

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-Ger-

man 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, surveil-

lance 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 constitute 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 au-

thorities 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

for complete freedom in all member countries by the end of 1992, and in most of them by the middle of 1990. But the continuation of exchange rate stability is also of great importance for the daily conduct of trade and industry and for the formation of rational investment decisions. The task of managing the EMS becomes more demanding in the presence of free capital movements and more intensive intra-Community flows of goods and services, and the demands extend beyond the field of monetary policy into public finance. The improvements to the EMS which have been decided upon extend the range of action available to economic policy-makers so that the system can be strengthened in spite of the free movement of capital.

The understandings concerning economic policy, and the enhanced financing arrangements for the exchange rate mechanism, provide a sound basis for the short-term management of the EMS in situations of acute tension. However, they will only win the lasting confidence of the markets if they ensure stability through the pursuit of coherent macroeconomic policies. Thus the commitment to monetary stability remains the really essential part of successful policy towards the EMS, and greater efforts in this respect are needed in some countries. Many of the dominant elements of the policies which will ensure the stability of the EMS have been traced out in the Monetary Committee's previous activity reports. More recent experience has made particularly evident the need to orient public finance in a cooperative way to the requirements of the EMS. The Committee's work has also shown the usefulness of economic indicators, but these cannot be allowed to trigger measures in an automatic way or to become a substitute for policy evaluation. Indicators give the measure of the current situation and can help to improve recognition of inconsistencies in economic policy.

Analysis has revealed that some current-account imbalances may persist within the Community in the near future. Excessive importance should not be given to regional break-downs of current accounts, since what matters for each member country is global balance in its external payments. There are, in the Community, countries whose economic development lags behind for structural reasons. Fortunately, private capital flows within the Community have become a powerful force making for equilibrium; in this situation member countries must pay attention to their basic balances as well as to their current accounts, and to the economic policy which will establish conditions favourable to inflows of private capital through the markets.

The greater stability of the EMS resulting from the convergence of fundamental economic factors, and the actions of the member countries, have helped to protect the system from the disturbances generated by the US dollar in particular. It is as true at world level as in the Community that intervention cannot on its own ensure lasting stability of exchange rates. Lasting stability requires the timely adjustment of economic policies to the macroeconomic objectives incorporated in the major international agreements.

Nyborg, 12 September 1987

STRENGTHENING THE EMS

*(Report by the Chairman of the Monetary Committee
to the informal meeting of the Finance Ministers)*

At the conclusion of last January's Realignment Meeting, Ministers requested the Monetary Committee to examine measures to strengthen the operating mechanisms of the EMS and in responding to this request the Committee has examined a wide range of proposals.

Experience in the recent past and in particular the disturbed conditions in the markets at the end of 1986 revealed the need to strengthen the EMS. This need is all the more pressing because capital flows are becoming larger and more volatile, and because exchange controls, which are in any event losing their effectiveness, are being dismantled. In these circumstances it is above all necessary to make better use of all the instruments as they are at present, but there is also room for improving some of them.

Interim reports were made to Ministers in April and in June of this year. The present report, which, like them, has been drawn up on the personal responsibility of the Chairman, presents the full results of the Committee's work.

I. STRENGTHENING THE EMS: ECONOMIC POLICY

1. Convergence

Last June the European Council confirmed the importance of a strengthening of the EMS for the completion of the internal market which will be a source of stronger, non-inflationary economic growth. In recent years there has been an increasing degree of convergence in the data relating to fundamental economic factors in the Member States. The position is however not yet fully satisfactory in all respects and in all countries. Public sectors deficits and current account balances remain worrying in some cases. Continuous efforts are necessary to preserve the degree of convergence which has been achieved, and to make it more complete.

2. Mutual surveillance

The Monetary Committee is of the view that cooperation within the EMS has to be extended beyond the short-term aspects of policy, in a surveillance process which is expected to reveal in particular:

- (i) inconsistencies of policies within individual EMS countries;
- (ii) inconsistencies between EMS countries;
- (iii) any danger of the emergence of unsustainable positions;
- (iv) incompatible approaches to major third currencies.

Surveillance of this type can be made more effective by the use of macroeconomic indicators and projections. It is considered that in such a process the objectives can be attained which at one stage it was suggested should be pursued through a single indicator of convergence. In July of this year the Committee conducted its first examination on the basis of a set of macroeconomic indicators projected to 1990. The aim is to achieve greater consistency of economic policies within the EMS and in the wider international field. This is to become an established procedure and the Committee will carry out surveillance of this type on a regular basis, probably twice a year.

3. Closer cooperation in the field of monetary policy

Recent experience, and in particular that of late 1986, has shown that close cooperation in the field of monetary policy is an essential component of the EMS. In order to improve convergence and strengthen the EMS in view of the new demands put upon it, it is necessary to raise cooperation to a new level, while respecting the distribution of institutional competences within each country. For this purpose a variety of instruments are available and they should be used in a flexible and comprehensive manner.

- (i) Monetary authorities must stand ready to defend the stability of the parity grid by ensuring that interest rate differentials between EMS countries are appropriate, and to this end there must be a willingness to make timely changes in national rates.
- (ii) The flexible use of the permitted fluctuation margins can, under certain conditions, help to deter speculation.
- (iii) Intra-marginal intervention has a recognized role within the system which is discussed further in point 7.
- (iv) Official and semi-official statements on the exchange rate situation may exacerbate tensions and should be avoided as far as possible

There is an understanding that realignments should in future be infrequent and as small as possible, especially in order to ensure that speculation is not rewarding. This understanding and the appropriate use of the instruments mentioned above constitute the core of a stronger management of the system.

Alongside the Committee of Governors, the Monetary Committee examines the latest exchange and interest rate developments at each monthly meeting and considers what conclusions can be drawn.

4. Coordination of policies towards USA and Japan

The Louvre Agreement, as reaffirmed in Washington in April, was an important step forward in international cooperation on exchange rates and improves the environment for the EMS. The markets, which were initially sceptical, have subsequently shown signs of accepting that there has been a change in the conditions in which they operate. This changed perception has been due to the determination with which the parties to the agreement have cooperated in the short-term management of the system. However, an essential feature of the new approach to exchange rates is the commitment to appropriate economic policy measures, and some of the necessary steps have not yet been fully implemented, particularly in the USA and Japan.

II. STRENGTHENING THE EMS: TECHNICAL EXCHANGE RATE ISSUES

This is an area of responsibility which also concerns the Committee of Central Bank Governors very closely. The discussions in the Monetary Committee, and much experience, have shown that there is scope for improving the functioning of the EMS within the present structure of the system. Members have moreover stressed the need for caution before proceeding to the introduction or extension of automatic obligations.

5. Divergence indicator

The divergence indicator has lost some of its significance as a result of the widespread use of intra-marginal intervention. Although some technical imperfections have been identified in the present method of calculating the indicator, a set of simulations conducted with the aid of Commission staff has shown that the elimination of these imperfections would not greatly improve its effectiveness. The divergence indicator is regarded by the Committee as a useful but not as a privileged source of information about the situation in the exchange rate mechanism. The Monetary Committee will continue to use the divergence indicator in its internal examination of exchange and interest rates and will endeavour to make that use more effective.

6. Intra-marginal intervention

Intra-marginal intervention has played an important role in the past, although this was not anticipated in the EMS Agreement. It can be useful, particularly in the event of external shocks, but it can cause problems if conducted on a substantial scale and in a rigid way. It should not be seen as an alternative to the adjustment of policies when that is necessary, and it should not be seen as a substitute for the use of other instruments; large and persistent intra-marginal intervention raises the question as to whether other instruments, in particular interest rates, have been used in an adequate and timely fashion. It is a key feature of the EMS that intra-marginal intervention in Member States' currencies is a matter for consultation since the central bank issuing the intervention currency has an interest in the techniques and in the amounts used.

At present there is no right of access to the very short-term financing (VSTE) arrangements to cover intra-marginal intervention. In special cases it can be so used by mutual agreement. Such access should in future be possible within certain limits and unless the central bank whose currency is being used shows that there are reasons justifying a refusal. However, such an extension of present arrangements must not entail a relaxation of the disciplinary effect of the EMS.

7. Cross-holdings of EMS currencies in member countries' reserves

Cross-holdings of EMS currencies and holdings of private ecus in reserves would be seen by some members as a sign of increased solidarity. On the other hand other members emphasized that not all EMS currencies can be used with equal ease in the markets, and that this issue has implications for attitudes to the development of the international monetary system. The Committee noted that the present EMS Agreement allows the holding of working balances in partner currencies, while larger holdings require the consent of partner central banks.

The Committee will discuss further whether, and, if so, in what conditions the cross-holding of Member States' currencies could have a constructive and stabilizing effect on the development of the EMS and of the international monetary system.

8. The financing available for compulsory intervention

The discussion on this subject showed that there is a consensus in favour of some extension of the time-limit for initial settlement under the VSTF and for some raising of the ceiling for automatic renewal under that facility.

As regards the settlement of debts incurred under the VSTF in official ecu, this can be effected as of right to the extent of 50% of the amount due, although 100%

of the amount may be settled in this way by agreement. Some members consider that this formal limit is inconsistent with the central role envisaged for the ecu in the system, but it is to be borne in mind that any higher formal limit would mean extending an obligation. Nevertheless, given the satisfactory experience so far with official ecu mechanisms, which has not given rise to excessive debtor or creditor positions in ecu, there is now a willingness to go beyond this limit *in practice* and to review the formal obligations at a later stage.

9. The use of the ecu

Since provision has been made in all member countries for the free use of the private ecu, the Committee has again taken up certain questions related to the use of the private ecu as a reserve and intervention currency; these matters will be discussed further in the Committee.

10. Realignment procedure

The Monetary Committee is of the view that there is no such thing as a technical realignment. Experience has shown that even small general changes of central rates can raise issues of political importance. No technical changes need to be made to the present procedure, but it is desirable to de-dramatize realignments as far as possible. The usual practice should be for the decision to be prepared by the Monetary Committee, and given the approval of ministers by telephone, whenever possible.

11. Special regimes

The countries of the Community have several different statutes as regards monetary integration:

- (i) Members of ERM having special arrangements (wider margin, double exchange market);
- (ii) EMS members not participating in the ERM;
- (iii) countries outside EMS.

It is desirable that all make the efforts necessary to the extent that conditions allow. This is however basically a matter for decision by the countries concerned. The dismantling of present special regimes and the creation of uniform conditions in the ERM would strengthen the EMS, but at this stage there may be more pressing steps such as the recent liberalization of capital movements in Italy which also are in the interests of the system.

III. FULL FREEDOM OF CAPITAL MOVEMENTS

The Monetary Committee has always pressed for a more complete implementation of the freedom for capital movements which is laid down in the Rome Treaty. It therefore welcomes the Commission's announced intention of presenting in the near future a draft of a new Directive which would lead to full capital liberalization. Substantial progress has been made over the last two years and it is a matter of great satisfaction that the Community authorities have been able to abrogate the safeguard clauses which applied to France and Italy. Moreover, independently of the many changes made to exchange control legislation, the growing internationalization of capital markets has been reflected in a large increase in the volume of capital flows, and controls have become less effective. In its recent discussions the Monetary Committee concentrated on the monetary implications of capital liberalization, and has not dealt with other aspects such as the fiscal issues.

12. Relationship between capital liberalization and the EMS

Capital liberalization is changing the environment within which the EMS must be managed and there will in particular be much less room for independent monetary policies within the system.

These developments have many implications. On the one hand the greater need to adjust economic policies will help to make the system secure on a lasting basis. Moreover, the commitment to full liberalization will be seen by the markets as a sign that the EMS authorities are confident in the strength of the system. On the other hand the move to complete freedom of capital movements is as such not without risk. Member countries do not all start from the same position, particularly as regards the degree of development of their financial systems. However, the Committee is convinced that the stability of exchange rates can be maintained in the new situation provided that cooperation within the system is intensified, and provided that appropriate transitional arrangements can be made for specific cases.

13. Safeguard clause

It should be recalled that the Rome Treaty itself includes a number of safeguard clauses and in particular Article 73 relating to disturbances to capital markets, and Articles 108 and 109 relating to balance-of-payments problems.

Several members of the Committee are however of the opinion that these clauses do not cover the specific problems which can arise from capital liberalization, and that the procedures involved are too inflexible. They therefore argue that the new draft Directive should include a specific safeguard clause for dealing with financial

disturbances arising for purely monetary reasons when the fundamental economic situation is sound.

Other members view the question rather differently and consider that monetary movements are always closely linked to the soundness of the fundamental situation and to the credibility of the authorities' policies. These members generally consider that the existing safeguard clauses are sufficient, although some of them would prefer to have available an escape clause relating exclusively to capital inflows which threaten stability-oriented monetary policy.

This question requires further discussion; if agreement is to emerge, it must be clear that the clause will apply

- (i) only for short periods of time;
- (ii) exclusively to transactions not yet liberalized;
- (iii) only in exceptional circumstances;
- (iv) by a Community procedure.

There was also discussion of the future role of the 1972 Directive on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity. Many members are of the opinion that in the fundamentally different conditions of today this Directive is no longer necessary and should be abrogated.

14. Medium-term credit facilities

The Committee has reviewed the Community's medium-term credit mechanisms. In its view the Community loan mechanism is the normal instrument, and medium-term financial assistance should be retained only as a safety net. Many members argued that the scope of the Community loan mechanism should be extended so as to make it available to countries in which the fundamental economic situation is sound and which introduce a substantial programme of capital liberalization; the extension would thus be subject to specific conditionality. It is felt by some members that this extension might be needed to deal with the substantial adjustment of private portfolios which may follow liberalization. Moreover, several members argued for raising the limits applying to medium-term Community credit.

However, other members consider that no change is desirable in the size or conditions of access to these facilities. They doubt whether substantial additional intervention will be necessary as a result of liberalization, if appropriate policies are followed, although it may be necessary to change policy mixes.

15. Supervisory problems

The complete liberalization of capital movements is only one element in the financial integration of the Community. The freedom to provide financial services across national boundaries within the Community is also potentially a source of great benefit and it is to be hoped that there will be rapid and simultaneous advance on both these fronts. The Banking Advisory Committee is at present discussing a full programme to achieve the liberalization of financial services, including new draft Directives which will be presented to the Council. The Committee has taken note of the Commission's view that the full liberalization of capital movements is not conditional on the implementation of any element of the freedom to provide financial services.

IV. CONCLUSIONS

The most important conclusions which can be drawn from the Committee's work as a whole are as follows.

1. Particularly in view of the increasing mobility of capital and the progressive liberalization of capital movements, a strengthening of the EMS is desirable.
2. The basis for this strengthening must be a further improvement of the fundamental economic factors. This requires above all a reinforcement of efforts to bring about a progressive convergence of economic and financial policies and still closer cooperation in the field of monetary policy. To this end periodic monitoring should take place in the competent committees, supported by the use of macroeconomic indicators, account being taken of relationships with the important international currencies, particularly the US dollar and the yen.
3. Further progress is also desirable in cooperation within the EMS exchange rate mechanism. One-way speculative capital movements can and should be countered in future by a flexible use of available instruments and policies. In this connection, there is a consensus in favour of granting access to the VSTF for some financing of intra-marginal intervention, as indicated above. Further, the financing available under this facility could be somewhat extended in time and amount. These changes would only be acceptable if the necessary balance is preserved between adjustment and financing within the EMS.

In the view of the Committee there is also room for progress in the field of the acceptability of the ecu.

4. Further, the special regimes which still exist (wider margins, non-participation in the exchange rate mechanism, double exchange market) should be permanently subject to review to decide whether circumstances justify their continuation.

5. The creation of the single domestic market in the Community requires a liberalization of capital movements. This liberalization process will increase the credibility of European cooperation in the field of monetary policy. In the view of the Committee, the stability of the EMS can continue to be assured even while capital movements are further liberalized, in so far as cooperation within the system is intensified in the ways described above and appropriate transitional arrangements are made in specific cases.

COUNCIL DIRECTIVE

of 24 June 1988

for the implementation of Article 67 of the Treaty

(88/361/EEC)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Articles 69 and 70(1) thereof,

Having regard to the proposal from the Commission, submitted following consultation with the Monetary Committee,¹

Having regard to the opinion of the European Parliament,²

Whereas Article 8a of the Treaty stipulates that the internal market shall comprise an area without internal frontiers in which the free movement of capital is ensured, without prejudice to the other provisions of the Treaty;

Whereas Member States should be able to take the requisite measures to regulate bank liquidity; whereas these measures should be restricted to this purpose;

Whereas Member States should, if necessary, be able to take measures to restrict, temporarily and within the framework of appropriate Community procedures, short-term capital movements which, even where there is no appreciable divergence in economic fundamentals, might seriously disrupt the conduct of their monetary and exchange-rate policies;

Whereas, in the interests of transparency, it is advisable to indicate the scope, in accordance with the arrangements laid down in this Directive, of the transitional measures adopted for the benefit of the Kingdom of Spain and the Portuguese Republic by the 1985 Act of Accession in the field of capital movements;

Whereas the Kingdom of Spain and the Portuguese Republic may, under the terms of Articles 61 to 66 and 222 to 232 respectively of the 1985 Act of Accession,

¹ OJ C 26, 1.2.1988, p. 1.

² Opinion delivered on 17 June 1988 (not yet published in the Official Journal).

postpone the liberalization of certain capital movements in derogation from the obligations set out in the First Council Directive of 11 May 1960 for the implementation of Article 67 of the Treaty,³ as last amended by Directive 86/566/EEC;⁴ whereas Directive 86/566/EEC also provides for transitional arrangements to be applied for the benefit of those two Member States in respect of their obligations to liberalize capital movements; whereas it is appropriate for those two Member States to be able to postpone the application of the new liberalization obligations resulting from this Directive;

Whereas the Hellenic Republic and Ireland are faced, albeit to differing degrees, with difficult balance-of-payments situations and high levels of external indebtedness; whereas the immediate and complete liberalization of capital movements by those two Member States would make it more difficult for them to continue to apply the measures they have taken to improve their external positions and to reinforce the capacity of their financial systems to adapt to the requirements of an integrated financial market in the Community; whereas it is appropriate, in accordance with Article 8c of the Treaty, to grant to those two Member States, in the light of their specific circumstances, further time in which to comply with the obligations arising from this Directive;

Whereas, since the full liberalization of capital movements could in some Member States, and especially in border areas, contribute to difficulties in the market for secondary residences; whereas existing national legislation regulating these purchases should not be affected by the entry into effect of this Directive;

Whereas advantage should be taken of the period adopted for bringing this Directive into effect in order to enable the Commission to submit proposals designed to eliminate or reduce risks of distortion, tax evasion and tax avoidance resulting from the diversity of national systems for taxation and to permit the Council to take a position on such proposals;

Whereas, in accordance with Article 70(1) of the Treaty, the Community shall endeavour to attain the highest possible degree of liberalization in respect of the movement of capital between its residents and those of third countries;

Whereas large-scale short-term capital movements to or from third countries may seriously disturb the monetary or financial situation of Member States or cause serious stresses on the exchange markets; whereas such developments may prove harmful for the cohesion of the European Monetary System, for the smooth operation of the internal market and for the progressive achievement of economic and monetary union; whereas it is therefore appropriate to create the requisite conditions for concerted action by Member States should this prove necessary;

³ OJ 43, 12.7.1960, p. 921/60.

⁴ OJ L 332, 26.11.1986, p. 22.

Whereas this Directive replaces Council Directive 72/156/EEC of 21 March 1972 on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity;¹ whereas Directive 72/156/EEC should accordingly be repealed,

HAS ADOPTED THIS DIRECTIVE:

Article 1

1. Without prejudice to the following provisions, Member States shall abolish restrictions on movements of capital taking place between persons resident in Member States. To facilitate application of this Directive, capital movements shall be classified in accordance with the Nomenclature in Annex I.²
2. Transfers in respect of capital movements shall be made on the same exchange rate conditions as those governing payments relating to current transactions.

Article 2

Member States shall notify the Committee of Governors of the Central Banks, the Monetary Committee and the Commission, by the date of their entry into force at the latest, of measures to regulate bank liquidity which have a specific impact on capital transactions carried out by credit institutions with non-residents.

Such measures shall be confined to what is necessary for the purposes of domestic monetary regulation. The Monetary Committee and the Committee of Governors of the Central Banks shall provide the Commission with opinions on this subject.

Article 3

1. Where short-term capital movements of exceptional magnitude impose severe strains on foreign-exchange markets and lead to serious disturbances in the conduct of a Member State's monetary and exchange rate policies, being reflected in particular in substantial variations in domestic liquidity, the Commission may, after consulting the Monetary Committee and the Committee of Governors of the Central Banks, authorize that Member State to take, in respect of the capital movements listed in Annex II, protective measures the conditions and details of which the Commission shall determine.

¹ OJ L 91, 18.4.1972, p. 13.

² Not printed here: see OJ L 178/8, 8.7.1988.

2. The Member State concerned may itself take the protective measures referred to above, on grounds of urgency, should these measures be necessary. The Commission and the other Member States shall be informed of such measures by the date of their entry into force at the latest. The Commission, after consulting the Monetary Committee and the Committee of Governors of the Central Banks, shall decide whether the Member State concerned may continue to apply these measures or whether it should amend or abolish them.
3. The decisions taken by the Commission under paragraphs 1 and 2 may be revoked or amended by the Council acting by a qualified majority.
4. The period of application of protective measures taken pursuant to this Article shall not exceed six months.
5. Before 31 December 1992, the Council shall examine, on the basis of a report from the Commission, after delivery of an opinion by the Monetary Committee and the Committee of Governors of the Central Banks, whether the provisions of this Article remain appropriate, as regards their principle and details, to the requirements which they were intended to satisfy.

Article 4

This Directive shall be without prejudice to the right of Member States to take all requisite measures to prevent infringements of their laws and regulation, *inter alia* in the field of taxation and prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information.

Application of those measures and procedures may not have the effect of impeding capital movements carried out in accordance with Community law.

Article 5

For the Kingdom of Spain and the Portuguese Republic, the scope, in accordance with the Nomenclature of capital movements contained in Annex 1, of the provisions of the 1985 Act of Accession in the field of capital movements shall be as indicated in Annex III.

Article 6

1. Member States shall take the measures necessary to comply with this Directive no later than 1 July 1990. They shall forthwith inform the Commission thereof.

They shall also make known, by the date of their entry into force at the latest, any new measure or any amendment made to the provisions governing the capital movements listed in Annex I.

2. The Kingdom of Spain and the Portuguese Republic, without prejudice for these two Member States to Articles 61 to 66 and 222 to 232 of the 1985 Act of Accession, and the Hellenic Republic and Ireland may temporarily continue to apply restrictions to the capital movements listed in Annex IV, subject to the conditions and time-limits laid down in that Annex.

If, before expiry of the time-limit set for the liberalization of the capital movements referred to in Lists III and IV of Annex IV, the Portuguese Republic or the Hellenic Republic considers that it is unable to proceed with liberalization, in particular because of difficulties as regards its balance of payments or because the national financial system is insufficiently adapted, the Commission, at the request of one or other of these Member States, shall in collaboration with the Monetary Committee, review the economic and financial situation of the Member State concerned. On the basis of the outcome of this review, the Commission shall propose to the Council an extension of the time-limit set for liberalization of all or part of the capital movements referred to. This extension may not exceed three years. The Council shall act in accordance with the procedure laid down in Article 69 of the Treaty.

3. The Kingdom of Belgium and the Grand Duchy of Luxembourg may temporarily continue to operate the dual exchange market under the conditions and for the periods laid down in Annex V.

4. Existing national legislation regulating purchases of secondary residences may be upheld until the Council adopts further provisions in this area in accordance with Article 69 of the Treaty. This provision does not affect the applicability of other provisions of Community law.

5. The Commission shall submit to the Council, by 31 December 1988, proposals aimed at eliminating or reducing risks of distortion, tax evasion and tax avoidance linked to the diversity of national systems for the taxation of savings and for controlling the application of these systems.

The Council shall take a position on these Commission proposals by 30 June 1989. Any tax provisions of a Community nature shall, in accordance with the Treaty, be adopted unanimously.

Article 7

1. In their treatment of transfers in respect of movements of capital to or from third countries, the Member States shall endeavour to attain the same degree of

liberalization as that which applies to operations with residents of other Member States, subject to the other provisions of this Directive.

The provisions of the preceding subparagraph shall not prejudice the application to third countries of domestic rules or Community law, particularly any reciprocal conditions, concerning operations involving establishment, the provisions of financial services and the admission of securities to capital markets.

2. Where large-scale short-term capital movements to or from third countries seriously disturb the domestic or external monetary or financial situation of the Member States, or of a number of them, or cause serious strains in exchange relations within the Community or between the Community and third countries, Member States shall consult with one another on any measure to be taken to counteract such difficulties. This consultation shall take place within the Committee of Governors of the Central Banks and the Monetary Committee on the initiative of the Commission or of any Member State.

Article 8

At least once a year the Monetary Committee shall examine the situation regarding free movement of capital as it results from the application of this Directive. The examination shall cover measures concerning the domestic regulation of credit and financial and monetary markets which could have a specific impact on international capital movements and on all other aspects of this Directive. The Committee shall report to the Commission on the outcome of this examination.

Article 9

The First Directive of 11 May 1960 and Directive 72/156/EEC shall be repealed with effect from 1 July 1990.

Article 10

This Directive is addressed to the Member States.

Done at Luxembourg, 24 June 1988.

For the Council
The President
M. BANGEMANN

ANNEXE II

LIST OF OPERATIONS REFERRED TO IN ARTICLE 3 OF THE DIRECTIVE

| Nature of operation | Heading |
|--|----------------|
| Operations in securities and other instruments normally dealt in on the money market | V |
| Operations in current and deposit accounts with financial institutions | VI |
| Operations in units of collective investment undertakings | IV-A and B (c) |
| — undertakings for investment in securities or instruments normally dealt in on the money market | |
| Financial loans and credits | VIII-A and B-1 |
| — short-term | |
| Personal capital movements | XI-A |
| — loans | |
| Physical import and export of financial assets | XII |
| — securities normally dealt in on the money market | |
| — means of payment | |
| Other capital movements: Miscellaneous | XIII F |
| — short-term operations similar to those listed above | |

The restrictions which Member States may apply to the capital movements listed above must be defined and applied in such a way as to cause the least possible hindrance to the free movement of persons, goods and services.

| Articles of the Act of Accession (dates of expiry of transitional provisions) | Nature of operation | Heading |
|---|---|------------------------------|
| (b) Provisions concerning the Portuguese Republic (cont'd) | | |
| Article 229 (31.12.1990) | <p>Operations in securities normally dealt in on the capital market</p> <ul style="list-style-type: none"> – Acquisition by residents of foreign securities dealt in on a stock exchange <ul style="list-style-type: none"> – excluding bonds issued on a foreign market and denominated in national currency <p>Operations in units of collective investment undertakings</p> <ul style="list-style-type: none"> – Acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange <ul style="list-style-type: none"> – excluding units of undertakings taking the form of common funds | <p>III-A-2</p> <p>IV-A-2</p> |

ANNEX IV

REFERRED TO IN ARTICLE 6 (2) OF THE DIRECTIVE

- I. The Portuguese Republic may continue to apply or reintroduce, until 31 December 1990 restrictions existing on the date of notification of the Directive on capital movements given in List I below:

LIST I

| Nature of operation | Heading |
|--|------------|
| Operations in units of collective investment undertakings | |
| — Acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange | IV-A-2 (a) |
| — undertakings subject to Directive 85/611/EEC ¹ and taking the form of common funds | |
| — Acquisition by residents of units of foreign collective investment undertakings not dealt in on a stock exchange | IV-A-4 (a) |
| — undertakings subject to Directive 85/611/EEC ¹ | |

¹ Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 375, 31.12.1985, p. 3).

- II. The Kingdom of Spain and the Portuguese Republic may continue to apply or reintroduce, until 31 December 1990 and 31 December 1992 respectively, restrictions existing on the date of notification of the Directive on capital movements given in List II below:

LIST II

| Nature of operation | Heading |
|--|------------------|
| Operations in securities normally dealt in on the capital market | |
| — Acquisition by residents of foreign securities dealt in on a stock exchange | III-A-2 (b) |
| — bonds issued on a foreign market and denominated in national currency | |
| — Acquisition by residents (non-residents) of foreign (domestic) securities not dealt in on a stock exchange | III-A-3 and 4 |
| — Admission of securities to the capital market | III-B-1 and 2 |
| — where they are dealt in on or in the process of introduction to a stock exchange in a Member State | |
| Operations in units of collective investment undertakings | |
| — Acquisition by residents of units of foreign collective investment undertakings dealt in on a stock exchange | IV-A-2 |
| — undertakings not subject to Directive 85/611/EEC ¹ and taking the form of common funds | |
| — Acquisition by residents (non-residents) of units of foreign (domestic) collective investment undertakings not dealt in on a stock exchange | IV-A-3 and 4 |
| — undertakings not subject to Directive 85/611/EEC ¹ and the sole object of which is the acquisition of assets that have been liberalized | |
| — Admission to the capital market of units of collective investment undertakings | IV-B-1 and 2 (a) |
| — undertakings subject to Directive 85/611/EEC ¹ | |
| Credits related to commercial transactions or to the provision of services in which a resident is participating | VII-A and B-3 |
| — Long-term credits | |

¹ See footnote to List I.

III. The Hellenic Republic, the Kingdom of Spain, Ireland and the Portuguese Republic may, until 31 December 1992, continue to apply or reintroduce restrictions existing at the date of notification of the Directive on capital movements given in List III below:

LIST III

| Nature of operation | Heading |
|---|----------------------|
| Operations in securities dealt in on the capital market – Admission of securities to the capital market – where they are not dealt in on or in the process of introduction to a stock exchange in a Member State | III-B-1 and 2 |
| Operations in units of collective investment undertakings – Admission to the capital market of units of collective investment undertakings – undertakings not subject to Directive 85/611/EEC ¹ and the sole object of which is the acquisition of assets that have been liberalized | IV-B-1 and 2 |
| Financial loans and credits – medium-term and long-term | VIII-A and B-2 and 3 |

¹ See footnote to List I.

IV. The Hellenic Republic, the Kingdom of Spain, Ireland and the Portuguese Republic may, until 31 December 1992, defer liberalization of the capital movements given in List IV below:

LIST IV

| Nature of operations | Heading |
|---|----------------|
| Operations in securities and other instruments normally dealt in on the money market | V |
| Operations in current and deposit accounts with financial institutions | VI |
| Operations in units of collective investment undertakings – undertakings for investment in securities or instruments normally dealt in on the money market | IV-A and B (c) |
| Financial loans and credits – short term | VIII-A and B-1 |
| Personal capital movements – loans | XI-A |
| Physical import and export of financial assets – securities normally dealt in on the money market – means of payment | XII |
| Other capital movements: Miscellaneous | XIII-F |

ANNEXE V

Since the dual exchange market system, as operated by the Kingdom of Belgium and the Grand Duchy of Luxembourg, has not had the effect of restricting capital movements but nevertheless constitutes an anomaly in the EMS and should therefore be brought to an end in the interests of effective implementation of the Directive and with a view to strengthening the European Monetary System, these two Member States undertake to abolish it by 31 December 1992. They also undertake to administer the system, until such time as it is abolished, on the basis of procedures which will still ensure the *de facto* free movement of capital on such conditions that the exchange rates ruling on the two markets show no appreciable and lasting differences.

Washington, 14 April 1988

*Statement by Mr Gerhard Stoltenberg,
Chairman of the Council of the European Communities,
to the Interim Committee of the IMF*

Since Germany currently holds the presidency of the Council of the European Communities, I have the honour of addressing this meeting on behalf of the Member States of the Community.

Economic activity in the industrialized countries during 1987 turned out stronger than expected. The outlook for 1988 and 1989 is one of moderate growth, although unemployment will remain high in many countries. This growth will be accompanied by an encouraging degree of price stability and progress in reducing international imbalances. The stock market decline of last October did not affect confidence as negatively as initially feared. The coordinated policy actions undertaken by the industrialized countries have brought about a noticeable shift of real resources from the domestic to the external sector in the United States and vice versa in the surplus countries. However, imbalances will remain large and further efforts will be needed to bring them down towards more sustainable levels.

The close cooperation between our countries in the European Monetary System, and the international cooperation confirmed and intensified last December, have also contributed to greater stability in exchange markets. These developments are creating a favourable climate for improvements in the functioning of the international monetary system.

Nevertheless, there are risks and uncertainties. Therefore, the main policy task for the industrialized countries lies in building on the progress already achieved, by pursuing the policies that are needed for the adjustment of external imbalances. This would foster exchange rate stability through a strengthening of the underlying economic fundamentals, and promote self-sustaining non-inflationary growth. The use of indicators can be helpful in promoting cooperation.

In the major deficit countries, in particular in the United States, this requires further progress in reducing fundamental fiscal imbalances, while surplus countries need to sustain adequate rates of growth of domestic demand and tackle structural imbalances.

We are aware of the important role the European Community and its Member States can play in supporting the international adjustment process. Within the

framework of the Cooperative Growth Strategy, the Member States of the Community are committed to effective coordination of economic policies. An important element of this strategy is the maintenance of an adequate rate of growth in domestic demand, without endangering medium-term fiscal objectives. The growing convergence of economic policies has been reflected in a remarkable degree of stability in the European Monetary System on the basis of improved price stability. In this way, the European Monetary System has also contributed to a stabilization of exchange rate relations in the international context. Moreover, the Community is now going ahead with the completion of the internal market for goods, services and capital by 1992 which should unleash new forces for growth. Rapid progress in removing the remaining barriers between member countries together with the reduction of structural rigidities and a strengthening of supply-side conditions should also help alleviate the pressing problem of high unemployment in the Community. More dynamic, efficient and open markets in the Community will provide increased opportunities for both our industrial and developing trading partners.

The industrialized countries, however, are not the only ones who have a responsibility towards the world economy. Other countries with strong external positions, particularly those in East Asia, should also contribute to promoting the adjustment of international imbalances by liberalizing their trade regimes, by reducing their degree of export dependence and by allowing exchange rates to adjust in order better to reflect their relative economic strength.

A credible and continuing fight against protectionism is a key requirement for sustaining economic growth and for reducing international imbalances and the debt servicing problems of the developing countries. The Community strongly supports a successful conclusion of the Uruguay Round with its commitment to standstill and rollback and an expanded role for the GATT. For the Community countries, progress in these negotiations in all areas, including improved market access for the developing countries, is a major goal.

A stable international environment, including sustained non-inflationary growth, low interest rates, more stable exchange relations and open markets, is an essential condition for the developing countries to overcome their pressing economic and financial problems. While a good deal of progress has been made thus far within the cooperative, case-by-case approach to developing countries' debt problems, for many indebted countries the economic situation remains fragile.

Growth rates continue to vary considerably between different regional country groups. Compared with the strong economic expansion which is under way in Asian countries, economic growth in many countries of sub-Saharan Africa and Latin America remains insufficient to achieve an increase in living standards or a lasting reduction of debt ratios.

While this is partly due to unfavourable external developments, including large terms-of-trade losses, especially in countries with an undiversified export base, it

can also be attributed to slippages in macro-economic policy. Many indebted countries still have unsustainably large fiscal deficits and high and rising rates of inflation.

This underscores the need for stronger multilateral efforts and for further adjustment efforts in the developing countries to overcome deep-seated financial and structural imbalances. It also points to a need for flexibility, sensitivity and patience, with due regard to the individual circumstances of each country and for the continued use of the case-by-case principle.

As far as the low-income countries are concerned, important steps have been taken during the course of the last year. The successful conclusion of the eighth IDA replenishment, the establishment of the Enhanced Structural Adjustment Facility in the IMF, and the World Bank's Special Programme of Assistance for low income debt-distressed countries in sub-Saharan Africa have given an important boost to the growth-oriented adjustment efforts of low income debtors. The Paris Club has granted longer repayment periods for some of the poorest countries and proposals have been discussed for reducing interest rates.

Turning to the middle-income debtors, difficulties remain in ensuring an adequate flow of financial resources. A lasting solution to the debt problem can only be achieved if indebtedness and debt-servicing capacity are reconciled through appropriate adjustment policies, against the background of sustained growth of the world economy. Countries which pursue strong adjustment policies deserve strong financial support. The greater use of new financing techniques under the 'menu of options' approach can provide greater flexibility in creditor-debtor relations; it may contribute to an easing of the debt service burden and encourage new financial and banking flows. It remains essential, however, that creditors and debtors arrive at voluntary, mutually-agreed solutions and act on their own responsibility. It is not the responsibility of governments to take over the risks of the banks. The task of governments is to allow the banks adequate flexibility by regulatory and fiscal means, as they have already done in several countries.

There is no doubt that the international organizations, especially the IMF and the World Bank, have to continue to play their central role in a cooperative debt strategy. This requires these institutions to be equipped with the necessary means and instruments for fulfilling their key role. We welcome the unanimous agreement that has now been reached on the substantial general increase in the World Bank's capital and we are looking forward to its speedy implementation. The Member States of the European Community also support a quota increase in the IMF sufficient to ensure that the Fund can continue to play its central role as the global monetary institution without excessive reliance on borrowed resources.

Given the often narrow path that indebted countries have to follow in balancing the need for strong, lasting reforms and securing the necessary public support and

acceptance, the IMF, too, must continue to show an adequate degree of flexibility without endangering its principles. One objective of the ongoing review of the IMF's lending policies must be to strengthen the Fund's ability to assist effectively its member countries in their pursuit of growth-oriented adjustment policies. The Managing Director's proposals concerning the EFF are being studied in this context. The Fund should also be better equipped to assist its member countries when confronted by certain unforeseen adverse external circumstances.

However, when discussing these issues we need to ensure that IMF conditionality is not weakened and that Fund resources are used in support of programmes which clearly offer the prospect of medium-term viability. The observance of this principle in the IMF is essential to safeguard the revolving nature of the Fund's resources, but it is also important because the role of the Fund as a catalyst of additional financial resources depends crucially on the confidence created by credible stabilization programmes.

In addition to the continued need for consistent macroeconomic policies, structural reforms in the context of growth-oriented adjustment are also essential. Therefore, it has become increasingly important that the IMF and the World Bank cooperate closely—each within its respective field of responsibility and expertise—in order to ensure the complementary character of their advice and financial support to member countries.

The increase of its general capital will provide the World Bank with the resources necessary to play an increased role in supporting growth and structural adjustment. As is the case with the Fund, the Bank can only provide a fraction of the overall financing needs of members. This underscores the catalytic role of the Bank which rests on the credibility and effectiveness of its programmes.

While the main emphasis of the Bank has to remain on project-based lending, quick-disbursing adjustment loans have become an important element in the Bank's development programmes.

Care should be taken, however, to ensure that these loans effectively strengthen the productive capacity of recipient countries. We therefore welcome the ongoing evaluation by the World Bank's Executive Directors of the experience with such lending.

Mr. Chairman, the Community and its Member States will continue to contribute its part to the common efforts of the Fund membership to enhance and spread sustainable world economic growth which is a key to solving many of the problems in the industrialized as in developing countries. The Community countries recognize the undiminished need for an influential role of the Fund and the Bank. As in the past, both institutions can rely on our strong and active support.

European Communities — Monetary Committee

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