached by the fund;

— one-sixth (25 million ounces) to be sold by the fund, in a manner that could maximize the yield, either in the market, or to members at prices that take into account the current situation in gold markets; the equivalent of the official SDR value of gold sold would be retained in the IMF general account, and any surplus would be used in accordance with future decisions on expenditure in the interests of developing countries, particularly those with low income.

Although the proportions specified above are acceptable to all members of the Committee, there could be some room for negotiation; but the relative percentage under the last two categories should remain equal.

[1] The problem of maintenance of value in respect of currencies paid to the fund in exchange for gold was recognized by the Committee. It was felt however, that this problem would most appropriately be studied by the executive directors.

Gold transactions by monetary authorities

4. All Community countries are prepared to enter into arrangements on gold transactions by monetary authorities outside the articles of the fund provided such arrangements are faithful to the Zeist consensus and do not include any limitation on transactions by individual countries in addition to those indicated in Annex I, which sets out the text proposed by the Committee.

5. As agreed by the Interim Committee, the arrangements would be outside the articles but there would be scope for reference in IMF articles in two forms:

[(a) maintenance in Article VIII of obligations to report gold holdings by monetary authorities;]

(b) a clause on policy on gold generally, linked with and explained further in the following section.

Reserve currencies

6. During earlier discussions of international monetary reform, the Community adopted an agreed position in favour of arrangements for settlement and convertibility which would have involved the phasing out of reserve currencies. While accepting the impossibility in the immediate future of implementing such arrangements, all members of the Committee would see advantage in incorporating in IMF articles some indication of this direction of future evolution of the international monetary system. The point could perhaps be covered by a clause on the following lines:

'Each member undertakes to collaborate with the fund and with other members to promote the establishment of the special drawing right as the principal reserve asset and the reduction of the role of gold and of reserve currencies in the international monetary system.'

Exchange rate arrangements

7. The disputed points in the Paris meeting were: the definition of the ultimate objective, and the sequence of arrangements or rules for declaration of a future par value system and initial adherence and subsequent obedience to it.

8. On the ultimate objective, the Committee would wish to see included in the articles the language agreed in the Paris communiqué, which was in turn based on language in the 'Outline of reform' agreed in Nairobi in 1973, namely:

'The ultimate objective is a system based on stable but adjustable par values and the floating of currencies in particular situations, subject to appropriate rules and surveillance of the fund.'

9. Annex II contains a series of drafts on the main issues of the establishment of a future par value system and adherence to it. There is no dispute over the formula for establishing the new system, on a decision which would require only a [simple] majority. It is on the two remaining points that difficulty arises:

— the degree of obligation on an individual member to adhere to the new system by declaring par values for its own currency;

— the degree of constraint to be applied to a member which has adopted a par value and wishes subsequently to allow its currency to float.

The Annex offers three alternatives under each heading, ranging from free choice of the member to full authority of the fund. A great majority of members could agree to alternative 2 under both headings, either as a first choice or as an attempt to find a common position.

Revision of quotas

10. The Committee has not considered quota revision possibilities in detail. It considers, however, that the Community should approach US authorities in order to give them assurances that an adequate procedure could be arranged so that their new voting power resulting from quota revision would not come into effect before approval of the amended articles.

Appendix I

Proposed undertaking with respect to trading in gold

Participants to the undertaking agree that monetary authorities are free to engage in transactions in gold subject to the understanding outlined below:

(a) transactions in gold will not be undertaken with the objective of *de facto* establishing a fixed price of gold;

(b) no purchase of gold will be made when the effect would be to increase the combined volume of gold holdings of the member governments plus the IMF above the level of 1 May 1975;

(c) these undertakings will be reviewed within two years or at any time if it appears that, contrary to the intention expressed in (a) above, transactions in gold are in fact leading to the establishment of a fixed gold price.

Some members consider that the effective date of the agreement cannot be left open, and neither do they accept that the agreement be subject to continual review. They accordingly propose the following alternative version of (c):

'These undertakings will run for two years following the entry into force of the amended articles. During this period they may be subject to concertation if, contrary to the intention expressed in (a) above, transactions in gold are in fact leading to the establishment of a fixed gold price.'

Appendix II

(a) Establishment of system

The fund shall notify members, as soon as conditions permit, that par values may be re-established for the purposes of this agreement in terms of the special drawing right, or such other common denominator as is prescribed by the fund. The common denominator shall not be gold or a currency.

(b) Adherence of a member to the system

Alternative 1

A member may propose a par value at any time after the notice is given under (a) above.

Alternative 2

A member shall propose a par value within a reasonable time after the notice is given under (a) above unless the member represents to the fund that the member's circumstances do not permit the establishment of a par value. The fund shall not challenge such representation. The member shall, however, keep in regular consultation with the fund and conduct its exchange rate policy in accordance with such guidelines for floating as the fund may establish.

Alternative 3

A member shall propose a par value within a reasonable time after the notice given under (a) above unless the member represents to the fund and the fund agrees that the member's circumstances do not justify the establishment of a par value.

(c) Subsequent temporary floating

Alternative 1

The par value of a member's currency established under this agreement shall cease to exist for the purposes of this agreement if the member informs the fund that it has terminated the par value.

Alternative 2

The par value of a member's currency established under this agreement shall cease to exist for the purposes of this agreement if the member represents to the fund that its circumstances no longer permit it to maintain a par value. The fund shall not challenge such representation. A member which has thus terminated its par value shall immediately consult with the fund and shall conduct its exchange rate policy in accordance with such guidelines for floating as the fund may establish.

Alternative 3

The par value of a member's currency established under this agreement shall cease to exist for the purposes of this agreement if the member informs the fund that it intends to terminate the par value and the fund authorizes termination subject to such conditions as it may deem appropriate.

Certain members consider that the Committee could usefully make an inventory of a range of possible technical variants to the alternatives 2 and 3 above concerning both adherence to the system and subsequent temporary floating. In all cases, the final decision, which in the last analysis belongs to the member country, can only be taken after having previously exhausted the following procedures which are listed in ascending order of moral constraint:

1. the member must justify its request, and authorization will be granted on the overwhelming benefit of the doubt;

2. the member must justify its request, and authorization will be accompanied by specific guidelines defined by the fund on an *ad hoc* basis;

3. the member must justify its request. Before granting its authorization, the fund may ask the member to reconsider its position (within a certain time period); the member may, however, confirm its position;

4. the member must justify its request. Authorization will be granted by the fund on a temporary basis and at the end of the agreed period, the member shall renew its request;

5. the member must justify its request. Authorization of the fund will be granted but on a temporary basis, and may be revoked at any time;

6. the member must justify its request. Authorization of the fund will be granted on a majority of [85] [80] [70] [50 %].

Other members have suggested an intermediate position between alternatives 1 and 2 under (b) above, as follows:

A member may propose a par value at any time after the notice is given under (a) above. If it does not feel to be in a position to do so, it shall keep in regular consultation with the fund and shall conduct its exchange rate policy in accordance with such guidelines for floating as the fund may establish.

ANNEX III

METHODS OF PROTECTING THE HOLDER OF BONDS AGAINST INFLATION AND THEIR EFFECTS ON INTRA-COMMUNITY CAPITAL MOVEMENTS IF THEY WERE ADOPTED

The high rate of inflation prevalent in most Member States has led the members of the Working Party on Securities Markets to look into the question of protecting the holder of fixed-interest securities against losses caused by the fall in the value of money.

The experts concentrated on two aspects in particular:

— the methods which might be used in this connection,

— the effects on intra-Community capital movements if they were adopted by some member countries, and the related problem of the adoption of concerted policies on the subject by member countries.

I. **General**

1. The real yield on bonds falls when the currency in which they are denominated depreciates, dropping to zero or even becoming negative when the rate of inflation matches or exceeds the coupon rate of the securities. Further, the capital loss may be compounded by a fall in the stock market price of securities brought about by the rise in interest rates which usually occurs in times of high inflation.

This drop in the real value of invested savings is mainly to the advantage of the borrowers. To begin with, it would therefore be necessary, if only for considerations of equity, to adopt measures to restrict and even eliminate this transfer of wealth.

But this observation must be qualified.

Firstly, because these transfers of wealth from lender to borrower frequently cancel each other out, in the whole or in part, when only a single estate is involved. This is, for instance, true of banks, which have liabilities which depreciate at the same time as their claims, or of individual bond holders who acquired real assets with borrowed funds. The latter situation occurs very frequently as ownership of real property becomes easier.

Secondly, if one wished to compensate the holders of bonds retroactively, the date to be taken into consideration would need to reflect the date and terms when the bonds were acquired. It would be inequitable to compensate all bondholders as if they had held the bonds from the date of issue, because the bonds might have been purchased on more favourable terms later than that date.

Compared with the situation before the First World War, there are perhaps not many estates at the present time which are made up exclusively of bonds, and still more rare are persons who depend only on fixed-interest securities for their income. Nevertheless, such situations do arise in the case of private individuals such as retired farmers who have invested the proceeds of the sale of their land in stocks, or institutions, particularly pension funds. The latter are obliged to finance expenditure which increases at about the same rate as inflation while the value of their assets is steadily shrinking, and this alone would justify the adoption of suitable provisions in their favour. Nevertheless, these various reservations show that the problem of protecting the holder of bonds is not as simple to resolve as might first appear.

2. Apart from considerations of simple equity, it should be pointed out that a continuing high level of inflation will strengthen the need for measures to help

bondholders and savers in general if the finance needed to sustain economic growth is to be made available. In many European countries, the post-war years show that this was the main reason behind the measures taken at the time to protect savings.

3. The most effective protection for holders of claims would obviously be success in combating inflation itself, and the members of the Working Party agree that keeping the value of money comparatively stable should remain a primary objective. But despite the stabilization policies adopted in the member countries, and owing probably to the variety and complexity of factors behind the progress of inflation, the currencies of the Community countries are all depreciating, although to differing degrees.

Consequently, there is unanimous agreement among the experts that a study should be made of ways and means of giving holders of fixed-interest securities minimum protection against the decline in the real value of their investments.

4. Finally, it is for consideration whether arrangements to protect the interests of savers should cover the past as well as the future, and this raises the problem of the compensation to be paid to bond holders for the losses they have suffered.

II. The various methods of protecting the bondholders

The various methods of ensuring that the real value of the bondholder's capital and of his income from this capital remains comparatively stable can be broken down into three groups:

1. techniques for bringing issues more closely into line with market conditions;

2. increasing, in one form or another, the nominal yield of loaned funds, so as to ensure that the real yield on the capital remains positive;

3. index-linking.

The members of the working party mainly concentrated on the first two points, but index-linking was also discussed at length. However, the general feeling was that the introduction of index-linking raised a general problem which involved much more than the protection of the holder of fixed-interest securities.

In addition, the inconclusive results of past or current index-linking schemes have led the majority of the experts to adopt a very reserved, not to say negative attitude to this matter.

1. *Techniques for bringing issues more closely into line with market fluctuations*

To begin with, issues could be brought closely into line with market conditions if operators were given greater freedom in setting the conditions and terms of new issues. This would help to recreate on national markets conditions similar to those prevailing on the international capital market, where, given the absence of any regulations, lenders and borrowers can at all times adapt to circumstances.

The techniques to be considered relate to the level of interest rates and the maturity of loans.

(a) The bondholder would no doubt be better protected by an interest rate policy designed to allow him a positive return on his capital. However, the level of interest rates on national markets depends on the economic situation in each country and particularly the intensity of inflationary pressures, but also on the action taken by the monetary authorities, which is itself determined by the general requirements of economic policy. The monetary authorities are, in any case, far from enjoying complete freedom of action in this field, their freedom being restricted by the influence of external factors once cross-frontier capital movements have been freed to a satisfactory degree.

These general considerations explain why protection of the holder of fixed-interest securities or of the saver generally cannot be one of the monetary authorities' major policy objectives.

Consequently, the holder of fixed-interest securities will always incur a loss once the cost of money rises above the interest rates on his securities. Of course, this risk exists even in times of comparative stability, but is considerably greater in times of inflation.

Some of the risk can be removed if the interest paid on bonds is periodically brought into line with market conditions. Variable-rate issues, which appeared first on the international capital market and then on certain national financial markets, perform this task.

Examples of such transactions carried out in the Member States include a loan which ENEL in Italy floated in June 1974; this loan carried an interest rate which, without being allowed to drop below 4 % per half-year, varies in line with the average stock market yield of a sample of bonds. Similarly, in December 1974 in France the Groupement de l'industrie Sidérurgique floated a loan carrying an interest rate that is to be established in the light of average rates on the money market during the six months prior to the coupon's date of maturity.

It should, however, be noted that this technique normally protects the holder against a loss in the nominal value of capital, but not always against a loss in its real value. Such is the case when the interest rate stays below the rate at which the value of money falls because inflation rates (and in particular, expected rates) are only one of the factors determining interest rate levels.

(b) Another technique which facilitates adjustment to changing market conditions for the operators is the reducing of maturities of loans. Its advantage for the holder is that he, during periods of sharply increasing interest rates, can switch more rapidly to better yielding investments. Also the loss in value will not be so large with short-term bonds as it is with long-term securities. A trend towards bonds with shorter maturities has in fact been observed during the past few years in certain Member States of the Community.

Thus, the average maturity of new loans issued by public authorities and enterprises in Germany has been shortened in recent years from about 15 to 20 years to 10 years and temporarily even five years in the autumn of 1974, and that of mortgage bonds from 30 to 40 years to 5 to 10 years.

In Belgium, there has been a similar trend and an increasing number of loans are issued with an intermediate maturity which gives the investor the option of repayment or of holding on to his securities until final maturity, with the interest rate then generally higher.

Similarly, the loan contracts could feature anticipated repayment clauses for the benefit of lenders, while at present such clauses are usually for the benefit of borrowers only, or provision could be made for frequent and regular options of repayment after a certain date. The GIS loan in France mentioned above carries a clause of this type from the second year.

2. *Increasing the yield of loaned funds*

(a) The techniques described above can only be applied to new issues and therefore only protect new investors. This leaves the case of the holders of old bonds whose capital is shrinking as a result of inflation and of rising interest rates. Generally, no overall solution has ever been evolved for this problem since it is virtually impossible to find the resources that would be required to compensate the holders. This is particularly true with regard to securities issued by the central government or public bodies, which are heavily indebted in some countries. The amounts which would need to be paid to bondholders would call for a very substantial increase in tax revenue, which in most countries would probably be difficult to obtain.

Additionally a basic problem should be pointed out. As far as public saver protection is concerned it could be considered desirable to amend loan conditions in favour of the saver during the term of the loan, consequently deviating from the actual prospectus conditions. Such measures, one imagines, could also be taken as a result of governmental influence. On the other hand, measures of this kind would hardly represent real help for the saver, for they might create precedents which put the character of a fixed-interest security (fixed interest, fixed maturity) into question. They could also contribute to an unfair overburdening of the issuer which he, in the form of prices or higher taxes, would have to pass on. Furthermore, in a large market there exists the possibility that, unjustly, investors who sold bonds on the secondary market before the measures took effect would not benefit from the improvement in conditions. Insecurity on the market and a corresponding loss of confidence would follow although the opposite result was sought after.

This does not exclude the possibility, in the case of the existence of flexible loan conditions, of such conditions being implemented by the issuer in order to accelerate the amortization of low interest bonds, thus avoiding the necessity of savers being bound to interest rates for too long a period of time — these interest rates, considering the tendency towards increased inflation, appearing to be too low.

In Germany, this solution has been recently adopted. There the mortgage banks and other issuing banks have committed themselves, via their associations, to the Government to using an annual amount of DM 200 million for the voluntary redemption of their low interest (5 and 5·5 %) debt. These voluntary redemptions are, in most cases, carried out by repurchase outside the Stock Exchange at the average issue price. These repurchases are limited in amount per individual bondholder who has also to prove that the securities have been his property since a certain date. This is designed to exclude, wherever possible, the benefit of these measures to securities previously acquired at the Stock Exchange at prices below the issue price. A further form of voluntary redemption is the anticipated drawing or redemption of single tranches or whole issues.

In various countries there are also isolated cases of private or public sector borrowers who have agreed to repurchase their securities below the stock market price — usually when new issues are launched, such as the recent IMI issue in Italy — or to raise the interest paid on bonds in circulation, as has happened recently in Austria.

(b) Consideration could also be given to tax arrangements under which tax is levied only on that part of the interest which exceeds the rate of the fall in the value of money, i.e. the real income. Some years ago in Germany a taxpayer tried to obtain a ruling along these lines from the Federal Finance Court, but without success at the time.

Similar proposals have been made in several countries by various economic and political groups. Under all of them, tax would be levied only on part of the nominal interest yield: either on the basic interest rate — interest received in excess being exempt — or only on that part of the interest that corresponds to the proportion of the rate in excess of the rate of inflation. None of these proposals has as yet been implemented, at least in the various Community countries.

(c) In practice, the interest paid to bondholders is increased only indirectly and in a general way through measures to encourage savings generally. Examples include the French tax exemptions for bond interest up to FF 3 000, the tax exemptions granted in some countries for funds invested in the form of securities under savings schemes, and premiums granted by the State.

3. *Index-linking*

Index-linking is a highly controversial technique. It consists of establishing a link between the nominal value of capital or interest, or both, and an index of purchasing power.

The cost-of-living index is usually taken as a reference but this is not an absolute rule and it is equally possible to use the wholesale price index (Brazil), the index of a foreign currency's rate of exchange (the US $ in Israel) or an index reflecting the activity of the borrower (turnover for example).

A large majority of the members of the working party agreed that it was hardly possible to isolate the problem of indexing fixed-interest securities from the more general problem of indexing claims in the economy as a whole (1).

In the present economic setting, it would be difficult to introduce index-linking on to the financial market without extending it to other forms of saving. However, general index-linking of savings would in the end be likely to sustain, if not exacerbate, inflationary pressures. Merely because of transfers between accounts, the financial institutions and the banks would be obliged to index virtually all their commitments whilst being practically unable to reassess their old claims.

It would no doubt be possible to restrict index-linking to financial assets tied up for a given period of time, such as fixed-term deposits and deposits at notice, or blocked savings accounts. However, were such a distinction to be made, the financial institutions and the banks, particularly those in countries where credit institutions are highly specialized, would find themselves in very different competitive situations, depending on the proportion of indexed items in their resources. Finally, choosing a reference index for financial assets is, in itself, quite a delicate matter.

Apart from these general considerations, another decisive reason that in the view of a majority of the experts militates against adopting index-linking as a measure to protect the holder of fixed-interest securities is that the experience gained in the past has not been very convincing. The Finnish authorities had had to acknowledge failure in this field. The Brazilian model, which is frequently cited as an example, operates against an economic and political background that would be difficult to imagine in Europe.

In the Community, France is the only country where there were any significant issues of index-linked bonds by the public and the private sector (during the 1950s). However, careful studies have shown, at least where securities issued by the private sector are concerned, that holders of index-linked securities had generally not been any better protected than if they had bought ordinary bonds.

Index-linking to general purchasing power indices and to indices of certain products or raw materials, representative of price levels (for example gold), has not been permitted in France since the 1958 stabilization plan, but index-linking to the price of goods and services produced by the borrower is still permitted. In other countries, notably Germany, any linking with the monetary value of goods and services, or with indices representative of the general price trend, is subject to authorization, which, however, is never granted in the financial field.

In the United Kingdom, there has not been a full indexed savings scheme of any kind so far. However, the Government are introducing in June and July 1975 two modest, experimental indexed savings schemes strictly limited to small savers and in restricted amounts. Under these schemes only capital will be indexed. A small bonus will be paid at maturity which will give the saver a low but positive real rate of return. There are no proposals for extending indexation beyond these schemes.

III. Effects on intra-community capital movements of the adoption by one or more States of measures to protect bondholders

Let us assume that one or more Community countries take measures to protect holders of fixed-interest securities. Would such decisions disrupt capital movements to the detriment of the other member countries? There is no clear-cut answer to this question.

1. In the present circumstances it should first be borne in mind that private individuals investing in fixed-interest

(1) The subject is discussed further in the study by the OECD Financial Markets Committee entitled 'Index-linking of fixed interest securities' (OECD, Paris 1973).

securities on national markets usually know little about foreign capital markets and consequently are hardly likely to place their money there. There would have to be a considerable difference in the conditions between markets for it to be otherwise. Where there are tax advantages, these are not usually any better known outside the frontiers and are frequently available to nationals only. This ignorance of markets other than the national market is further aggravated in some countries by the existence of rules prohibiting advertising for foreign issues.

Institutional investors are in a much better position to assess the advantages of investing on one market rather than another, but many of them are subject to rules on the investment of their assets which in practice considerably reduce their freedom of action.

2. Furthermore, until a high degree of economic, monetary and financial integration has been achieved within the Community, and particularly as long as currencies continue to float, investors acquiring securities issued in other Community countries will be faced with an exchange risk that is difficult to evaluate.

From this point of view, measures taken by a country to protect bondholders or savers in general could lose a great deal of their appeal in that they would reflect the weakness of that country's currency.

3. These general arguments are less cogent in the specific case of economies which, like those in the Community, have particularly close economic, monetary or financial links with each other. Clearly, therefore, any measure taken in isolation by one of the member countries to protect or help bondholders or savers in general could affect the direction or size of capital movements.

4. This will be exactly the pattern which will emerge throughout the Community as the conditions in which capital markets operate are aligned within the wider framework of the programme to achieve economic and monetary union.

IV. Conclusions

All this highlights the need for Member States to coordinate, within the Community institutions, any significant initiatives they may take to help the holder of fixed-interest securities. The arrangements to be made or developed further should be based on the techniques described in II (1) and (2) above, although even these measures can pose substantial difficulties.