MONETARY COMMITTEE
OF THE EUROPEAN COMMUNITIES

TWENTY-NINTH ACTIVITY REPORT

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1. INTRODUCTION

The realignment which occurred in the very first days of 1987 revealed that the European Monetary System had not been backed up by an adequate level of cooperation among the participating countries, given the rapidly growing mobility of capital. That realignment now seems, in retrospect, to form a watershed and subsequent developments have raised cooperation in the formulation and execution of many aspects of policy to a qualitatively new level which has done much to ensure that, in spite of a very disturbed international environment, no further realignment has been necessary over the last 18 months.

The EMS has been strengthened by the closer coordination of interest rate policies and by a readiness to allow currencies participating in the exchange rate mechanism to fluctuate more freely within the margins allowed by the system; but these arrangements have been successful only because they rest on a fundamental commitment by the countries concerned to price stability and on their manifestly improved success in respecting that commitment. The importance of maintaining a zone of monetary stability in Europe, after the tension which had occurred in the previous months, led the Monetary Committee and the Committee of Central Bank Governors to make further progress in developing the EMS. The ensuing work culminated in an agreement among EC central banks and a new understanding among ministers at their informal meeting at Nyborg in September 1987. Understandings were reached on the proper use of interest rate differentials, the more flexible use of fluctuation margins and the need to ensure that realignments in the EMS are small and infrequent. Also the financing facilities in the EMS were expanded. An important aspect of the understandings was an acceptance of the need for more systematic and objective surveillance of each other's economies on the basis of macroeconomic indicators. In this way the member countries of the Community seem to be advancing to a stage in which common concerns are extended considerably beyond the monetary field.

While making its contribution to the progressive development of EMS arrangements, the Monetary Committee has also on many occasions discussed the appropriate response to passages of pronounced turbulence in the relations between the major currencies at world level.

In February 1987, after the downward adjustment of the US dollar had continued for about two years, the Louvre Agreement incorporated an understanding that the levels of the US dollar then obtaining were appropriate and should in broad terms be maintained by the pursuit of stated macroeconomic objectives. These aims for exchange rates had to be supported in an initial period by heavy intervention but by the middle of the year the policy of the major countries began to carry conviction and private capital flows took over the equilibrating role. In the latter part of the year there was a need to renew the vigour of international cooperation in the context of the abrupt adjustment of equity values; the Franco-German joint monetary policy operations of November 1987 and the renewal of the Louvre Agreement at the end of the year had a marked effect, although intervention continued to be necessary on occasion over the following months.

2. STRENGTHENING THE EMS – THE PROCESS LEADING TO THE NYBORG AGREEMENTS

In the course of its discussions during 1986 the Monetary Committee had already emphasized that heavy intervention used on its own can be counterproductive as a means of influencing the market, that vigorous and rapid use must be made of interest-rate changes when exchange rates come under pressure, and that there should be more flexibility in the use of the EMS band. In the aftermath of the realignment of 12 January 1987 it seemed natural to ask whether these principles had been respected and whether they had proved their worth. Furthermore, the ministers and central bank governors of the Member States, in their communiqué at the time of that realignment, asked the Monetary Committee and the Committee of Central Bank Governors to examine measures to strengthen the operating mechanisms of the EMS. In this connection the Monetary Committee received a memorandum from its French members advocating a more coherent approach by the Community authorities to the US dollar and the yen, and a more symmetrical view of how the EMS should operate, both as regards macroeconomic adjustment and as regards intervention obligations which, it was argued, should be backed by greater resources.

The Committee's initial work on these problems resulted in an interim report to Finance Ministers at their informal meeting in Knokke in April 1987. It was noted that the growing internationalization of capital markets and the progressive elimination of exchange controls in the Community (see 4 below) would call for more intensive cooperation in the management of the EMS, but would at the same time have a disciplinary effect which could ultimately serve to strengthen the system. There was agreement on the need for a much closer coordination of interest rate changes and of intervention, both in defending intra-EMS parities and in making the Community's contribution to a better functioning of the international monetary system.

Without having completed its discussion of the role of intervention, the Committee did draw attention at this stage to the fact that intra-marginal intervention has become larger and more frequent than was envisaged by the designers of the EMS. One consequence of this is that it has become more difficult to draw conclusions from the divergence indicator about tension within the system.

Further, it was at this stage that the Committee concluded that the short-term tensions of the EMS could be overcome more effectively if there were also a medium-term coordination of the course of economic policy. Specifically, surveillance on the basis of macroeconomic indicators, which already has a place at world level, was accepted as being particularly useful in the Community context.

The Chairman was able to supplement this work by an oral report to the Council of Ministers in June 1987 in which the importance of resolute and timely action to maintain appropriate interest rate differentials between EMS countries was emphasized. Stress was also laid on the desirability of avoiding changes in bilateral market rates at the time of realignments and thus preventing speculators from realizing overnight gains. Furthermore, in times of high capital mobility, full use of the fluctuation band gives the markets a clear indication that speculation is a matter of high and imponderable risk, as well as being expensive.

The work on the strengthening of the EMS culminated at the informal meeting of Finance Ministers in Nyborg, Denmark in September 1987, and in the meeting of the Committee of Central Bank Governors in the same month. *On economic policy,* it was reported to ministers (see Annex 1) that the Committee's work on the coordination of medium-term policies would proceed on the basis of reports of national objectives or expectations for the main macroeconomic variables and the monetary and budgetary policies considered consistent with them and by testing for:

(i) inconsistencies of policies within individual countries;

(ii) inconsistencies between the expectations of different member countries;

(iii) any danger of the emergence of unsustainable positions;

(iv) incompatible approaches to major third currencies.

On monetary policy, it was reported that the abovementioned understandings about the proper use of interest rate differentials, about the more flexible use of fluctuation margins, and about the need to ensure that realignments are small and infrequent consitute the core of a stronger management of the EMS; and that limited intra-marginal intervention has an important role to play in the management of the system, although it should never be seen as a substitute for the appropriate use of other instruments. These conclusions are of course only valid to the extent that economic policy continues to have internal stability as its goal—this is the essential anchor of the EMS.

The acceptance of these understandings formed the basis for progress in the continuing debate about the financing of both intra-marginal intervention and compulsory intervention undertaken when a currency reaches its limits. The Monetary Committee discussed some technical aspects of these questions, particularly access to very short-term financing, and reached a common view. The Committee of Central Bank Governors negotiated an agreement covering a number of these points. Finally, several subordinate but nevertheless important questions were examined for ministers, notably cooperation in the area of policy towards outside countries, realignment procedures and exchange rate regimes within the Community.

The third feature was the Committee's conclusion on the important question of the freedom of capital movements (see 4 below) and its monetary consequences. As the Committee emphasized that with full freedom of capital movements 'there will in particular be much less room for independent monetary policies within the system'. After examining the different parallel issues which arise in this context, the Committee concluded that setting capital movements completely free would also help in the strengthening of the EMS.

3. STRENGTHENING THE EMS – IMPLEMENTATION BY THE MONETARY COMMITTEE

The approach agreed upon for the strengthening of the EMS has had direct consequences for the work of the Monetary Committee. Since the middle of 1987 there have been more intensive reviews of recent exchange and interest rate developments and of the policy stances which lie behind them. This has contributed to the successful month-to-month management of the exchange rate mechanism, but developments have been such that this procedure has been of even greater value in coordinating attitudes and actions during the major disturbances on world financial markets.

The Committee has also begun to develop a procedure for mutual surveillance with a longer time horizon on the basis of macroeconomic indicators, drawing on technical work done by Commission staff. When conducted by the Community, such surveillance should be more far-reaching than that conducted at other levels, since the objective of convergence is particularly important for the member countries of the EMS. This work is of special importance and value not least because it is based on a wealth of experience of country examinations and analyses of monetary policies.

At the end of 1987, projections to the year 1990 were studied for demand, output, prices, employment and fiscal and external balances, given an assumption of unchanged intra-EMS exchange rates; in the middle of 1988 a similar range of indicators was studied with a rather shorter time horizon in order to take a view of the prospects to the end of 1989. Certain concerns were expressed during this discussion. After the rapid improvement of recent years the inflation rate remains obstinately stuck at around 5% in some important cases. External current account deficits are projected for some countries, but there is a feeling that, in the perspective of the harmonious development of the whole European area, these deficits correspond in most cases to the need of these economies to bring in savings from abroad at the present stage of their development; the important thing is for them to create the conditions which will attract private capital. The review of likely growth rates provoked some concern that the Community may be drifting away from a full use of its potential and that renewed efforts must therefore be made to identify and eradicate the rigidities in the national economies and to improve the flexibility of supply. However, fiscal policies continue to stand out in sharp contrast against the background of generally greater convergence; the Committee is aware that, in a Community of free capital movements, better coordination of fiscal policy will be required in future.

4. THE FULL FREEDOM OF CAPITAL MOVEMENTS

The free movement of capital is one of the foundation stones of the European Economic Community and it can contribute to the economic progress which is the objective of the Rome Treaty by creating pressures for the efficient use of scarce resources. A wide measure of freedom was enacted by the 1960 Directive on capital movements, but its practical effects were blunted by legislative exceptions ('safeguard clauses') subsequently granted to several countries. The 1960 Directive gave the Monetary Committee the task of regularly examining the capital restrictions persisting in the Member States and since 1984 the Committee has applied renewed pressure to make the existing legislation fully effective. The adjustment programmes implemented by the countries benefiting from safeguard clauses—which had been subjected to regular review by the Committee—had led to a gradual recovery in their situations. These developments opened the way to the abrogation of the legislative exceptions applying to France and Italy in June 1986 and July 1987 respectively, and to an attenuation of that applying to Ireland in December 1987. Thus by the end of 1987 most citizens of the European Community enjoyed a very wide measure of freedom to move their capital.

It is worthwhile emphasizing that this progress was achieved during a period of increasing capital flows and of strong tensions in the foreign exchange market—yet these factors did not breach the cohesion of the exchange rate mechanism and the participating currencies showed remarkable stability. Moreover, with one brief exception, the member countries did not have to envisage recourse to protective measures to deal with external threats.

The decision to remove the remaining obstacles to the effective operation of a *single domestic market in the Community for goods, persons, services and capital* by 1992 had clear implications for the exchange controls still permitted by the amended 1960 Directive, particularly as the need to allow for these controls constituted a major legal block to permitting the free provision of financial services under the Rome Treaty. The permitted controls concerned essentially short-term loans, money-market instruments and the use of bank accounts.

The Monetary Committee discussed, and took positions on, the main issues which would arise in preparing new legislation, making interim reports on several questions to ministers, particularly at Nyborg (see Annex 1). The Committee welcomed the Commission's proposal of November 1987 for a simple Directive which would replace existing, rather complicated legislation and achieve its central objective in a single sentence: *without prejudice to the following provisions, Member States shall abolish restrictions on the movement of capital taking place between persons resident in Member States.*

During the preparation of the new Directive the Monetary Committee had to debate a number of specific issues.

(i) *Medium-term credit from the Community*

The progressive liberalization of capital movements in the recent and the coming years, the greater intensity of trade flows to be expected with the completion of the single internal market, and the enlargement of the Community constitute a strong argument for increasing the credit available by way of mutual assistance within the Community. At the same time, the Committee has emphasized the need to preserve the balance between financing and adjustment in the EMS and to ensure that mutual assistance is conditional on undertakings relating to economic policy which are actually put into practice. There was also seen to be a case for consolidating the little used legislation on medium-term financial assistance, which rests on a system of contributions from Member States, with that for Community loans for balance of payments purposes, which are financed by market borrowing in the name of the Community. After prolonged discussion the Committee was able to agree to a consolidated text setting a ceiling of 16 billion ecu for the total amount of such credit which may be outstanding at any one time, and a sub-ceiling of 14 billion ecu for support financed by market borrowing, such borrowing being the normal and preferred form for the activation of the facility. These figures—negotiated in the Monetary Committee—represent a substantial increase on the amount effectively available before. The Committee also prepared the ground for a formal understanding that the concept of balance of payments need, to which this assistance is tied, includes the case of a country introducing a programme of capital liberalization while it considers its balance of payments position to be precarious.

(ii) *Safeguard clause*

The Committee considered very carefully whether the new Directive should allow its provisions to be set aside if capital movements bring an exchange rate under severe pressure. There was some feeling that Treaty Articles 108 and 73 provide the proper means for dealing with such problems, particularly as Article 108 covers balance of payments difficulties whether they occur in the current or the capital accounts. On balance, however, it was felt that a specific clause in the new Directive would be acceptable in view in particular of the potential impact of capital movements on domestic liquidity, if it related only to short-term movements, if it could only be in force for short periods and only if it applied within the framework of a Community procedure.

(iii) *Parallel issues*

Concern was expressed by some members that complete freedom of capital movements might increase the scope for tax evasion and would have premature consequences for the free provision of financial services. It was agreed at an early stage that the solution of these problems should not be made a precondition for progress to capital freedom, but that parallel progress should be made in these associated areas; in fact the Commission has already published a major element of the draft legislation which would provide a framework for the free provision of financial services and is committed by Article 6 and the preamble of the new Directive on capital movements to submit proposals designed to deal with the tax evasion problem before the end of 1988.

(iv) *Movements of capital to and from third countries*

The Committee has stressed on a number of occasions that it is an important objective that the freedom of capital movements should apply in respect of all countries (*erga omnes*) and not just within the Community. There has been concern at various times that capital flows to or from third countries might impede the conduct of monetary policy and a Directive of 1972 contained an elaborate set of provisions related to this problem; however this text reflected circumstances completely different from those now ruling and no longer serves any useful purpose. It therefore seemed preferable to abolish the 1972 Directive and to insert the provisions calling for consultation between Member States in the new legislation alongside the *erga omnes* principle.

The new Directive enacting the full freedom of capital movements and implementing Article 67 of the EEC Treaty passed into law on 24 June 1988 (see Annex 2). It names the Monetary Committee as having the responsibility:

(a) of receiving notification of measures to regulate bank liquidity which have a specific impact on capital transactions carried out by credit institutions with non-residents, and giving opinions thereon;

(b) of being consulted when there is recourse to the specific safeguard clause and of reviewing the working of that clause before the end of 1992;

(c) of advising whether the transitional arrangements for Greece and Portugal should be extended beyond 1992;

(d) of conducting consultations when capital movements to or from third countries produce serious disturbances;

(e) of examining at least once a year the situation regarding free movement of capital.

5. THE REGULAR AND ESTABLISHED TASKS OF THE COMMITTEE

While the strengthening of the EMS and the setting free of capital movements were the distinctive features of the period under review, the Committee also discharged the continuing responsibilities which the life of the Community gives it each year.

(i) At each meeting the *tour d'horizon* gives an opportunity to review recent policy measures and economic developments. This now stands in close relationship to the new procedure for reviewing recent exchange and interest rate developments.

(ii) Twice a year the Committee takes a view of monetary policy in the Community as a whole and of its coherence. The end-year exercise includes a discussion of monetary targets for the following year. In 1987, these assessments had to take account of a growing awareness that institutional changes may be producing shifts in long established demand-for-money functions, but there remains a consensus in the Committee that quantitative monetary targets, if pursued in the light of evolving economic circumstances and particularly external accounts, continue to provide a useful reference point for the monetary authorities.

(iii) Two or three times a year the Committee examines the economic and monetary situation of one member country in depth and these examinations, taking all the countries in turn, frequently result in policy recommendations addressed to the national authorities. In 1987 Ireland and the Federal Republic of Germany were examined in this way. In addition, the Committee continued its surveillance of the extent to which Greece has respected the policy conditions attaching to its Community loan.

(iv) A Council Decision of May 1964 provides that consultations are to take place within the Monetary Committee in respect of any important decision or position taken by Member States in the field of international monetary relations. The Committee therefore prepares the statements which are made each year on behalf of the Member States of the European Community to the Interim Committee of the IMF and to the annual meeting of the Fund and the World Bank. The statement made to the Interim Committee in April 1988 is given in Annex 3.

(v) In the spirit of fostering sound and favourable monetary relations in Europe, the Monetary Committee established special contacts with the monetary authorities of Norway in 1984. They involve primarily the mutual exchange of views and information on matters of common interest. Following a request by the Governor of the *Österreichische Nationalbank* relations of the same kind were instituted with the monetary authorities of Austria in the form of an exchange of letters in 1987.

6. THE LONGER-TERM VIEW OF MONETARY INTEGRATION

Given the substantial progress in strengthening the operating mechanisms of the EMS and in setting capital movements free, the authorities in several Member States have turned their attention to the longer-term aim of economic and monetary union, to which the Community has been committed since 1971. To this end, the European Council in June 1988 entrusted to a committee chaired by Mr Jacques Delors, President of the Commission of the European Communities, the task of studying and proposing concrete stages leading towards this union. It has become possible to put this subject on the agenda because the Member States have already had a large measure of success in establishing an area of monetary stability in Europe and because their commitment to maintain, and to improve upon that achievement is not in doubt. It is, moreover, natural that the completion of the Community's single internal market should be seen as pointing the way ahead: economic and monetary union is in no way a precondition for the completion of the internal market, but progress towards it would enable even greater benefits to be obtained from the single market, for example by the elimination of exchange risk and exchange costs, and by the simplification of payments systems.

In view of the activation of this debate in several quarters in early 1988, and of the request subsequently made by the Council of Ministers, the Monetary Committee has made a brief preliminary report to the Council, and will continue to study possible future developments in this area. It is already clear that three types of work must be undertaken:

(i) the identification of early steps which can be taken within present institutional arrangements and the EEC Treaty as it stands;

(ii) the definition of the form of the economic and monetary union;

(iii) conclusions as to the intermediate steps to be taken, in the medium term, towards the achievement of that objective.

7. CONCLUSIONS

The development of the Community in the monetary dimension has been substantial in the last 18 months. The most conspicuous—and overdue—achievements have come in the field of capital movements, culminating in legislation providing