MONETARY COMMITTEE

OF THE EUROPEAN COMMUNITIES

TWENTY-SIXTH REPORT ON THE ACTIVITIES

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Contents

I. General economic situation

1. The revival in economic growth spread during 1984 and gained significantly in strength. It was evident especially in industrialized countries, but the developing countries too were drawn into the recovery process of the world economy. This recovery, together with the adjustment efforts of these countries, enabled them to improve their balance of payments performance, but their external financial position continued to be difficult. World trade grew by 9 % in real terms in 1984, the highest rate for eight years. At the same time it was possible to make further progress in reducing inflation.

2. The decisive factor in the strong expansion of the world economy was the impetus provided by economic growth in the United States. Although domestic demand rose as well in some other industrial countries, it is true that, in 1984, the key US disequilibria (the current account deficit and the budget deficit) deteriorated and that the rise of the dollar and the very high level of interest rates, at least up to the autumn, at times restricted the Community countries' room for manoeuvre in economic policy, especially in the monetary field. Overall, however, the pull exerted by US import demand, and the high dollar, had a favourable effect on the Community economy, without imported inflation taking place to the extent that was feared.

3. The still modest upturn in economic activity in the Community countries, which was supported by external demand, but also by investment, was promoted by the fact that simultaneously progress was made on internal price and cost evolutions, thereby providing improved conditions for lasting and balanced growth. Externally, the balance of payments equilibrium already achieved for the Community as a whole in 1983 was maintained, although the differences between countries still remained substantial. All in all, 1984 was a year in which the adjustment measures began to bear fruit. The Community's gross national product increased by a good 2 % in real terms in 1984. Although this brought with it a small rise in employment, the already extremely high unemployment grew still further due principally to the large increase in the working population.

4. The convergence of economic policy stances and of performances in the individual countries, which is so important for the EMS, helped to strengthen the exchange rate system substantially in 1984. This is particularly true for the convergence of inflation rates to a lower level. The inflation differentials between EMS countries narrowed once again, but further progress has still to be made. It was also possible to improve incomes developments in most of the countries, so as to help firms' competitiveness and hence encourage investment. There was on the whole a less marked improvement in the stabilization and consolidation of government finances, although most of the EMS countries once again managed to achieve some reduction in the central government borrowing requirement as a proportion of GDP. However, the progress in convergence achieved in 1984 was undoubtedly facilitated by a favourable international environment, connected in particular with the attraction exerted on capital flows by the behaviour of the dollar; even so it was not such as to allow the member countries to relax their efforts to bring economic performances more into line with one another. The Committee believes in any case that convergence is not a permanent condition that is achieved once and for all and continues of its own accord. Rather, convergence threatens daily to fade away again and must therefore constantly be regained and secured through new efforts.

5. Monetary policy, especially in the countries that are still confronted with appreciable inflationary pressure, was a central element of economic policy. In Italy, it actually had to bear the main burden of the struggle against inflation. Monetary growth slowed down in most of the countries and on the whole followed a satisfactory trend. In cases where the monetary policy targets were overshot, the monetary authorities tolerated the situation in so far as stronger real economic growth compared with the original forecasts or structural changes in credit demand lay behind it.

II. The main fields of action of the Committee

6. In 1984, the Committee focused its attention on the following tasks in particular:

(i) First, it dealt with the improvement of convergence and fundamental economic factors, which constitutes one of the essential conditions for strengthening the cohesion of the exchange rate framework of the EMS.

(ii) Secondly, the Committee regularly carried out its examinations of individual countries, and it continued to draw the necessary conclusions from these in 1984. Similarly, it continued its horizontal coordination efforts, which it undertakes in mid-year with regard to the coherence of monetary policies and towards the end of the year in respect of the coordination of monetary targets.

(iii) Thirdly, in a year in which there was considerable progress in convergence, it was appropriate to review the five years of operation of the EMS and to initiate thinking on ways of strengthening it. The Monetary Committee was also able to start discussion on the scope — neglected for many years — for liberalizing capital movements in the Community. The room for manoeuvre for further developments in the use of the ECU is still not known precisely; the Committee will take up this question again in order to investigate it thoroughly.

(iv) Fourthly, international economic and monetary relations as usual raised questions which called for detailed discussion. As is stipulated in a Council Decision dating from 1964, the Monetary Committee is the body responsible for the necessary consultations 'in respect of any important decision or position taken by Member States in the field of international monetary relations'.

7. In the examinations of individual countries and in the Community-wide analyses, a broad consensus was reached, as last year, on the diagnosis of the problems and on economic policy priorities. As always, one of the main points of reference in looking at economic policy was an analysis of the developments in the money supply and its counterparts. Inclusion of the counterparts of the money supply is important in two respects. First, this approach makes it possible to determine rapidly where the causes of a possible overshooting are and where the areas for applying corrective action lie. Secondly, it extends the field of vision to include key areas of economic policy such as budgetary policy: it is important to take account of the repercussions of these areas on monetary policy. Of course, the influences by and on the money supply work in both directions. Particularly in cases where monetary policy carries the main burden in the struggle against inflation, it is important that other policies enable the maintenance of control over the counterparts of money creation, for instance the budget deficit.

Expanding on what was said in the last report on the Committee's activities, the following four guiding principles are of importance in this context:

(i) In countries with a high rate of price inflation and/or a large public deficit, in which monetary growth has been brought down partly with the aid of financial innovations through the development of relatively liquid financial instruments, which can develop a velocity of circulation of their own, it is necessary to take account of the importance of this phenomenon in assessing the evolution of the monetary aggregates.

(ii) In countries with large balance of payments deficits on current account, it is not enough to ensure that the rate of monetary expansion is apparently consistent with the guidelines; the expansion of domestic credit and the external counterpart of monetary creation must also be closely monitored. Rapid domestic credit expansion that pulls in more imports and fuels outflows of capital is incompatible with a balanced development of the economy.

(iii) In the countries where official external borrowing has traditionally been high and accompanied by a substantial external deficit, problems of domestic monetary control may occur if the external account improves faster than the budget deficit. In such cases, it is appropriate to reduce public foreign indebtedness gradually and to switch to more non-monetary financing of the persistent public deficit, accepting the consequences described at (iv) below.

(iv) In countries where credit to the public sector is the main source of monetary creation, the achievement of monetary expansion consistent with stability represents a very difficult problem, requiring either a substantial squeeze on private sector borrowing or the acceptance of excessive domestic credit expansion accompanied by the destruction of liquidity by the external sector, or some combination of these two. More use of non-monetary financing for the public sector would be a first step in the right direction; high long-term interest rates would then reveal more clearly the fact that the financial demands of the public and private sectors are in competition for the limited supply of savings. In the final analysis, the only way out of the dilemma is to reduce the public deficit.

8. In the spring of 1984, on the occasion of the fifth anniversary of the EMS, the Chairman of the Committee presented to the Ministers for Economic and Financial Affairs a review of five years of operation of the European Monetary System. He emphasized in particular that the stabilizing effect of the EMS goes hand in hand with two important innovations. First, member countries' exchange rate policies have effectively been treated as a matter of common concern: central rates and realignments are solely the result of common decisions. Secondly, the EMS has made it possible at realignments to avoid an overshooting of the changes justified by fundamental economic factors and hence to prevent distortions of competition caused by exchange rates.

At an informal meeting of Ministers for Economic and Financial Affairs at Rambouillet in May 1984, a number of proposals for strengthening the EMS were put forward within the framework of this review, and the Monetary Committee and the Committee of Central Bank Governors were entrusted with the task of examining them. Some of the proposals have since been put into effect.

In view of its function and the particular legal situation of the EMS, the Committee had a special role to play in preparing the examination of the weights of the currencies in the ECU. At a special meeting at the beginning of September, the Committee put forward proposals for revising the composition of the ECU. The Greek members took the opportunity to apply for the inclusion of the drachma in the ECU, pursuant to the Accession Treaty. At the same time, they affirmed that such a step would strengthen economic policy and monetary cooperation within the Community. The Greek authorities undertook the obligation to guarantee sufficient possibilities for forward transactions in drachma in relation to its weight in the ECU basket. The Committee took the view that the revision of the weighting should be decided on and carried out rapidly, so as to prevent any disruptive monetary effects. On 17 September 1984, the Council decided on a corresponding revision of the ECU, and this was implemented immediately, allowing a smooth transition.

The negotiations on the enlargement of the Community meant that the question of the possible inclusion of the peseta and the escudo in the ECU had to be dealt with once again in 1984. The Monetary Committee confirmed its earlier Opinion and emphasized that any such decision must take account of the need to ensure the stable development of the role and uses of the ECU. This means that the countries participating in the EMS could propose to defer the inclusion of one of these currencies at that time, if such an inclusion were to create disturbances in the European Monetary System.

9. A free capital market with maximum harmonization of legal provisions would promote the development of a unified internal market within the Community. Above all, though, the liberalization of capital movements would reinforce the pressure to adjust economic policies and thus serve to strengthen the EMS. As part of its work on how to strengthen the EMS, the Committee endeavoured to get the liberalization of capital movements under way again and pointed out that the goal of liberalizing capital movements is an obligation under the Treaty of Rome. For many years liberalization on the Community's capital markets has fallen well behind that on the other markets. However, overrapid liberalization of capital movements could in certain circumstances pose dangers for the stability of exchange rates. The Monetary Committee therefore favours a gradual and active liberalization.

Even so, the convergence achieved in Member States' economic policies in the last years has opened up much greater scope for step-by-step liberalization of capital movements. In Denmark, the existing restrictions were largely removed in 1984. In France and Italy too, it became possible at the end of 1984 to embark on the liberalization of capital movements with some initial selective measures.

Pursuant to its statutory obligations, the Committee set up a process of reviewing existing restrictions more closely and decided in particular on the following:

(i) At least once a year and in December at the latest, the existing restrictions on capital movements will be examined. The purpose of the examination will be to determine which restrictions it is possible to remove.

(ii) Recourse to or, as the case may be, a renewal of recourse to the safeguard clauses should in future be allowed only for a limited period.

(iii) As part of the Committee's examinations of individual countries, the relevant country's justification for applying the safeguard clauses should be examined particularly in the light of balance of payments developments.

The Monetary Committee invited the Commission to continue to take an active role in the process of capital liberalization as it already has with its measures of December 1984.

10. On international monetary questions, the Committee as usual prepared the statements made on behalf of the Community to the IMF Interim Committee and to the annual meetings of the IMF and the World Bank. The focus of activity shifted in 1984 to the Group of Ten — comprising the main Western industrialized countries — which undertook a thorough examination of the conditions for improving the functioning of the international monetary system. The Community countries, through their contributions and as a result of holding the chair within the Group, took a major role in the progress of this work, various aspects of which were the subject of a prior exchange of views within the Monetary Committee. Consideration of how the international debt problem should be dealt with further was a key focus of attention in 1984. Thanks to the progress made so far in achieving stabilization, it was possible to turn attention more towards the medium-term outlook.

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European Communities Washington, 12 April, 1984

Statement by Mr Jacques Delors, chairman of the Council of the European Communities, to the IMF Interim Committee meeting

I have the honour to address this meeting on behalf of the countries of the European Economic Community.

Our intention is to deliver a message of optimism, pragmatism and hope:

(i) optimism as regards the short-term prospects for the world economy (I);

(ii) pragmatism as regards the choices we have to make jointly (II);

(iii) hope that we will be able to come to grips with and overcome the risks that await us in the longer term (III).

I. The world economic setting is now distinctly more favourable

Since we met last fall, the world economic scene has clearly brightened up. Following years of stagnation and recession, major industrial economies are once again set on a path of renewed growth. Economic activity in the United States continues to be buoyant. In Europe, too, the expansionary forces have been gaining strength although with differentiation among countries. In the Community as a whole, GNP, in 1984, is expected to grow by about 2% and activity is likely to further accelerate next year.

The faster pace of activity in Europe, while, no doubt, supported by the expansion in the United States, is also being spurred by the improvement achieved in the underlying domestic conditions for growth. However, for the EEC as a whole, the recovery is to date well below the US rate and has, so far, only led at best to a stabilization rather than a fall in the underlying rate of unemployment. Improved policy coordination between all the industrialized countries would facilitate a more rapid and broader based recovery to the advantage of the world economy generally.

The recovery is so far more modest in the developing countries, and some regions primarily in Africa, remain in serious economic stagnation. Nevertheless, participation of the non-oil developing countries in world trade flows is showing an appreciable improvement in two respects:

(i) the reduction in their overall external current deficits which occurred in 1983, due to the growth in their exports as well as to the contraction in imports;

(ii) the upturn in the prices of commodities, which are still a key source of export earnings for numerous developing economies.

Provided that the world economic environment continues to improve and also the headway made on the adjustment continues, many developing countries, too, can expect to see a gradual resumption of growth.

At the same time, the oil-producing countries, which have undertaken major efforts at domestic adjustment and at cooperation to reduce market fluctuations, seem to be returning to a more orderly growth path.

These initial results are all the better founded in that they owe little to easy remedies and are accompanied by a continuing and successful drive against inflationary factors.

In general, monetary policy remains firmly committed to keeping credit expansion and money creation under control. Increased wage restraint has contributed to the gains on inflation. There is increasingly wide recognition of the priority that needs to be accorded to productive factors. Moreover, a large number of economies have made significant headway in controlling overall public sector budgets. However, particularly in those countries where growth is more buoyant or where efforts are being made to establish a new price/wage equilibrium, careful attention has to be paid to keep inflation under control.

Simultaneously, in several EEC member countries, investment is beginning to take over from the upturn in consumption, while the control over production costs and the recovery in companies' financial situations are factors that will stand us in good stead in the future.

Lastly, turning to the operation of the international economic and monetary system, two new developments are adding to the optimistic tone:

(i) some recovery in international trade, connected, of course, with the renewed growth in the industrialized countries, but also with the fact that the open trading system has been largely preserved;

(ii) the remarkable adjustment efforts made by indebted countries towards bringing the growth of their external debt more in line with their capacity to service that debt. We can take satisfaction from the way in which the international financial community has supported these adjustment efforts in a spirit of responsible and effective cooperation. Renewed world economic growth will help developing countries to overcome their debt problems in an orderly way.

Adding to the elements of confidence we welcome the first signs of a return to a more balanced and hopefully more stable pattern of exchange rates, including some correction in the exchange rate of the US dollar. Within the European Community, thanks to better convergence, it is encouraging to note that the European Monetary System has been strengthened over the last 12 months.

So much for the factors generating optimism in the short term.

II. Now we must display pragmatism as regards the choices we have to make jointly

With regard to the activities and financing of the Fund, solutions or generally satisfactory compromises have now been found for most of the problems left unsettled at the Committee's last meeting.

The Community countries have agreed to make an essential contribution to the solution of the Fund's financing problems by means of new credit lines arranged mainly under the aegis of the BIS.

They welcome the additional credit lines being established by other countries and Saudi Arabia in particular, but regret that not all industrial countries considered it possible to take part in the joint effort. Despite this imbalance, their main consideration is to ensure a constructive and rapid solution which would be of benefit to the international community as a whole. Fund credit policies will have to be based on the balance of payments needs, the progress of the adjustment effort as well as the availability of Fund resources including the General Arrangements to Borrow.

As to the question of an SDR allocation, views differ over whether or not a long term global need to supplement existing reserve assets, which is the decisive criterion for an allocation, has been established. The supporters of an allocation argue that the growth of global reserves has been sharply reduced, that the proportion of SDRs in reserve assets has fallen and that the reserves of many developing countries have dropped to very low levels, while the gains on inflation have reduced the risks of an allocation in this field. On the other side is argued that world reserves are again growing and that, at the present juncture of the world economy, the overriding need is for credible adjustment efforts by debtor countries supported, as far as the Fund is concerned, by conditional financing.

The Community will therefore formulate its position on a possible allocation taking into account the balance of developments in these areas.

Other points which are of relevance and should be born in mind whilst monitoring the international liquidity situation over the period ahead, are the size of a possible allocation and the date of its application.