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I

(Information)

COUNCIL AND COMMISSION

EIGHTEENTH 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 in the course of 1976.

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.

At its session of 30 January it elected its officers. It elected as chairman Mr K.-O. Pöhl, Secretary of State in the Federal Finance Ministry, Bonn, and, as Vice-Chairmen, Mr J.-Y. Haberer, Ministry of Finance, Paris, Mr S. Palumbo, Ministry of the Treasury, Rome and, while awaiting a Council Decision creating a third vice-chairman, provisionally elected Mr S. Andersen, joint-Governor of Danmarks Nationalbank to this post. This was confirmed at its meeting of 31 March. The terms of office of the new officers will expire on 31 December 1977. A list of members as at 31 December 1976 is annexed.

The report was adopted as at 31 December 1976.

INTRODUCTION

1. In 1976, the world economy saw marked progress, with production and trade showing growth rates similar to those obtaining before the oil crisis. This favourable development was not, however, a return to the status quo. Balance of payments disequilibria continued to reflect the aftermath of the quadrupling of oil prices. The external deficit of the non-oil producing developing countries was reduced somewhat, but there was a sharp deterioration in the external position of the industrialized countries as a whole, which moved back into deficit, and the surplus of the OPEC countries was even higher than in 1975.

2. For the Community, 1976 marked an upturn out of the recession. The growth of output, very high in the first half of the year, but more moderate later, was not however accompanied by any reduction in unemployment, because of the size of spare productive capacity and the increase in wage costs. The average rate of inflation diminished, although the differences from one country to another remained large. On the other hand, the Community's current account showed a sizeable deficit, particularly due to a worsening in the current account position of some countries which were already in deficit. In these conditions, divergences in the exchange rates of Community currencies were further accentuated. The activities of the Committee were concentrated on analysing these features and on trying to conceive of methods to cushion the effects of those problems on Community affairs. Moreover the Committee constructively worked on solutions to monetary questions in a worldwide context.

COMMUNITY ACTION AND THE ACTIVITIES OF THE COMMITTEE

3. In 1976, the Committee devoted a large part of its time to examinations of the economic situations of Member States, paying particular attention to monetary policy measures used in response to the overall economic situation. During the year all Community countries were examined at least once, and some of them much more frequently. These more frequent examinations were either undertaken in conformity with the provisions governing the use of Community credit mechanisms or as a consequence of the non-participation of Member States in the financing of intra-Community assistance.

4. One of the countries whose economy was examined by the Committee on numerous occasions was Italy. At the beginning of the year, the *ad hoc* working party chaired by Mr de la Genière prepared a report to the Committee on the economic situation in Italy and the economic policy conditions which could be attached to a Community loan to that country. The Committee adopted that report at its February meeting and submitted an opinion to the Council and the Commission (Annex I). This opinion was taken into account when the Council adopted a Decision on 15 March 1976 fixing the economic policy conditions to be observed by Italy. In November, the de la Genière group delivered a new report on the Italian economy which was approved by the Committee and submitted to the Commission in December 1976. The Italian lira came under renewed pressure in late April and May, and the Italian Government requested the Commission's authorization to take emergency measures under Article 108 of the EEC Treaty. The Monetary Committee was consulted on this occasion, and again on 2 October when the Italian authorities decided to introduce a temporary (for 15 days) tax on purchases of foreign currency and on 26 October when this tax was re-introduced although at a lower rate, along with a whole series of other measures aimed at stabilizing the Italian economy. The Committee continued to monitor the Italian situation on a permanent basis right through the year.

5. The Committee twice examined the situation in the United Kingdom, as required by that country's non-participation in the provision of medium-term financial assistance for Italy. The Committee, aided by the work of the *ad hoc* working party chaired by Mr Andersen, agreed that the United Kingdom's non-participation was justified by its balance of payments and reserves positions.

6. During autumn, the pound sterling came under severe pressure on the exchange markets, and at its meetings in September and December, the Committee held an examination of the economic situation in the United Kingdom and of the economic and monetary policy measures being taken to meet this situation. The Committee, during its deliberations, kept itself informed about financial assistance made available to the UK by other international organizations.

7. The working party chaired by Mr Andersen also met in December to prepare a report on the economic situation in Ireland and the extent to which the economic policy conditions for 1976 in connection with the Community loan to that country had been met. The Committee took note of the progress made and estimated that a basis for further progress in 1977 had been established.

8. In response to the communication 'Economic and Monetary Policy Measures' presented by the Commission to the European Council on 1 and 2 April, and to the suggestions put forward by the Netherlands President of the Council for strengthening the economic and financial cohesion of the Community, the Committee devoted a number of meetings to examining three aspects of monetary problems which presented themselves to the Community. These were the Community's exchange rate arrangements, the fixing of quantitative monetary policy objectives, and control of the Euro-currency markets. At the end of its discussions it adopted a report, which was submitted to the Council and the Commission (Annex II).

(a) Discussion on the Community's exchange rate arrangements was based on proposals made by the Netherlands members. Account was also taken of proposals made by the French members in 1975. The objective of both sets of proposals was to aim at a more coordinated and less divergent system of exchange rates in the Community. The Dutch proposals reflected a desire for a better cooperation between snake countries and those countries whose currencies float independently without recreating exchange rate rigidities. The essence of these proposals was to provide a framework for discussion within the Community on exchange rate policies and related measures by introducing a system of so-called target zones expressed in effective exchange rates. The Committee concluded that the introduction of a coherent system to cover all Member States along the lines suggested would not be feasible at present, given the wide divergences in the trends of the economies of the Member States as well as differences of opinion on various aspects of the proposed scheme. However, the Committee proposed to the Council that it continue its discussions on the proposals. Work is now proceeding to see how and

under what circumstances the proposals could be implemented and the Committee will report back to the Council in early 1977.

(b) Discussion on the fixing of quantitative monetary policy objectives was based on an initial exchange of views on the experiences of Member States in using this kind of instrument, and on a preliminary report prepared by the Working Party on Harmonization of Monetary Policy Instruments (Annex III). The Committee concluded that internally established monetary objectives which vary from one Member State to another should be discussed from time to time in the Committee, which should compare the outturn with the objectives, examine and account for any deviations and discuss possible remedies. The theoretical and technical studies of ways and means of gradually aligning intermediate objectives without encroaching upon national powers and areas of responsibility is being pursued in the working party.

(c) The examination of ways of controlling the Euro-currency markets was prepared by the Working Party on Short-term Capital Movements, which submitted a report to the Committee on 'The Euro-currency markets and the regulation of international financial flows' (Annex IV). The Committee was sceptical of the practical possibility of introducing control of the Euro-currency markets by monetary policy means, and concluded that only steps aimed at improving transparency of these markets could be undertaken at present. It supported efforts being made in various fora to improve the available information on countries' indebtedness and to resolve the problems involved in a greater degree of collaboration between national risks bureaux.

9. In March, the Council took a decision to raise a Community Loan in favour of Italy and Ireland. This loan, upon which the Committee was consulted, for a total amount of $ 1 100 million and DM 500 million, was made up of four parts. Firstly, a fixed-interest, six-year bond issue of $ 300 million, a fixed-interest seven-year bond issue of DM 500 million, a fixed-rate four-year private placement of notes of $ 500 million, and a five-year floating rate bank loan of $ 300 million. Later in the year, it was considered opportune and useful to consolidate a part of the floating-rate bank loan into a medium-term fixed interest loan. The Committee was consulted on this proposal at various stages of the negotiations, and on the filing of the registration statement with the SEC following the assignment of a triple A rating to the Community. This operation was successfully concluded in October with the floating of a $ 100 million five-year note issue on the New York market.

10. As usual, the Committee discussed international monetary problems on a number of occasions, including the finalizing of the revision of the IMF Articles of Agreement, and problems arising out of the sale of gold by the IMF, with a view to arriving at a common position of Community countries. In addition, it monitored the work of the fourth commission (finance) of the Conference on International Economic Cooperation. The Committee was also instrumental in arriving at common positions of Member States for the annual meetings of the World Bank and International Monetary Fund at Manila in October.

11. The Committee also examined various other matters, the main ones being foreign exchange market practices and regulations in Member States, proposals to change the conversion rates for national currencies into units of account for the purposes of the Common Agricultural Policy, and monetary compensatory amounts within the Common Agricultural Policy.

WORKING PARTIES OF THE MONETARY COMMITTEE

12. The Working Party on Securities Markets met four times in 1976, and continued to examine developments in the capital markets of the Member States and in the international bond markets and also discussed capital market policies. In view of the growing tendency for issuers to use variable rate techniques for raising loans in a period of monetary erosion and instability of interest rates, the working party decided to undertake a study of the different formulae used for issuing floating rate notes on the international market, and the implications of this method for the future of the national fixed-interest bond markets as a means of raising long-term capital. This work has begun and will be continued in 1977. In addition, the working party also held an exchange of information on accounting procedures and tax treatment of transactions in securities.

13. The Working Party on Harmonization of Monetary Policy Instruments, a joint group of the Committee and the Committee of Governors, met several times in 1976. In June, it submitted an interim report (Annex III) to the two Committees who examined it and, on this occasion, confirmed the direction in which the working party proposed to orient its work. As a result, the working party then commenced a new series of studies of simulation exercises with monetary policy instruments and analyses of the transmission process of monetary policy.

14. Following the revised terms of reference given to it by the Committee and the Committee of Governors in 1975, the joint Working Party on Short-term Capital Movements continued its work on the 'Euro-currency markets and the regulation of international financial flows'. It submitted a report on this matter to the two parent Committees in June (Annex IV) and this report formed the basis for the Committee's discussions and subsequent report on this topic (see paragraph 8 (c) above).

LIST OF MEMBERS AND ALTERNATES OF THE MONETARY COMMITTEE

Chairman

Mr K.-O. Pöhl	Staatssekretär — Bundesministerium der Finanzen (Bonn)

Vice-Chairmen

Mr S. Andersen	Nationalbankdirektør (Copenhagen)
Mr J.-Y. Haberer	Chef du service des affaires internationales à la direction du trésor — ministère de l'économie et des finances (Paris)
Dott. S. Palumbo	Dirigente generale al Ministero del Tesoro (Rome)

Members

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 (until 17 November 1976)	Central Bank of Ireland (Dublin)
Mr R. de la Genière	Sous-gouverneur de la Banque de France (Paris)
Mr A. Dondelinger	Commissaire au contrôle des banques (Luxembourg)
Dr O. Emminger	Vizepräsident der Deutschen Bundesbank (Frankfurt-am-Main)
Mr K. Hansen	Departementschef — Det Økonomiske Sekretariat (Copenhagen)
Mr M. Horgan (since 10 September 1976)	Department of Finance (Dublin)
Mr G. Janson	Directeur de la Banque nationale de Belgique (Brussels)
Mr N. Jordan-Moss (since 19 January 1976)	H.M. Treasury (London)
Mr R. Kirsch	Conseiller de gouvernement — Ministère des finances (Luxembourg)
Prof. G. Magnifico	Banca d'Italia (Rome)
Dott. U. Mosca	Director-General for Economic and Financial Affairs — Commission of the European Communities (Brussels)
Mr T. O'Cofaigh (until 10 September 1976)	Department of Finance (Dublin)
Mr T. O'Grady-Walshe (since 17 November 1976)	Central Bank of Ireland (Dublin)
Dr C. J. Oort	Thesaurier generaal bij het Ministerie van Financiën (The Hague)
Drs. A. Szasz	Directeur van de Nederlandsche Bank NV (Amsterdam)
Mr J. van Ypersele de Strihou	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

Mr H. Baquiast (since 24 June 1976)	Sous-directeur à la direction du trésor — ministère de l'économie et des finances (Paris)
Dott. V. Barattieri di San Pietro	Banca d'Italia (Rome)
Mr J.-M. Bloch-Lainé (until 24 June 1976)	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 (until 25 March 1976)	Department of Finance (Dublin)
Mr H. Dalgaard	Kontorchef — Danmarks Nationalbank (Copenhagen)
Dr W. Flandorffer	Ministerialrat — Bundesministerium für Wirtschaft (Bonn)
Mr R. H. Gilchrist (since 21 June 1976)	Bank of England (London)
Mr F. L. Hall (until 21 June 1976)	Bank of England (London)
Mr P. Jaans	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. McCormack (until 30 January 1976)	Central Bank of Ireland (Dublin)
Mr J. Mertens de Wilmars	Conseiller économique de la Banque nationale de Belgique (Brussels)
Mr L. Meulemans	Inspecteur général à l'administration de la trésorerie (Brussels)
Mr J. E. Nash	Director in the Directorate-General for Economic and Financial Affairs — Commission of the European Communities (Brussels)
Mr G. Reynolds (since 30 January 1976)	Central Bank of Ireland (Dublin)
Mr M. Schmit	Inspecteur des Finances (Luxembourg)
Mr B. Scully (since 25 March 1976)	Department of Finance (Dublin)
Mr N. Ussing	Kommiteret — Det Økonomiske Sekretariat (Copenhagen)
Drs. R. Van Boven	Ministerie van Financiën (The Hague)
Dr M. Wegner	Director in the Directorate-General for Economic and Financial Affairs — Commission of the European Communities (Brussels)
Dott. A. Zodda	Ministero del Tesoro (Rome)

Secretariat

Mr G. Morelli

Mr G. Lermen

Mr A. Chapman

ANNEX I

REPORT TO THE COUNCIL AND THE COMMISSION ON THE ECONOMIC SITUATION IN ITALY AND THE ECONOMIC POLICY CONDITIONS WHICH COULD BE ATTACHED TO A COMMUNITY LOAN

Introduction

1. At its meeting of 16 February 1976, the Council authorized the opening of the negotiations necessary for a Community Loan operation in favour of Italy. Council Regulation (EEC) No 397/75 concerning Community loans, lays down (Articles 3 and 8) that the Council, acting on a proposal from the Commission, which consults the Monetary Committee on the matter, shall decide the economic policy conditions to be fulfilled by the beneficiary Member State in order to redress its balance of payments.

2. In accordance with this Regulation, on 27 February 1976, the Committe held an examination of the economic situation in Italy, prepared by an *ad hoc* working party chaired by Mr de la Genière, First Deputy-Governor of the Banque de France. The Monetary Committee's conclusions on this matter are summarized in this report, which revises and up-dates that which the Monetary Committee prepared on 28 November 1975 (II/858/75) in the framework of the medium-term financial assistance granted to Italy by Council Directive 74/637/EEC.

Economic situation in Italy

3. The Italian economy was hit by the recession in 1975. The main economic indicators show, however, that the trend pattern varied during the year: the recession steadily deepened in the first three quarters but a turning point was reached in the fourth, when signs of a recovery appeared. Compared with the same periods last year, the unadjusted index of industrial production fell 11·9% in the first quarter, 12·2% in the second, 12·3% in the third and 2·5% in the fourth, a drop of 9·8% for the year as a whole. As a result, the gross domestic product in terms of volume for 1975 was some 3·4% below the 1974 level.

4. The downturn in production in 1975 led to a progressive deterioration in the employment situation and an increase in unemployment, on an annual comparison of 0·5% in the first quarter, 37·8% in the second, 17·6% in the third, and 15·6% in the fourth (source: ISTAT). It should be added that these figures do not tell the full story, since they do not take account of short-time working, whether or not 'compensated' by the Cassa Integrazione (the number of hours covered by payments from this body increased three-fold between 1974 and 1975).

5. The rate of price increases slowed down somewhat in 1975. Thus, compared with the previous quarter, wholesale prices, after rising 0·4% in the first quarter, increased only 0·1% in the second quarter but 0·9% in the third quarter and 2·4% in the fourth. The rise in consumer prices, after reaching 3·6% in the first quarter of 1975 and 2·7% in the second quarter, was 1·9% in the third quarter and 3·0% in the fourth (still compared with the previous quarters). A further increase of 1·1% was recorded in January 1976. For 1975, the rise in wholesale prices averaged 8·5% and that in consumer prices 17·0%.

Although the rate of increase (year-on-year) lost momentum, the trend in recent months remains a source of concern.

These price rises were accompanied by a sharp increase in wages and salaries. During the year, hourly wages rose by 27%, representing an increase in real wages and salaries and hence a considerable extra burden for firms whose profit margins had already considerably narrowed.

6. The balance of payments improved in 1975: the overall deficit narrowed to Lit 1 129 000 million (as against Lit 3 588 000 million in 1974) and so roughly matched the drop in official reserves (Lit 1 239 000 million). On the basis of foreign currency statistics, the deficit on the trade balance (cif-fob) was Lit 2 520 000 million (as against Lit 6 481 000 million in 1974), and the balance of service transactions and transfers showed a surplus of Lit 1 079 000 million (Lit 607 000 million in 1974), giving a deficit on current account of Lit 1 368 000 million (Lit 5 830 000 million in 1974).

The most striking feature of this development was the recovery of the trade balance, which is all the more remarkable since it took place in a period of contraction in the volume of international trade. Imports fell 5·7% in terms of value in January-December and 14% in terms of volume in January-November 1975, compared with the corresponding periods in 1974. By contrast, exports during the same periods increased 15·6% in terms of value and 1·7% in terms of volume (all on a trade statistics basis). These figures, however, indicate the precarious nature of the recovery as it is shown to be primarily due to the fall in imports following the contraction in domestic demand: it should be noted that a third of the trade deficit in 1975 was recorded in the fourth quarter, when the recovery got under way.

The economic policy pursued in 1975 and observance of the economic policy conditions laid down for the grant of medium-term financial assistance to Italy
(Articles 6 and 7 of Council Directive 74/637/EEC of 17 December 1974)

7. From the beginning of 1974, the authorities, faced with the stagnation of domestic demand, had eased the restrictive nature of monetary policy; the depth of the recession in 1975

prompted them to adopt a monetary policy aimed at assisting the recovery of domestic demand. This policy resulted in a significant fall in interest rates, a return to a 'normal' structure of rates and, at the same time, a revival on the financial market. Together with a sharp expansion in the Treasury's borrowing requirement, it caused the ceilings fixed in connection with the grant of medium-term financial assistance to be considerably exceeded.

8. The growth in total lending will probably exceed the ceiling of Lit 24 700 000 million fixed for the period from 1 April 1975 to 31 March 1976 (Article 6 of Directive 74/637/EEC mentioned above) by about Lit 5 000 000 million, as the Treasury deficit is likely to be much higher than expected. Total lending has been running ahead of this ceiling since October 1975; until then, the intermediary objectives had been observed.

The ceilings on public finances fixed in Article 6 of the Directive were, likewise, very substantially exceeded: the rate of increase in central government expenditure was of the order of 23% in 1975 instead of the 16% laid down, and the deficit on Treasury transactions exceeded the figure of Lit 8 000 000 million by about Lit 5 400 000 million. It should, however, be noted that, while in 1974 three-quarters of the Treasury deficit had been financed by recourse to the Banca d'Italia, in 1975 only about 40% of it was financed in this way.

Outlook for 1976 and the economic policy conditions to be observed by the Italian authorities

9. According to macro-economic forecasts prepared by the Italian experts, the growth of GDP in 1976 could well amount to 1 to 2% in real terms. These forecasts assume a growth of 6% in the volume of world trade, with Italian exports maintaining their relative share. The expected rate would be based on a 2 to 3% increase in private consumption and a continuation, although at a slower pace, of the decline in investment (affecting primarily plant and machinery). There will probably be a further increase in unemployment over and above the high level reached at the end of 1975. Prices, measured in terms of the GDP deflator, will probably rise by 16%. Finally, the payments deficit on current account is likely to be of the order of Lit 500 000 to Lit 1 000 000 million.

Recent economic developments in Italy have thus highlighted the fragile aspects of the economy. Budgetary measures designed to stimulate demand, coupled with an easy monetary policy, have led to a certain upturn in activity but also to a deterioration in the balance of payments and to the risk of a quickening in the pace of inflation.

10. Given these macro-economic forecasts, the Committee has, together with the Italian authorities, reviewed the economic policy conditions laid down in Council Directive 75/784/EEC of 18 December 1975 adapting the conditions laid down for the grant of medium-term financial assistance to Italy. It has been found that the recent deterioration in Italy's internal and external situation would, if no corrective measures were taken, cause the ceilings fixed in that Directive to be once again considerably exceeded in 1976. Under these circumstances, the Italian authorities could, in connection with the grant of a Community loan, contemplate taking measures to ensure compliance with these conditions, some of which could even be tightened.

11. Directive 75/784/EEC provided that the growth of total lending in 1976 would be limited to Lit 31 000 000 million. The Italian authorities could lower this ceiling to Lit 30 000 000 million, necessitating a contraction in the public sector borrowing requirement and, at the same time, a reduction in the growth rate of the private sector's financial assets, which recently triggered flights of capital out of the country. In these circumstances, the rate of growth of money supply in 1976 will be at a similar level to previous years (about 18%).

12. Directive 75/784/EEC had limited the rate of increase in central government current expenditure to 15% in 1976. The present forecasts of current expenditure suggest that the rate laid down will be exceeded. The Italian authorities have proposed that it be replaced by a cash ceiling on total expenditure; so as to curb expenditure, they could accept a ceiling of Lit 40 000 000 million, which is slightly lower than the forecast of Lit 40 600 000 million in the Monetary Committee's November report (doc. II/858/75). The rate of growth of total expenditure will thus stabilize in 1976 at about 25%, the same as in 1975.

13. The deficit on Treasury transactions had been limited to Lit 14 800 000 million in 1976. The Italian authorities feel that this ceiling could be lowered to Lit 14 300 000 million. The main emphasis would have to be on cutting or postponing certain items of expenditure, but, to achieve the objective laid down, it would also be necessary to increase the tax burden.

14. By contrast, the Italian authorities have pointed out that the ceiling of Lit 5 700 000 million fixed for central bank financing of the deficit on Treasury transactions cannot be lowered and might even be exceeded.

15. Finally, it should be noted that Italy's application for a Community loan of around $ 1 000 million comes at a time when a deficit on the current balance of up to Lit 1 000 000 million ($ 1 200 million) is forecast. In addition, there is the need to take into account debt maturities totalling $ 2 300 million (about Lit 1 800 000 million) in 1976.

16. The Committee has noted the economic policy measures taken by the Italian authorities on 25 February 1976 to reduce internal liquidity. The Committee has also noted the adjustments envisaged by the Italian authorities to the economic policy targets for 1976 fixed by the Community, to take into account recent developments in the Italian economy. While appreciating the efforts that will have to be made by the Italian authorities to respect the revised targets, the Committee em-

phasizes that the restoration of internal and external equilibrium necessarily implies a significant reduction in the rate of monetary expansion which last year exceeded nominal growth of GNP by 5·9 percentage points (nominal GNP growth 15·6%, M2 growth 21·5%). A significant reduction in the Treasury deficit would facilitate the achievement of this objective. Moreover, the target for Treasury financing by the Central Bank is excessive and should be further reduced.

Outside the strictly monetary and financial sphere, the Committee suggests that an essential element for the re-establishment of equilibrium in the Italian economy is a moderation in the rate of increase of nominal incomes. Monetary and budgetary policy cannot by itself moderate in a satisfactory manner pressures which are incompatible with growth of output in real terms.

Finally, the Committee recongized that, in accordance with their specific declarations, the Italian authorities will not take any measures of a financial or commercial nature to restrict imports or subsidize exports. In this context, the Committee recognizes that, given the Italian balance of payments prospects, the proposed Community Loan operation is opportune.

ANNEX II

REPORT TO THE COUNCIL AND TO THE COMMISSION

1. In a communication entitled 'Economic and Monetary Policy Measures' the Commission presented certain propositions to the European Council on 1 and 2 April 1976. At the Council meeting (Economic and Financial Affairs) held in July 1976, the Netherlands President put forward certain suggestions for strengthening the economic and financial cohesion of the Community. It was these two events which led the Committee to examine three aspects of the present currency problems which are very closely interlinked and of great importance to the Community, namely, the Community exchange rate arrangements, the fixing of quantitative monetary policy objectives and control of the Euro-currency markets.

In accordance with the Council's request of 26 July 1976, the Committee now submits a summary of its findings.

Community exchange rate arrangements

2. A working paper presented by the Netherlands Members served as basis for discussion of this topic. Account was also taken of proposals made by the French delegation in 1975. The Committee noted that the two sets of proposals are motivated by the same considerations. Both:

— are based on the belief that the present situation is unsatisfactory;

— reflect a desire for a better cooperation between snake countries and those whose currencies float independently without recreating rigidities to the detriment of currencies which are currently outside the snake;

— are based on the recognition of the fact that exchange rate developments of all Community currencies should be subject to some kind of Community coordination.

3. The essence of the Netherlands Members' proposals is:

(a) to provide a framework for discussion within the Community on exchange rate policies and related measures (in particular monetary policy, intervention and exchange controls) with the aim of coordinating the various policy aspects;

(b) to avert the threat of a politically undesirable division between those Member States which take part in the European snake arrangement and those which do not. Snake members have clear obligations towards each other which make coordination of policy a necessity. Member countries which do not participate in the snake arrangement do not have the same obligations in respect of exchange rate policies as snake members;

(c) to create certain flexible guidelines which could contribute to improving the coordination of economic policies. These guidelines might include:

(i) fixing of non-binding 'target zones' in terms of effective exchange rates either for the floating currencies alone or for all Community currencies. These target zones will initially serve only as a trigger for consultation on the Community level, when market rates move outside the target zone;

(ii) negative intervention and monetary policy obligations (no obligation to keep the exchange rate within the target zone, but the commitment to refrain from policy measures which would push the exchange rate out of that zone in a downward direction);

(iii) possibly, in a later stage, the obligation to direct monetary policy at preventing a depreciation below the target zone.

4. The Committee welcomed the determination of the present members of the 'snake' to maintain their participation in it and noted that this was in itself a measure of the success of economic policy coordination in these countries.

The Committee also recognized that in circumstances in which there were large differences in domestic rates of inflation both within the Community and outside, a system of floating rates had to a certain extent played a stabilizing role and had helped to avoid the adoption of undesirable trade restrictions. However, it expressed concern about excessive fluctuations in exchange rates and pointed to the danger that these might spread their effects to other currencies, thus increasing the general instability and even creating the risk of retaliatory protectionist measures.

5. The Committee is of the opinion that a higher degree of exchange rate stability in the Community would be desirable, but that its achievement presupposes stability of underlying economic conditions as well as close convergence in the trend of the economies of the Member States, which is directly dependent on the effective coordination of general economic policy. The coordination of monetary and credit policies is particularly important in this connection owing to their direct impact on capital flows (see the second part of this report). However, while stressing the key role of coordination, the Committee recognized that even with closely coordinated policies, the economic development in the various countries could still diverge.

6. The Committee acknowledged that the system of target zones offers flexibility as the operating rules can be made as binding as desired. Moreover, there are several alternative ways of defining the target zones and their size. The Netherlands approach would allow the present snake machinery and rules to be retained, with wider and less binding target zones being established for countries with independently floating currencies and possibly also for snake currencies taken as a group. This means the approach does not imply a weakening of discipline in the snake mechanism, and does not require the countries with independently floating currencies to accept binding obligations to intervene in the exchange markets.

7. Opinion in the Committee was divided on the question of whether target zones should be established only for independently floating currencies to the exclusion of snake currencies, taken as a group or individually.

Those in favour of target zones for the independently floating currencies only are afraid that the obligations entailed in the fixing of target zones for snake currencies might conflict with snake rules. They stress the fact that the snake is meant to serve as an instrument under which the Member States exchange rate policies *vis-à-vis* each other are governed by precise rules, but externally it is intended to constitute a joint float. By definition, this excludes the Community from maintaining the currencies of non-member countries at given levels on the exchanges.

Those opposed felt that separate treatment for snake and non-snake currencies constituted an undesirable distinction. Member States participating in the snake should pursue a policy coordinated at Community level *vis-à-vis* other Community currencies and the currencies of the rest of the world, in particular the US dollar. Only in this way could an asymmetrical pattern between the burdens and duties of both groups of countries be avoided.

It was further argued that, both because of the dollar's general importance as a vehicle and reserve currency and because of its different weight in member countries' external transactions, it will be difficult to achieve a reasonable degree of stability between snake and non-snake member currencies (and even to avoid tensions within the snake) without concerted endeavours to keep exchange rate movements between the snake and the dollar within reasonable bounds.

8. Some members suggested that there would be a case for allowing countries with independently floating currencies in certain circumstances and in consultation with countries affected to intervene in snake currencies. The Committee noted that the Committee of Governors is studying the question and it may consider the matter further when the Governors' conclusions are available.

9. Opinion was divided over the scale of lending facilities — some automatic, others less so — at present available in the Community. Some members felt that it was essential to establish adequate machinery for Community credit as without this the task of organizing exchange arrangements in the Community would be impossible. Other members argued that sufficient credit facilities already existed within the Community and through the International Monetary Fund, and that the provision of new drawing facilities might have inflationary implications. The Committee noted however, that countries with independently floating currencies, are always able to draw on the existing short- and medium-term credit facilities of the Community if they comply with their rules and conditions. It was suggested that, in order to reinforce the process of convergence of economic policies, the credit mechanisms of the Community should be made instrumental to that end. This could be achieved by partitioning the credits available to a country in tranches and imposing stricter conditions for drawings in higher tranches. Both the adequacy and the conditionality of credit will be studied further.

10. The Committee agreed that, at present, given the wide divergences in the trends of the economies of Member States, particularly inflation rates, as well as differences of opinion on various aspects of the proposed scheme, it would not be feasible to introduce a coherent system along the lines suggested. However, the Committee expressed its willingness to continue its discussion of these proposals, which are part of a more comprehensive package aiming at convergence of economic policies in the Community. They should be studied further both as proposals for Community action and in the framework of the preparation of discussions in the International Monetary Fund on this subject.

II. Fixing of quantitative monetary objectives

11. In its Communication to the European Council of 1 and 2 April 1976, the Commission emphasized the need for better coordination of economic policy for the Community. Since monetary policy has an appreciable impact on growth, the value of money and employment, the coordination of monetary policy in the Community is an essential component of the coordination of economic policies. Its aim must be the re-establishment and maintenance of stability in the countries of the Community. It is also one of the preconditions for greater stability in exchange rate relationships between the member countries (see paragraph 5). Stability is not a goal in itself, but the key condition that must be fulfilled if full employment and balanced economic growth are to be ensured.

12. The Committee agreed that coordination of economic and monetary policies with a view to stabilization is not only necessary for the maintenance of the European exchange rate system (the 'snake') but is also indispensable if European integration is to make progress.

13. When discussing the scope for coordination of monetary policy, the Committee began by considering what have so far been the intermediate objectives of monetary policy at national level, and reviewed experience gained. This discussion showed that there has been a trend in recent years towards heavier emphasis on money supply objectives. One Member State has established and published monetary targets for the past two years while two Member States have established similar targets for the first time this year. However, both the national definitions of money supply and also the degree to which quantitative targets are regarded as binding still vary substantially from country to country.

At present, the money supply is treated as a dominant intermediate monetary objective in four countries and as an ancillary intermediate objective in two other countries. In only two countries is the money supply disregarded altogether as an intermediate objective.

In some member countries global credit is the main intermediate monetary objective, though here again definitions vary from country to country. Interest rates, bank liquidity and the monetary base are also used as intermediate monetary objectives.

14. The differences in the choices made by the various governments of intermediate objectives are mainly a matter of the varying importance and weight of the following factors:

(i) relative importance enjoyed by monetary policy in the overall framework of economic and financial policy;

(ii) size of and method of financing the public-sector deficit;

(iii) structure of the national financial markets;

(iv) economic impact of, and relations with, the rest of the world;

(v) theoretical approach adopted and credit policies pursued by the relevant central bank.

15. The Committee members agree that a reduction in the differences between the intermediate objectives would be useful in itself, because these differences would have an increasingly disruptive effect the more progress is made towards economic and monetary union. They are aware of the danger that too hasty an alignment of intermediate monetary objectives might fail to take sufficient account of the structural differences between the Member States and could therefore limit the effectiveness of monetary policy.

The basis for coordinating monetary policy must, in the first instance, be the intermediate objectives tested at national level; subsequently, efforts could be made to reduce gradually the differences. It should also be remembered that any improvement in monetary policy cooperation depends essentially on the political will of those concerned.

16. At present, a majority of Member States are prepared, not only to attach more importance to management of money supply, but also to establish quantitative intermediate monetary objectives and to use them as benchmarks for their own policy; there is also a broad measure of recognition by the members of the Committee of the great importance for those involved in the economic activity of publishing monetary and/or credit guidelines. Admittedly, these objectives range from general notions about medium-term monetary trends to fairly binding quantitative objectives. It must also be remembered that the scope available to the central banks for influencing the economy is by no means unlimited and that some room must also be left for revising monetary policy objectives given the complexity of actual economic activity and the multiple and sometimes conflicting objectives of economic policy.

Those Member States whose economies are particularly dependent on external factors take a more cautious approach to the idea of fixing quantitative intermediate monetary objectives which would be binding, their main concern being their need to be able to react flexibly to exchange rate fluctuations.

17. The Committee considers that it would be appropriate to make pragmatic use of any opportunity of aligning monetary policy objectives without encroaching upon national powers and areas of responsibility.

The Committee therefore concluded that internally established national monetary objectives which vary from one Member State to another should be discussed from time to time in the Committee, which should compare the outturn with the objectives, examine and account for any deviations and discuss possible remedies. The theoretical and technical studies of ways and means of gradually aligning intermediate objectives should be pursued.

III. Control of the Euro-currency markets

18. On the basis of a report submitted by the Working Party on Short-term Capital Movements, the Monetary Committee has

studied the problems involved in controlling the Euro-markets. The BIS was represented at the Committee's discussion.

19. Improvements in arrangements for prudential supervision have been made in recent years to shield the Euro-markets from critical developments. The authorities have strengthened protective measures at both national and international level. The Euro-banks, too, have generally become more cautious in their business policy. However, there is a latent danger of disturbances occurring in view of the amount and mobility of Euro-funds and the constantly developing and changing general situation.

20. The Committee has conducted an exchange of views on the possibility of improving control over the potentially disturbing effect of the Euro-markets on monetary and exchange rate policy by joint credit policy measures (e.g. by introducing minimum reserve requirements on foreign currency assets or liabilities in all member countries of the EEC). Different views emerged on the usefulness and practicability of such controls and also on whether or not the Euro-markets are a source of liquidity creation.

21. Some members are of the opinion that the Euro-markets only act as an intermediary between national money and capital markets without creating money to any significant degree. In the view of some other members, the Euro-markets are capable of creating money autonomously, increase global credit supply and can become an additional source of inflation when uncontrolled developments occur.

22. The way in which the usefulness of joint measures is judged depends on the different views referred to in paragraph 21 above. It depends also on differences between national exchange control practices. Several members consider that capital flows through the Euro-markets are no different in their monetary and exchange rate effects from any other international capital flows and that it is possible and practicable for individual countries to isolate themselves against disturbing influences associated with international capital flows by means of suitable national controls (restrictions on capital transactions). Some of them therefore see no need for joint management of the Euro-markets by credit policy measures. Some other members whose countries apply capital restrictions, however, stress the national inability to ward off massive inflows from the Euro-markets, especially in times of monetary upheaval. They, therefore, are in favour of joint measures to curb the expansion of the Euro-markets, Finally, joint measures are of particular interest to those countries that resort to capital controls only in extreme cases. In circumstances where capital transactions are in principle free of direct controls the national market is always exposed to influences originating in the Euro-markets. This also applies under flexible exchange rates which can cushion disturbances originating in the Euro-markets, but cannot ward them off completely.

23. There are also differences of view regarding the feasibility of effective monetary controls over the Euro-markets. If joint management by means of credit policy measures is conducted in a limited region, there is a danger — which will increase with the severity of the measures adopted — of an acceleration of the tendency which already exists for Euro-market business to shift to areas where no control can be exercised and in which banking supervision is perhaps carried out with less stringency. In the opinion of some members, the effect of joint measures would thus be thwarted. These members consider that it would hardly be possible to get agreement on joint control measures over a wider area encompassing major financial centres outside the Community. Other members see little danger of business shifting its location. In their view, any shifts would be within narrow limits owing to the established structure of banking.

24. During discussions within the Monetary Commitee, a number of members pointed out that management of the supply of funds through Euro-banks in a regulated area by means of credit policy measures would need to be complemented by restrictions on the demand for capital in the Euro-markets by non-bank residents of the area (perhaps by means of a cash deposit) in order for it to be effective. This would prevent non-bank residents of the regulated area from going to banks outside the area when taking up loans. However, it was also pointed out that such a combination of measures cannot be considered a permanent solution but only a temporary one when critical monetary developments occur.

25. Given the present differences in assessing the role of the Euro-markets, progress towards a coordinated or common action would, in the view of the Committee, presuppose that a political consensus to this effect be achieved and manifest itself within the EEC Council. Some members emphasized their view that, if the Community is to become a zone of monetary stability, a more active and coordinated Euro-market policy is necessary.

26. Under these circumstances, the Committee is of the opinion that only steps aimed at improving the transparency of the Euro-markets can be undertaken at present. The Committee therefore welcomes the work recently initiated by the central banks of the member countries of the EEC and the other members of the Group of Ten and Switzerland to improve the information available on countries' indebtedness. Transparency in this area is still not complete. The reporting procedure should cover as large a number of countries as possible, including the major financial centres outside the Community.

27. In addition, the Committee notes that efforts are being made by the Commission, in its Working Party for Coordinating Banking Legislation, to resolve the problems associated with the possible establishment of a system of collaboration between national risks bureaux of Member States on individual large loans.

ANNEX III

INTERIM REPORT OF THE WORKING GROUP ON HARMONIZATION OF MONETARY POLICY INSTRUMENTS

Introduction

In the first stage of its work, the expert group has focused on intermediate objectives of monetary policy. These constitute, in its opinion, an important reference point for the coordination of monetary policy in the Community (see points 1 and 2 of the mandate) and a study of them should logically precede the examination of instruments.

Thus Chapter I of this report gives an account of the intermediate objectives chosen in each member country while Chapter II presents a comparative analysis of them and sets out the reasons for differences between the intermediate objectives which are set.

In Chapter III the group develops some preliminary ideas on the problem of the harmonization of intermediate objectives, while emphasizing that its scope should become more clearly defined as the work of the group proceeds.

I. Intermediate objectives in the different member states

1. In *Germany,* the intermediate objectives of monetary policy are the monetary aggregates, that is the money stock in its various definitions, but above all central bank money (notes in circulation plus compulsory reserves on banks' domestic liabilities, calculated at constant reserve ratios).

On the other hand, the level of interest rates is not an objective in itself and interest rate policy has only an instrumental character. The success of monetary policy is not measured by the level which interest rates reach but by the achievement of a desired monetary expansion.

For 1975 the Bundesbank announced for the first time an intermediate objective in the form of a quantified rate of growth of central bank money. For 1976 this objective has been formulated as a rate of growth of, on average, 8% over the previous year.

2. In the *Netherlands,* also, monetary policy seeks to influence monetary aggregates. The resulting levels of interest rates are accepted unless the policy is jeopardized by external constraints. The most important intermediate objective is the level of the ratio between the liquidity of the economy (M2 according to the national definition) and nominal net national product. In relating the stock of M2 to nominal income, account may be taken of the scope for changes in velocity of circulation, which in conjunction with the rate of M2 creation provides the basis for the appraisal of the monetary situation and prospects. Bank credit, or more generally domestic M2 creation, serves as an important complementary intermediate objective. While total M2 creation affects the level of demand and thereby the current account of the balance of payments, the domestic component of M2 creation not only affects the size of M2 itself, but also to an important degree determines the relative shares of domestic and external sources in M2 creation through its direct and indirect influences (recourse to foreign lending and interest rate effects) on the capital account of the balance of payments.

3. In *France,* the objective of the monetary authorities is to adapt the actual or probable future amount of money in circulation to the value of production and trade. As there is no accurate way of recording and analysing monetary flows in the economy, the central bank tends to refer to representative aggregates that are easy to obtain. Thus the most widely accepted intermediate monetary objective is the growth of the money supply (M2 is taken as the best indicator), defined in relation to the projected trend of GNP.

To fix this objective, the authorities assume a certain degree of stability in the ratio of money supply to GNP, but allowance is made for changes that may occur in the attitude of economic agents towards the holding of cash balances and liquid assets.

To attain the desired rate of growth of the money supply, the authorities seek to control all sources of money creation. By far the most important source is still credit to the economy (i. e. bank lending to companies, households and local authorities) and in periods of restrictive monetary policy specific limits are set on its expansion.

4. In *Belgium,* the intermediate objectives of the monetary authorities are global credit to the corporate and household sectors and the level of interest rates.

Since de-specialization has reached a very advanced stage among financial intermediaries and there is a high degree of substitution among the various forms of financial asset, monetary aggregates of any kind undergo distortions which considerably reduce their validity as intermediate objectives. In formulating their intermediate objectives, monetary authorities use analytical forecasts of the financial deficits and surpluses of each sector (government, companies, households and external).

5. In *Denmark,* loans extended to the private sector by financial institutions, especially banks, are the main intermediate objective. There has, however, been a tendency to favour a wider concept, namely the overall expansion of credit from either domestic or foreign sources.

After a long period of surplus, the budget has recently moved into deficit and the monetary authorities have therefore been led to pay greater attention to the growth of the money supply.

Interest rates play a more limited role as external constraints call for an adequate margin between domestic and foreign interest rates, especially in the short-term range.

6. In *Italy,* the major intermediate objectives are credit to the private and public sectors (credit granted by banks and specialized credit institutions, and global credit), monetary base (in particular, the total reserves of the banking system) and interest rates.

The money supply is regarded as less significant than it is in other countries, because there is a high degree of substitution between money and other financial assets, which is rendered greater by the fact that banks are able to pay very high interest rates on current-account deposits.

To provide a formal framework for the choice of intermediate objectives, the Italian monetary authorities make forecasts of financial accounts, on the basis of which an overall comparison can be made of the financing capacity and financing requirements of the different sectors and forecasts of financial flows consistent with these aggregates can be formulated.

7. In the *United Kingdom,* the formulation of intermediate objectives is carried out against the background of overall forecasts for the real economy and for financial flows. Those forecasts — amended to reflect any policy measures that are adopted in response to them — constitute an accepted compromise between final objectives that may be in conflict: objectives for the level of domestic economic activity, for the state of the external balance on both current and capital transactions and for price stability. The forecasts also produce projections for various monetary aggregates — M1, M3, DCE (Domestic Credit Expansion) and bank credit to the private sector — and for the pattern of interest rates, which are judged to be mutually consistent and may therefore be included in the category of intermediate objectives.

None of these intermediate objectives is 'normative' in the sense that a departure from forecast would promptly lead to policy action to restore it. The policy response to departures from forecast depends on an evaluation of many factors: the instability and uncertainty of the relationships between real and financial variables, and even between different financial variables, may allow some of the latter to depart from their projected levels without invalidating the forecast as a whole. Greater weight would normally be attached to a major aggregate, such as M3, than to one of its individual counterparts, such as bank lending to the private sector. The emphasis placed on different intermediate objectives shifts over time as the goals of overall economic management change and the role given to monetary policy in economic management varies.

8. In *Ireland,* monetary policy is based on the existence of a reasonably stable relationship between monetary aggregates and national income. The intermediate objectives are, first, the money supply and, secondly, bank credit.

The growth rate of money supply is fixed in the light of forecasts of national income in value terms. The intermediate objective for credit (credit granted by banks — including the central bank — to the private and public sectors) is calculated by subtracting the expected increase in external monetary reserves from the projected growth in the money supply.

Interest rates in Ireland cannot differ appreciably from those in the United Kingdom without provoking heavy capital movements, because of the close monetary ties between these countries.

II. Comparison of intermediate objectives within the Community

9. *Monetary aggregates* (money stock and central bank money) are treated as the key intermediate objectives in Germany, the Netherlands, France and Ireland and are also considered important in the United Kingdom and, quite recently, in Denmark. However, the definition of money stock varies considerably from country to country.

10. The supply of *bank credit* to the private sector is the key intermediate objective in Denmark. In Italy, Ireland, France, the United Kingdom and the Netherlands, the monetary authorities also make use of this concept, but rather more as a complementary intermediate objective.

In France and in Italy bank credit is adopted as an objective with the principal aim of controlling internal demand. In the Netherlands and in Denmark, account is also taken as far as possible of the way in which this objective may affect the overall balance of payments outcome.

11. *Global credit* is the key intermediate objective in Belgium and Italy and a similar notion is used in Denmark. The concept of global credit differs from one country to another according to the definition of lenders and borrowers. With regard to the former, global credit may be defined to include not only that extended by the banks and other financial intermediaries, but also finance obtained on the capital market and by borrowing abroad. As to the borrowers, there is a difference between the concept used in Denmark and Belgium of companies and households only, and that in Italy where the Treasury is also included.

	Predominant intermediate objective	Complementary intermediate objective
Money stock		
(1) M1, M2, M3	France Ireland Netherlands	United Kingdom Denmark
(2) Central bank money	Germany (FR)	
Bank liquidity		Germany (FR) Belgium
Monetary base		Italy
Credit		
(1) Bank credit	Denmark	France Ireland Netherlands United Kingdom Italy
(2) Global credit	Belgium Italy	Denmark
Interest rates	Belgium	Italy United Kingdom Denmark

12. *Interest rates* represent an important intermediate objective in Belgium, and also to a lesser degree in the United Kingdom, Italy and Denmark. The rates taken into consideration may be those ruling on the money market, those ruling on the capital market or those applied by financial intermediaries. On the other hand, rates of interest under the direct control of the central bank are regarded as instruments.

13. *Bank liquidity* constitutes a complementary intermediate objective in Germany and Belgium. The definition adopted includes not only free reserves held by the banks with the central bank, but also assets which the latter is committed to purchase together with the banks' unconditional lines of credit at the central bank.

14. *Monetary base* represents a complementary intermediate objective in Italy. It consists of notes and coin, claims on the central bank (compulsory and free reserves) and all assets which can be converted into central bank money at any time. Monetary base (excluding postal deposits) virtually corresponds to central bank money plus bank liquidity as defined in Germany.

15. The financial variables treated as intermediate objectives are closely related to each other.

— There is for example an interdependence between the level of interest rates on the one hand and the money stock and the volume of credit on the other. The monetary authorities may be led to adopt specific measures in order to diminish such interdependence; thus they may for example, when restrictive measures are required, resort to credit ceilings in order to limit the rise in interest rates.

— There is, equally, interdependence among other intermediate objectives. Manipulation of the monetary base or of bank liquidity influences market rates of interest and monetary developments. In the transmission process (the effect which instruments have on intermediate objectives and, through them, on final objectives) bank liquidity and monetary base are closer to the instruments, while money stock and credit are closer to final objectives.

— A similar comment may be made about the relationship between bank credit and the money stock. The former is related to the assets and the latter to the liabilities of the banking system. The difference between the two magnitudes may nevertheless be considerable if money creation by the Treasury (for example in the form of postal deposits) and by the external sector, or issues or purchases of bonds by the banks are important. Clearly the difference between the money stock and the volume of credit is even more substantial if the notion used is that of global credit.

16. The reasons for differences in intermediate objectives are fundamentally the following:

(a) the means of influence and control which existing institutional arrangements make available to the monetary authorities (§ 17);

(b) the characteristics of financial intermediation and in particular the nature and size of financial circuits outside the banking system (§ 18);

(c) the structure and the influence of non-financial sectors (external, public, households and companies) and, in particular, their financial surpluses or deficits (§ 19 to 21);

(d) the theoretical approach, the traditions of central banks and practical considerations, for example the availability of statistics (§ 22).

All these factors are at work in each country, but their relative importance varies. Thus it is generally a number of causes and only exceptionally a single cause which determines the attitude of the monetary authorities in the selection of intermediate objectives.

Thus, whereas some countries only make minor adjustments to their intermediate objectives over a period of time, others adopt a more eclectic approach, having a 'basket' of intermediate objectives and giving them different priorities as circumstances require. The two ends of this spectrum are represented by Germany, which has a single intermediate objective, and the United Kingdom, where the weight placed on different intermediate objectives changes over time.

17. The means of influence and control available to the monetary authorities in the various Community countries depend on a large number of factors. The comparative roles assigned to monetary and financial policy are important in this respect, as is the extent to which priority is given to a policy geared to a market economy. Monetary policy instruments will therefore focus on different aspects depending on the situation of the country concerned and will be tailored to suit a specific policy. This situation affects the choice of intermediate objectives.

18. The structure of a country's financial markets can also influence the choice of intermediate objectives. If a large part of financial intermediation takes place on the capital market or through non-banks, it is more likely that the money stock will be distorted as a result of substitution between financial assets.

The phenomenon of substitution becomes more important if there exist financial assets which economic operators regard as liquid, but which are not included in the definition of the money stock. On the other hand, it is less substantial if financial flows are relatively segmented, as is the case in France. Some countries have resolved the problem by letting liquidity fall into the background and concentrating instead on credit. In particular, the choice of global credit as a complementary objective enables the authorities not to be misled by any distortions arising from substitution between different sources of credit.

The characteristics of financial intermediation may also lead the monetary authorities to seek to maintain a certain structure of interest rates, with the aim in particular of preventing unwanted shifts of funds between intermediaries whose rates of interest respond more quickly to market forces and those whose rates are less flexible.

19. The influence of external factors on a country's choice of intermediate objectives is positively related to the importance of its international trade and the degree of openness of its financial markets. The most obvious example of external influence occurs when a country has to adjust its quantitative objectives because the resulting rates of interest provoke undesired capital movements. In such a case the 'external constraint' (which has been reduced but not eliminated by the system of floating exchange rates) may lead Member States to base their actions rather more on interest rates. The constraint depends on the size of the country, on the level of foreign exchange reserves, on whether it belongs to the 'snake' and also on whether its money serves as a reserve currency.

20. The size of the national debt and of the public sector deficit may also explain the inclusion of interest rates among intermediate objectives. For example, the desire to facilitate the placing of government bonds may lead the monetary authorities to pursue a policy of stabilizing prices on the capital market. Further, some central banks regard the public sector deficit (and to a certain extent its monetary financing) as a constraint which leads them to base their action more on bank credit (or on global credit) extended to the private sector.

21. The financial structure of the household and corporate sectors also has an influence on the choice of intermediate objectives and on the effectiveness of monetary policy. Thus, the size of the corporate sector's net financing requirement and changes in its financing capacity and its indebtedness are likewise factors influencing the choice of credit as an objective.

22. The choice of intermediate objectives can also be affected by the theoretical approach, which is often related to specific knowledge about the transmission process.

Finally, administrative and organizational factors also play a role. Examples are the ways in which statistics are collected and processed.

III. The harmonization of intermediate objectives and their role in the coordination of monetary policies

23. Harmonization of intermediate monetary objectives within the Community implies the gradual improvement of mutual knowledge, which might in turn progressively reduce existing differences. Such harmonization can only arise in so far as a closer coordination of final objectives is achieved and as progress is made towards monetary integration. At present, forced attempts at harmonization would involve the risk of reducing the effectiveness of monetary policy in some member countries. The Council resolution of December 1972, in which all the Member States were called upon to limit the growth of M2, is an example of premature harmonization; although in itself this resolution contributed to the fight against inflation, the Member States had difficulty in fulfilling it.

24. The expert group has examined two questions:

— how far differences in intermediate objectives represent an impediment to the coordination of monetary policy, both at present and in the future;

— what possibilities there are of reducing these impediments to coordination.

25. On the first question, the working party came to the view that at the present stage a reduction of differences in intermediate objectives would already be useful because it would facilitate the work of the Committees concerned with monetary coordination within the Community. However, nothing would be gained by agreeing on more closely aligned intermediate objectives if this meant that the effectiveness of monetary policy was reduced in some of the countries. As further steps are taken towards achieving economic and monetary union, differences could definitely have a disturbing effect. Possible ways of reducing them cannot, however, be looked at in isolation from other efforts towards achieving economic and monetary union. The choice of intermediate objectives depends essentially in some cases, as stated above, on the final objectives pursued. Harmonization of intermediate objectives therefore cannot be considered in isolation from harmonization of final objectives and of financial structures. Moreover, even if such an interrelationship does not exist, the choice of intermediate objectives is often a reflection of how monetary and credit policy is conducted in a given country and of how its role and its effectiveness are seen.

26. In so far as the second question is concerned, it is obviously not possible simply to 'transpose' the intermediate objectives of one country into the intermediate objectives of another. It is not a question of concepts which can replace each other, but of taking account of different situations which may diverge considerably in their development. Consequently, work towards 'harmonization' of intermediate objectives should initially be based on enabling individual countries to have a better understanding of the intermediate objectives of the other countries by getting each country to analyse its own development in terms of the intermediate objectives pursued in the other member countries as well, even where it considers these intermediate objectives would be analytically unsuitable if applied in its own country. For example, such an exercise would require country A, which applies M2 as its principal intermediate objective, to compare the trend of that aggregate during a certain period with the evolution of credit. Similarly country B, which applies credit as its objective, would observe the trend of M2. This experience, and further work by the Group, will make it possible to extend the consensus on the way monetary and credit policy works and on the advantages and disadvantages of various intermediate objectives.

27. The future work of the Group will concentrate on extending its mutual understanding of intermediate objectives. It will:

- continue the comparison of the evolution of different intermediate objectives described in § 26 which has already been started by the Group,
- start work on the transmission process of monetary policy on the lines of point 5 of the mandate.

EXPLANATION OF THE CONCEPTS USED

1. The *final objectives* of monetary policy are the same as those of general economic policy, i.e. price stability, external equilibrium, growth and full employment, to the extent that these can be materially affected by monetary policy. The importance attached to each of these objectives varies as between countries and according to circumstances.

2. *Intermediate objectives* are the financial variables affected by the instruments of monetary policy. Examples of intermediate objectives are: money supply, credit, bank liquidity and rates of interest.

3. *Indicators* are variables which make it possible to identify the direction and measure the intensity of monetary policy and which also permit the authorities to determine whether their objectives have been achieved. These variables are often intermediate objectives at the same time, but they are then fixed *ex ante,* while as indicators they are observed *ex post.* Nevertheless, intermediate objectives and indicators do not necessarily coincide; for example, when an intermediate objective for bank credit is not attained because demand has been too low, interest rates and bank liquidity become better indicators of the direction of monetary policy.

4. *Instruments* are the means used by the monetary authorities to achieve the intermediate objectives which they have set themselves. Instruments can be classified into direct and indirect. The use of direct instruments (for example credit ceilings and the fixing of minimum levels for banks' lending rates) may extend to administrative intervention in the economy by means of regulations. Other instruments, such as rediscount policy or open-market operations, operate indirectly through market forces.

5. At this stage the group has restricted itself to giving provisional explanations of coordination and harmonization. The following are therefore to be taken as merely working concepts.

(a) *Coordination* of the monetary policy of Member States implies the fixing of mutually consistent final objectives, and examining the instruments used to achieve them. At its present stage of integration, coordination means the joint development of policies which, while based on different techniques, can ensure the highest practical state of coherence in final objectives.

(b) *Harmonization* means the progressive reduction of the institutional and conceptual differences which exist between member countries. Complete harmonization implies the use of intermediate objectives and instruments of the same type.

ANNEX IV

THE EURO-CURRENCY MARKET AND REGULATION OF INTERNATIONAL FINANCIAL FLOWS

(Report of the Working Party on Short-term Capital Movements to the Monetary Committee and to the Committee of the Governors of the Central Banks)

Introduction

This report, which is intended for the Monetary Committee and the Committee of the Governors of the Central Banks, is part of the working party's work on the regulation of international financial flows. In accordance with the wishes of the Monetary Committee, the working party has mainly dealt with national measures (¹) which are liable to exert an influence on the Euro-currency market and which might be susceptible of harmonization. Questions concerning the Euro-bond market, banking supervision and intervention by the central banks as 'lenders of last resort' remain outside the scope of this examination.

I. Participation of Member States in the Euro-currency market

In principle, the participation of Member States in the Euro-currency market may be assessed on the basis of the following criteria:

- use of national currencies on the Euro-currency market;
- role on the Euro-currency market of banks established in the various member countries of the Community;
- role of non-banks within the Community as initial suppliers or ultimate recipients of funds generated by or channelled through the Euro-currency market;

The statistics given below are from the Bank for International Settlements and are intended to illustrate these three criteria. They do not reveal the growth of total volume or the shifting composition of the market over time, as they reflect only the situation as per end of 1975. No figures are given for Ireland and Denmark, which are not members of the Group of Ten and therefore do not report to the Bank for International Settlements.

1. *Use of national currencies on the Euro-currency market*

The following table illustrates the relative share of each currency in the external foreign currency claims of banks in the nine European countries reporting to the BIS (²).

(Situation as at 31. 12. 1975) (³)

Currency	in US $ '000 million	%
US $	190·2	73·7
DM	41·6	16·1
FS	15·4	6·0
FF	2·6	1·0
Fl	2·1	0·8
£ Stg	2·0	0·8
Others	4·2	1·6
	258·1	100·0

The US dollar has always been the most widely used currency on the Euro-currency market but the DM share has been growing rapidly over recent years.

For a given country the share of its national currency in the total volume of the Euro-currency market is not the only element determining the extent of the possible impact of that market on its balance of payments, exchange rate and internal monetary policy. On the contrary, given full convertibility of all Euro-currencies it is the total volume of the market and its ability to mobilize funds quickly that is relevant to problems which the Euro-currency market might pose for Member States.

2. *The role on the Euro-currency market of banks established in the various Member States of the Community*

The activities of banks established in the various member countries of the Community may be assessed in terms of relative shares or absolute amounts of external liabilities and

(¹) The Member States' experts have supplied the working party with full information, which may be obtained from the secretariat of the Monetary Committee.

(²) As defined by the BIS, the external foreign currency positions of banks in the nine European countries reporting to the BIS comprise the claims and liabilities of these banks in respect of non-resident banks and non-banks. The positions do not include the banks' foreign currency claims and liabilities in respect of residents of the respective countries.

(³) Latest figures available.

claims in foreign currencies of the banks of the nine European countries (seven member countries of the EEC, two non-members) which report to the BIS. The following figures include interbank loans: 76 % of the assets represent claims *vis-à-vis* non-resident banks.

(Situation as at 31. 12. 1975) (1)

	Liabilities		Assets		Net position
	US $ '000 million	%	US $ '000 million	%	US $ '000 million
EEC Member States					
United Kingdom	128·2	49·6	118·2	45·9	— 10·0
France	38·1	14·8	39·0	15·2	0·9
Luxembourg (2)	23·3	9·0	24·5	9·5	1·2
Netherlands	16·4	6·4	17·3	6·7	0·9
Italy	15·0	5·8	15·0	5·8	0
Belgium (2)	14·5	5·5	14·4	5·5	— 0·1
Germany	9·3	3·6	10·6	4·1	1·3
Non-member countries					
Switzerland	12·0	4·6	16·3	6·3	4·3
Sweden	1·8	0·7	2·6	1·0	0·8
	258·6	100·0	257·9	100·0	

(1) Latest figures available.
(2) The figures for Luxembourg do not include positions in foreign currencies *visà-vis* residents in Belgium and *vice-versa*.

This does not fully reflect the volume of Euro-currency transactions carried out by banks established in Switzerland, since assets and liabilities reported by banks in Switzerland do not include trustee funds.

Gross positions of banks in Italy which are mostly active in the interbank market have been sharply contracting since April 1974; in September 1974 the positions were only half of the amount registered at the beginning of 1974 but they have recovered remarkably in the last quarter of 1975. By contrast the gross position of banks in the other European countries have not increased since April 1974; this applies especially to banks established in Luxembourg.

This breakdown of the market by country does not correspond to that of the currencies used on the market: banks in Germany play a minor role compared with the important share of the mark. The share of banks established in various countries of the Community in the Euro-currency market would seem to depend, apart from questions of expertise and tradition, on the different national regulations concerning monetary policy and international capital transactions. In addition this share is influenced by the proportion of foreign trade transactions which are carried out in national rather than in foreign currencies.

It is to be noted that, as a result of the definition of Euro-currency transactions, the tables do not show the foreign claims and liabilities of banks denominated in national currencies.

3. *The role of non-banks as initial suppliers or ultimate recipients of funds channelled through the Euro-currency market*

This role can be seen with the help of the following table:

Positions in Euro-claims and Euro-liabilities (1) of non-banks in each of the nine reporting countries *vis-à-vis* resident banks and *vis-à-vis* banks of the other European reporting countries at 31 December 1975

(US $ '000 million)

Non-banks of the following countries	Liabilities owed to banks			Claims on banks			Net position *vis-à-vis* banks in the nine reporting countries
	resident	in the eight other countries	in the nine reporting countries	resident	in the eight other countries	in the nine reporting countries	
EEC Member States							
United Kingdom	15·8	1·7	17·5	5·5	0·6	6·1	— 11·4
Germany	0·8	8·6	9·4	0·5	0·7	1·2	— 8·2
Italy	1·4	2·9	4·3	0·6	1·2	1·8	— 2·5
France	2·8	1·0	3·8	0·9	1·2	2·1	— 1·7
Belgium/ Luxembourg	1·7	0·8	2·5	1·7	0·9	2·6	+ 0·1
Netherlands	0·6	1·4	2·0	0·9	0·5	1·4	— 0·6
Non-member countries							
Switzerland	0·9	1·9	2·8	1·8	3·6	5·4	+ 2·6
Sweden	—	1·3	1·3	0·7	0·1	0·8	— 0·5

(1) — These claims and liabilities are always in foreign currency from the point of view of the bank on which the claim is held or to which the liability is owed.
— This table is a different presentation from table 4 published by the BIS in its bulletin: Euro-currency statistics — fourth quarter 1975 of 29 April 1976.

During the past years the increase in liabilities to banks of the nine European reporting countries conducting Euro-currency business has been most pronounced in the case of non-banks in the UK, mainly due to public sector borrowing in order to finance deficits of the balance of payments. The liabilities of German enterprises to the Euro-currency market are remarkably high, which can be explained by the fact that they have exploited an interest rate differential on DM loans due to the absence of minimum reserve requirements for foreign banks. Less important is the volume of Euro-credits taken up by non-banks in Italy and France which are mostly explained by efforts to cover balance of payments deficits.

Significant differences in the proportion of credits taken up with resident banks by the non-banks of the same country can to some extent be explained by the relative importance of the different banking systems in the Euro-currency market.

The amount of Euro-currency claims of non-banks on non-resident banks is influenced by the extent to which home countries permit capital exports within the exchange control regulations. This explains for instance why claims of non-banks in Switzerland on non-resident banks are several times greater than claims of non-banks in the UK on non-resident banks.

Euro-claims of non-banks on resident banks are important only in the UK, in Belgium/Luxembourg and in Switzerland. It is believed that these claims are generally held by large international companies or by their holding companies, as they periodically have to make large transactions in foreign currencies and prepare themselves in advance for these transactions.

The Irish and Danish experts have indicated that non-banks in these two countries, while they do not constitute a net source for funds placed on the Euro-currency market, have often had recourse to loans on this market on behalf of the public, semi-public and private sectors.

II. The regulation of international financial flows in the context of the Euro-currency market

1. *Problems for the national economies posed by the existence of the Euro-currency market.*

The working party looked at the question of whether the existence of the Euro-currency market posed problems in the management of economic policies for the monetary authorities in the Member States. This market, representing the channel through which a sizeable proportion of international liquidity is held, may conceivably affect Member States' economic policies in two ways:

(a) directly, as a result of capital flows between national credit markets and the Euro-currency market, which may interfere with the management of domestic monetary policy and the operation of the exchange market and affect balances of payments;

(b) indirectly, through the autonomous growth of international liquidity, increasing world demand and inflation.

Given the present state of knowledge characterized by conflicting theories and insufficient empirical evidence, the group did not consider that it was in a position to offer a significant contribution to the discussion of the latter problem, and therefore has concentrated its attention on the direct effects.

As the existence of the Euro-currency market is held by many experts to increase the international liquidity and velocity of capital, they consider that the Euro-currency market might intensify problems which are associated with international capital flows in general. Nevertheless, it would not be possible to determine precisely what proportion of international flows considered undesirable by the monetary authorities might be attributed to the Euro-currency market rather than to the conventional foreign currency markets.

The direct effects of capital flows channelled through the Euro-currency market on the economies of individual member countries vary over time, and from one country to another, depending on the following factors:

— the state of the economy and the balance of payments situation,

— the direction, volatility and size of these flows,

— the measures taken by the authorities to restrict or neutralize harmful effects,

— the degree of monetary controls over the Euro-currency markets.

In so far as the Euro-currency market generates or transmits net inflows (outflows) of capital to (from) the national markets, these flows could aggravate the problems faced by the monetary authorities in countries with a balance of payments surplus (deficit). Also, the liquidity creation or destruction effect of these inflows or outflows might conflict with the monetary policy objectives required by the internal economic situation of countries at the time these flows occur. However, it is held that under normal conditions, more flexible exchange rates should tend to reduce somewhat the size and frequency of speculative capital movements.

The real impact of funds generated by or channelled through the Euro-currency market on economies of member countries depends, of course, to a large extent on the willingness and ability of the authorities to adopt measures to restrict or neutralize these flows and the effectiveness of these measures. In this respect, the differences between member countries are quite pronounced. While all member countries subscribe in general to the greatest possible freedom of capital movements as an external policy objective, in practice the majority of countries are inclined to restrict such movements in cases where internal and/or external policy objectives are felt to justify such action. This has depended on the circumstances in which countries have found themselves and the priorities accorded to the different objectives of internal and external equilibria. Some member countries, on the other hand, have only reluctantly had recourse to such measures in crisis situations and on a temporary basis only. The latter category of member countries is consequently more concerned about the adverse effects of the Euro-currency market on the effectiveness of their own monetary policy. They consider overall measures of monetary control normally to be more appropriate than direct national interventions in the free flow of capital. Furthermore, the working party considers that, in the light of past experience, national measures aimed at restricting outflows of capital have generally been more successful than measures intended to restrict inflows of capital. Some experts have tried to explain these different results by pointing out that measures used to control outflows differed from those used to restrict inflows according to the different sets of national instruments and according to national priorities with respect to direct controls and market-oriented instruments. However, other experts have stressed the fact that domestic funds available to residents in order to finance outflows are normally limited under domestic credit regulations compared to international capital available to non-residents in order to finance inflows. The question remains open which of these alternative explanations fits the empirical evidence better.

The working party recognizes that the effect of capital flows emanating from or channelled through the Euro-currency market depends more on its overall size than its geographical breakdown or composition by currency. Nevertheless, it was noted that the existence of a substantial Euro-market in a particular national currency, as is the case, for example, with the DM, may pose particular problems for the effectiveness of that country's monetary policy. Indeed, German resident non-banks may borrow in Euro-DM at conditions which — because of

the absence of minimum reserve requirements abroad — are more favourable for them than at home and without having to bear the costs of exchange operations and exchange risk cover which recourse to other Euro-currencies would entail. Experience in Germany has shown that in periods of heavy speculation even direct controls were not enough wholly to prevent undesired capital movements executed via the Euro-currency market. This problem does not exist, however, to the same extent for countries whose currencies are not to the same extent demanded by the market and which therefore may more effectively use direct controls on borrowing by residents from non-residents.

2. *The regulation of international financial flows at national level*

The working party examined the question of whether the present use of instruments for regulating international financial flows by the monetary authorities in the Member States enabled the problems outlined above to be solved or whether these national measures should be incorporated in concerted action with regard to the Euro-currency market.

A look at the national instruments described in the experts' contributions shows that no Member State has at its disposal instruments specifically covering net inflows and outflows of capital emanating from or channelled through the Euro-currency market. This situation is due to the fact that the net inflows and outflows of capital which the monetary authorities in a Member State may consider undesirable in the light of the domestic and external monetary situation of the country in question have a similar effect whether or not these flows are originating in or channelled through the Euro-currency market; in addition, it is not always possible to verify the origin or destination of international capital flows in applying restrictions to capital movements.

It must also be emphasized that all the restrictions on capital movements in force in the Member States apply indiscriminately, that is to say without distinguishing between the various foreign currencies and between the supplying or receiving countries. National measures differ as to their purpose and in the range of instruments used. Whenever countries have been resorting to controls, their objective has been to protect their balance of payments and their exchange market and/or to neutralize undesirable effects on domestic liquidity.

The working party looked at the question whether, in the light of the dimension and fluidity of the Euro-currency market, the national measures in force in the Member States were adequate to control flows of capital considered to be undesirable. It found that in several Member States the monetary authorities appeared to be fairly satisfied with the effectiveness of their own national measures, as far as the protection of their domestic markets is concerned.

It was, however, recognized that these national measures might not prevent undesirable effects on the monetary policy in other countries. Monetary authorities in most other Member States felt that their national defences against massive inflows of foreign capital were not effective enough but that stricter controls were only maintainable with difficulty in the long term for political and/or practical reasons. The authorities in this latter category stated that they would like to see monetary controls introduced at Community level relating to the overall volume of international credit generated by or channelled through the Euro-currency market, through the means of joint action by the Member States of the Community or a wider circle. The authorities of other countries thought that such joint action was not practicable or had doubts on this score.

Thus, the working party was not in a position to give a uniform opinion on the opportuneness of joint action by the Member States to control the Euro-currency market, since there were differences of opinion as to the actual or potential effects of this market on Member States' economies and as to the effectiveness of the national measures at present in force. However, in order fully to fulfil the task remitted to it, the working party has examined from a technical point of view those instruments which seemed likely to be most suitable for use in a programme of joint action, were circumstances to arise in which such a programme would be possible.

3. *Instruments for coordinated action on Euro-currency activities of banks*

The working party concentrated on instruments affecting Euro-currency transactions conducted by banks, but did not ignore the use of instruments for regulating international financial flows transacted by non-banks. It was guided in its choice by the following particular factors:

— is easier for the authorities to control banks than non-banks, as the number of banks conducting Euro-currency business is relatively limited compared to the number of non-banks active on that market;

— most transactions on the Euro-currency market pass through banks established in the Community's financial centres and subject to the regulations of its monetary authorities, which differ from country to country;

— in most member countries instruments used by national monetary authorities to limit directly (credit ceilings) or indirectly (minimum reserves) the supply of credit by the national banking systems do not generally affect transactions by banks on the Euro-currency market. This has permitted some banks to increase the volume of their external transactions, with possibly undesirable effects on monetary policies within other countries

The introduction of measures to control the activities of banks established within the Community and dealing with Euro-currencies could act as a brake on the supply of Euro-credit by these banks.

The working party wishes to emphasize, however, that banks established in the financial centres of the Member States do not have a monopoly on the Euro-currency market and that financial centres in a number of non-member countries, which by definition would not be covered by any Community rules and regulations, could act as substitutes, in part at least, for those within the Community. If this proved to be the case, the desired objective, namely control of the expansion in total

volume of the Euro-currency market, could not be achieved in full and the main effect could be to shift the centres geographically at the expense of the Community's financial centres.

The group considers that joint action restricting only the supply of Euro-credits by banks established in the Community would be likely to result in a shift of demand by non-bank residents of the Community if they were free to take up Euro-credits with banks outside the Community, although there are different opinions about the magnitude of the shift. In addition, opinions differ among experts as to the necessity and usefulness of restrictions on demand as a complement to restrictions on supply if the authorities of Member States should initiate joint action to slow down the growth of the Euro-currency market.

Most experts feel that restrictions on demand by non-bank residents, either by direct controls or market-oriented instruments, would constitute a necessary and permanent complement to joint action on supply. These restrictions could however, in the opinion of several experts, increase the cost of public sector borrowing in the Euro-currency market, at least if such borrowing were not exempted from restrictions. Other experts feel that such restrictions should not be permanent and that they should not disrupt the free flow of capital. They point out that according to German experience it has been very difficult to influence resident non-bank foreign borrowing through various measures of capital controls. Problems did e.g. arise in the administration of the 'Bardepot' owing to the difficulty of distinguishing between financial credits and normal commercial credits, the former only being subject to the 'Bardepot'.

(a) **The external position of banks**

The external positions of banks comprise liabilities to and claims on non-residents, denominated in national currencies or in foreign currencies. Regulations governing these positions could influence the behaviour of banks on the Euro-currency market.

In several Member States, the regulations governing the external positions of banks are concerned only with the balance of their claims on and liabilities to non-residents: the control of net external positions is an effective way of curbing either net inflows or net outflows of capital via resident banks.

If the introduction or amendment of regulations governing their net external positions induces banks to reduce their net debit or credit positions, this may, it is true, also generate an expansion or contraction in the Euro-currency market, on a scale that would be difficult, however, to predict.

But the restrictions on their net positions leave the banks free to increase or reduce simultaneously their external claims and liabilities by corresponding amounts, and this may entail expansion or contraction of the volume of the Euro-currency market. Consequently, regulations governing the banks' net positions would not be an effective way of controlling the growth of the Euro-currency market.

The application of rules governing the gross external credit position of banks established in the Community *vis-à-vis* residents in the Community, whatever the currency in which such lending is denominated, should on the other hand, by imposing quantitative ceilings, allow a certain degree of control of the growth of credit granted by Euro-banks established in the Community. However, the working party is of the opinion that such restrictions on external credit involve constraints of such severity that their use can be justified only to cope with crises and only as long as such crises last.

(b) **Minimum reserves**

The supply of Euro-credit by banks established within the Community could be controlled, indirectly, to some extent if such banks were required, under a scheme of joint action, to set up minimum reserves at harmonized, or indeed uniform, rates on such credit or on their foreign currency deposits, which are the main source of such credit. Unlike the control of the external position of banks, which is an administrative measure, the application of minimum reserve requirements is a measure in line with market principles, since it would affect the liquidity and the profit margin of banks doing Euro-currency business. The profit margin effect would however create an incentive to transfer business elsewhere.

In order to put such a system into effect, the monetary authorities in the Member States would need to adopt harmonized or uniform provisions relating to the following aspects of implementation:

— level of rates;

— basis of rates;

— nature of the reserves to be set up.

In addition, arrangements would have to be made for the institutional management of the system.

The working party wishes to stress the importance of taking the following considerations into account if such a system were to be implemented.

If the supply of Euro-credit by banks established within the Community is made subject to minimum reserve requirements, it should be decided whether these requirements apply only to Euro-credit granted to Community residents or also to Euro-credit granted to residents of non-member countries. In the first case, banks established within the Community would continue to supply Euro-credit to residents of non-member countries on the same terms as Euro-credit supplied by banks established outside the Community, but the impact of joint action on the total volume of Euro-credit would probably be more limited.

If deposits made by non-residents of the Community with banks established in the Community were exempted from minimum reserve requirements, then banks established in the

Community would be in the same competitive position as banks outside the Community when bidding for these deposits. On the other hand, this would increase the potential of banks in the Community to grant Euro-credits to residents of the Community.

4. *Additional instruments affecting transactions by resident non-banks*

Although the existence of instruments applying to Euro-transactions by banks established within the Community can reduce the volume of transactions carried out by such banks with Community resident non-banks, Community non-banks may, if exchange controls permit, still be able to resort to banks in non-member countries [1], which by definition are not covered by controls on banks within the Community. Consequently, situations might arise in which it might be necessary to supplement controls relating to the activities of resident banks by restrictions on Community resident non-banks' deposits or credits with banks established outside the Community.

The working party does not consider that any such supplementary measures would from a technical point of view need to be identical as to the instruments chosen, provided that their effect is more or less equivalent from one Member State to another. Transactions by residents with banks in non-member countries could be limited, depending on the Member State in question, either by applying exchange controls, or by recource to measures in line with market principles (cash deposit system of the Italian type on exports of capital or 'Bardepot' (cash deposit) of the German type on imports of capital).

III. Differences in national experts' attitudes towards the Euro-currency market and towards joint action aimed at its control

The written or oral contributions of national experts concerning problems related to the Euro-currency market as seen from the capitals reflect divergent opinions between national authorities concerning joint action aimed at controlling the Euro-currency market. Therefore these submissions are summarized below.

(a) *The role of the Euro-currency market in creating or transmitting world inflation and undesirable capital flows*

The group as a whole recognizes that the Euro-currency market constitutes a very efficient international money and credit market. The market has contributed significantly to the integration of national markets, to developing world trade, to financing balance of payments deficits and projects in developing countries. Particularly since the end of 1973 the market has played an important role in placing and recycling part of surplus funds of OPEC countries.

However, the Belgian, Dutch, French, German and Italian experts draw attention to the fact that the Euro-currency market might give rise to numerous dangerous developments. They think that uncontrolled expansion of the Euro-currency markets increases international capital movements and international liquidity and thus contributes to worldwide inflation, to aggravation of monetary crises and to lesser efficiency of national monetary and credit policies.

The Danish experts to a certain extent share these views, whereas the Irish experts are not highly convinced of the dangers attributed to the Euro-currency markets.

The British and Luxembourg experts, on the contrary, maintain that the Euro-currency market does not lead to substantial credit creation but only to substitution of national credit markets. Worldwide it does not lead to a net increase in the credit volume, which implies that the market is not an independent source for inflation.

(b) *The opportuneness and effectiveness of joint action by the Member States aimed at monetary control of the Euro-currency market*

The German, Belgian, French, Italian and Dutch experts put forward the following considerations:

— national measures taken by one member country alone cannot in the long run neutralize these disruptive effects. Consequently, these problems can be solved only by joint action;

— joint action by several Member States could, however, weaken the competitive position of banks in these countries as against banks established in financial centres in other countries. In order to prevent any shifting of the Euro-currency market centres, joint action should be envisaged with respect to a larger controlled area than the Community.

In this context, certain experts have suggested that the introduction of the following measures be examined:

— minimum reserve requirements in respect of European banks' liabilities to non-residents in national currency and in foreign currencies and to residents in foreign currencies (German and Italian experts);

— minimum reserve requirements in respect of loans in national currency and in foreign currencies granted by European banks to foreign non-banks in the controlled area (Dutch experts);

— minimum reserve requirements in the form of cash deposits with the central bank in respect of borrowing by non-banks established within the controlled area from banks established outside that area (Italian and Dutch experts);

[1] The working party is aware of the fact that at present the vast majority of banks transacting Euro-currency business and established outside the Community are either owned or controlled by banks established in Canada, Japan, Switzerland, the United States or in the Community. If these non-member states would join the Community in initiating action to slow down the growth of the Euro-currency market the effectiveness of Community measures would be greatly enhanced. However, not all experts consider participation by non-member countries a necessary precondition for initiating Community action.

— joint central bank action in respect of Euro-banks using conventional monetary policy instruments (French experts).

The Belgian experts reserved their position on the opportuneness and effectiveness of these specific measures. The Irish experts doubted whether individual or even joint action by the Member States could provide a satisfactory solution to the problem of controlling the Euro-currency market, since there was a danger of market centres shifting towards non-member countries. Furthermore, in their opinion, the access of non-banks to this highly flexible and competitive market should not be restricted, especially at the present time. In addition, they see a technical problem in the administration of such controls. The Danish experts share to some extent the views of the Irish experts, especially concerning the point that the access of non-banks to the market should not be restricted at the present time.

The United Kingdom and Luxembourg experts were against any joint action with regard to the Euro-currency market. Their attitude is based on the following arguments:

— international control of the growth of the Euro-currency market, as distinct from international cooperation in matters of prudential supervision is neither necessary nor practicable;

— attempts to control the growth of the market, whether taken at Community level or within a wider area, would lead to the booking of Euro-currency operations outside the regulated area unless restrictions could be imposed worldwide;

— a ring fence would be necessary around any regulated area, and the larger the area the less effective would such a ring be in practice;

— attempts to control one specific channel of international finance would lead to the growth of other channels.

In addition, the Luxembourg experts are not in favour of controls which might increase intermediation costs on the Euro-currency markets, and thus would lessen their efficiency without strengthening reserves and solvency of banks dealing on these markets. This would especially be the case if minimum reserve requirements were introduced.

Final remarks

In examining, in conformity with its mandate, instruments likely to exert influence on the Euro-currency markets, the working party has focused its attention on the regulation of the net foreign position of banks and on minimum reserve requirements. However, several experts mentioned other courses of action, (e.g. open market operations in Euro-currencies by central banks or agreements between central banks aimed at limiting currency diversification in the investment of official reserves), but these were not examined by the working party. These and possibly other techniques could be examined at a later stage if and when it were considered useful.

As far as continuing its work on the Euro-currency market is concerned, the working party feels that, given the differences of view among the national experts, it would not be appropriate for it to pursue the study of possible joint action arrangements in the absence of further specific instructions from the Monetary Committee and/or the Committee of Governors of the Central Banks.