II-C-1/HW.ds/11.8.71

PROSPECTS FOR A EUROPEAN MONETARY UNION

I. What do we mean with Monetary Union

Characteristics of the final stage. The process towards monetary union.

II. Why Monetary Union

1. Political motivation

2. Economic motivation

III. Activities in the Past

1. Treaty of Rome and additional decisions

2. Capital movements

IV. Recent Actions and Proposals towards Monetary Integration

1. The Barre Plan 12.2.69
   a) Objectives of economic policy
   b) Prior consultations
   c) Short-term monetary support mechanism
   d) Medium-term financial support mechanism

2. The Hague Meeting 1.12.69

3. The Plan in Steps towards Monetary Union

4. The Werner Committee

5. The Ansiaux Report
   The economics of the reduction of margins. The institutional framework. The Fund.

V. <u>Council Decisions on Economic and Monetary Union 22.3.71</u>

1. <u>The Final Objectives</u>

a) Definition of the EMU
b) Distribution of Competences

2. <u>Common Instruments</u>

3. <u>First Stage: Three years</u>

a) Intensification of coordination of short-term economic policies (Council Decision)
b) Acceleration of free circulation of persons, goods, services and capital
c) Coordination of internal monetary policy (Council Decision)

4. <u>Review over the First Stage and Transition to the Second Stage</u>

VI. <u>The Exchange Rate Policy of the Community: Towards more Flexibility</u>

VII. <u>The Monetary Crisis of May 1971</u>

1. <u>The Origin of the Crisis</u>

a) Time lags in the short-term economic development between the U.S. and Europe
b) Structural factors responsible for short-term capital movements
c) Reduced efficacy of monetary policy

2. <u>Possible Solutions</u>

a) Better coordination of monetary policy
b) Changing policy mix
c) Regulation of international capital flows
d) Double exchange market
e) Widening of exchange rate margins

3. <u>Council Resolution of 8/9 May 1971</u>

4. <u>Council Session of 2 July 1971</u>

PROSPECTS FOR A EUROPEAN MONETARY UNION

I. WHAT TO DO WE MEAN WITH MONETARY UNION ?

Complete and unconditional absence of exchange risk in any possible form within the integrated area. Within this area, there is absolute freedom to move for persons, goods, services and capital.

1. All parity changes within the Community are excluded. The block may move as a whole against the rest of the world.

2. All fluctuations in the mutual rates in the foreign exchange markets (both officially regulated and the "free" markets) are eliminated.

3. Currencies are mutually completely convertible (external and internal convertibility).

The official intervention on the exchange market with respect to the rest of the world is carried out by a Community organ. Exchange reserves are completely pooled.

Such a situation would permit the creation of a common currency. This additional step does have important advantages:

- exchange operations within the Community are no longer needed;

- it creates a symbol to the public;

- it would make parity charges within the Community non only illegal but also impossible.

There is to a large extent agreement in the Community about the final objectives of such a union.

- these objectives seem rather far away and its implications have not yet been discussed in any detail;

- the problems of transfer of sovereignty have to be analyzed at the highest possible level;

- monetary union is a political goal, the inherent economic problems in the final stage can rather easy be assessed in general terms.

There are <u>widely divergent opinions</u> as to the process to reach monetary union because

– one observes different approaches (economic steps first vs. monetary steps first; small vs. big steps; adoption of intermediate goals; differences in objectives in economic policy; difference in degree to which the economy is likely to be kept under control; differences in overall philosophy of integration);

– gains are evident in the long run but in the immediate future the sacrifices appear often more clearly;

– during the transitional period, the European monetary system is likely to have a hybrid character. This may cause difficult problems, though not unsolvable.

II. <u>WHY MONETARY UNION?</u>

1. <u>Political motivation</u>: a newly discovered feeling of solidarity and mutual dependence after two senseless word wars. Treaty: its ultimate aim consists of establishing "an ever closer union among the European peoples" (Preamble)

2. <u>Economic motivation</u>: the conviction that the nation state in Europe has ceased to be the appropriate unit for the organization of economic activities. The optimum size of currency areas (Mundell).

III. <u>ACTIVITIES IN THE PAST</u>

1. <u>Treaty and additional decisions</u>

a) The Treaty: Art. 103 – 109 (principles and procedures)

b) Creation of new committees and procedures

- Short term economic policy committee (1962)
- Budget policy committee (1964)
- Regular meetings of Finance Ministers
- Procedure of prior consultation in case of modification of the exchange rate of one or more member states (1964)
- Procedure of prior consultation in matters of international monetary relations (1964)
- Committee of Governors of the Central Banks (1964).

2. Capital movements

a) Limited objective of the Treaty:

Elimination of restrictions on intra-CEE capital movements
but: "to the degree to which such is necessary for a good functioning of the Common Market".

The Treaty does not contain provisions about the establishment of a common capital market.

Progress has been limited because of the tightness of most national capital markets and the differences in efficiency and structure of these markets. Besides, the member states were keen in trying to maintain a large degree of control on the economy: control over capital movements is one of the conditions, determining the efficiency of credit instruments.

b) Principles

- progressiveness: "member states try to reach always the highest possible degree of liberalization"

- elimination of discriminations: no use of different criteria according to nationality or residence

- non-reversibility of liberalization measures

  - sauvegarde clause (art. 73 and 109) but conditions and procedures strictly laid down
  - more rigorous than "code de libéralisation" of OECD.

c) Two directives adopted by the Council 11.5.60; 18.12.62

- unconditional liberalization among member states

  - direct investment
  - real estate
  - portfolio investment (stock exchange)
  - capital movements of a personal character
  - credits operations (short and medium term), tied to commercial transactions

– conditional liberalization

  - issue of bonds and stocks
  - loans (of a financial character)

Art. 3 (first directive), par. 2 "… if the free movement of capital hurts the achievement of the objectives of economic policy, the member state is allowed to maintain or reintroduce exchange restrictions".

– draft 3rd directive 14.4.64

  - harmonization of liberalization commitments
  - elimination of barriers of an administrative and legal character
    - calendar
    - issue of stocks and bonds
    - rules for institutional investors.

IV. RECENT ACTIONS AND PROPOSALS TOWARDS MONETARY INTEGRATION

1. The Barre Plan 12.2.69

a) Quantitative objectives of medium-term economic policy; nature of these commitments;

b) Prior consultation on economic policy measures (Council decisions: 17.7.69; 16.2.1970);

c) Short-term ("monetary") facility (Agreement between Central Banks: 9.2.1970).

This arrangement between central banks aims especially at curbing acute disturbances of a short-term incidental nature (waves of speculation and monetary crises).

Main elements of the short-term mechanism

- 5 years; $ 1.000 million
- quota, indicating both the maximum amount that each participate can draw and its maximum contribution 30%, 30%, 20%, 10%, 10%
- automatic rights, no conditions
- three months, once renewable; however, on renewal, conditions may be attached concerning economic policy

– by unanimous decision, the ceiling can be raised to $ 2 billion (“rallonge” or extension). The fixed quotes for borrowing and lending do not apply to this extension.

The press considered the short mechanism to be an extremely important new facility. Its significance, however, should not be overemphasized. The mechanism should be looked upon as a formal context within which short-term support that already existed on an ad hoc and voluntary basis has been institutionalised. The system will not be able to prevent new crises. As a matter of fact, speculation against a currency is not in itself the cause of difficulties but only the consequence of underlying instabilities between national economies. Support mechanisms cannot solve real problems. It is therefore that the Commission has always emphasized that the four elements of the Plan should never be taken isolated but judged as a consistent set of proposals.

d) Medium-term (“financial”) facility

The aim is to render the mutual assistance, laid down in art.108, more effective by committing E.E.C. governments in advance up to certain ceilings when participating in financial support to other member states.

Main elements of the proposed medium-term mechanism

– reports of the Monetary Committee 17.1.70 and 10.4.70;
– 5 years;
– quota;
– 2-5 years; conditions;
– decisions by the Council by qualified majority;
– right of “opting out”;
– interest rates;
– provisions for mobility: refinancing of claims;
– increase of facilities or a substitute for existing medium-term facilities?
– priority for E.E.C. scheme ?

2. The Hague Meeting 1/2.12.69 – Point 8

Paragraph 8 of the final Communiqué of the Conference of the Heads of State or Government, held on 1 and 2 December 1969 at The Hague reads:

“They have reaffirmed their wish to carry on more rapidly with the further development necessary to reinforce the Community and its development into an economic union. They are of the opinion that the process of integration should end in a Community of stability and growth. With this object in view they have agreed that on the basis of the memorandum presented by the Commission on 12 February 1969 and in close collaboration with the Commission a plan by stage should be drawn up by the Council during 1970 with a view to the creation of an economic and monetary union.

The development of monetary cooperation should be based on the harmonization of economic policies.

They have agreed that the possibility should be examined of setting up a European reserve fund, to which a common economic and monetary policy would lead."

3. The Plan in steps towards monetary union

- Why do we need steps ?

  1. The all at once approach.
     Natura non facit saltus
  2. The step by step approach. Integration is a process.

     Steps must be taken to mark the results of the past and to confirm intentions about the future. Simultaneous action in various sectors. Use the spill-over process. The credibility needs once and a while a new and firm impetus.

- Commission Plan 4.3.70

  - three steps
  - four sectors
    coordination of economic policy
    capital market
    fiscal policy
    monetary solidarity
  - highlights of the plan

- Some other plans (similarities, differences).

4. The Werner Committee

Intermediate Report 20.5.70. Two schools of thought. First progress in the monetary field or first assure effective coordination of economic policy ? Final Report 8.10.70.

The progress should be irreversible: the “fiançailles” (engagement) should be followed by a real marriage.

The First Step

a) Procedures: at least 3 annual examinations of the economic situation.
b) Organs
c) Fiscal policy (“politique budgétaire et fiscale”)
   Quantitative guide lines of main flows: magnitude of the deficit or surplus; “régulateurs fiscaux” and “budgets conjoncturels”.
d) Internal monetary policy. Prior consultation in the Committee of Governors of the Central Banks; guide lines on interest rates, bank liquidity and expansion of credit to the economy.
e) External monetary policy. Concerted action on international monetary affairs, reduction of intra-EEC margins, European Fund for Monetary Cooperation (Report of the Ansiaux-Group).

5. The Ansiaux Report

This report is essentially dealing with the (absolute or relative) reduction of margins of possible fluctuation between the currencies of the E.E.C. on the spot market.

I. The Economics of the Reduction of Margins

Why ? Flexibility among the Six is twice as large as against the U.S. dollar.
Ultimate objective: elimination of all forms of exchange risks.
How ? The work of the Ansiaux Committee. Report to the Governors of the Central Banks: 1.8.70.

a) Gradual reduction vs. the all-at-once approach

- Divergent trends in balance of payments imply contradictory interests as to the “Community level” (niveau communautaire) of the dollar;

- Smaller margins reduce autonomy of central bank. How large is this autonomy now and by what factors it is continuously threatened ?

- Total elimination presupposes convergent economic policies and community decisions as to monetary policy and the determination of the exchange rate of the dollar.

b) Different possibilities to achieve a "differentiation" of margins are possible

- Concerted action of central banks to limit de facto the fluctuations of the market rates among their currencies (experimental and reversible stage)

- Official reduction of intra-community margins

- Wider band against the dollar, e.g. up to 1%, combined with an unchanged margin among E.E.C. currencies (two objections: could be interpreted as positive attitude of the Community towards more flexibility; is not a step towards elimination of margins, which is the ultimate objective).

c) Intervention methods in the exchange market

1. Only in dollars; the monetary authorities determine the "snake" ("serpent") within the "corridor". Intervention within the band is free. Conflicting interest if two currencies hit simultaneously the opposite limits of the band. Procedures necessary to move the band (snake) i.e. how to determine the "Community Exchange Rate" of the dollar ?

2. Simultaneous intervention in dollars and in national currencies.

    - only at the limits (easy, but the use of national currencies would be rather exceptional);

    - also within the band limits (constant concertation necessary to apply the right cross-rates).

d) Consequences (from the technical point of view)

- reserve needs

- nature and determination of reserves
    - determination of limits of balances in national currencies
    - exchange risks guarantees
    - yield on reserves hold in national currencies

- interest rates and forward market
    - harmonization of rates
    - incentive to harmonization of monetary policy
    - less need to cover exchange risk in the forward market (under normal conditions)

II. The Institutional framework of the reduction of margins

A. The first decision

Once the decision has been taken to differentiate the intracommunity margins from those applicable to the dollar, the concerted action which determines the width of the intracommunity margins and which fixes for the first time the "Community exchange rate" of the dollar, has to take place by the Central Banks governors. This concerted action will be decisive for the future evolution and should be very carefully prepared.

The system should start at a moment at which the exchange rates of the dollar expressed in each community currency will be well placed within the preselected margin.

B. Immediate concerted action under the participation of the central banks

Principles:

1. The concerted action should be a continuous one.

2. The Committee of the Governors should work out the guide-lines for intervention policy in the exchange markets.

3. No serious problems will arise as long as the exchange rates of the dollar in the different markets of the Community are moving within the predetermined margin.

4. Certain problems could arise:

   a) if the exchange rate of one currency will be situated at the lower or upper limit of the margin;

   b) if the exchange rate of the dollar of two or several currencies is situated simultaneously at opposed limits of the margin. What are the criteria for deciding that the snake should or should not move; in what direction and how much ?

5. To assure that sufficient time for concerted action is available, it is recommended to call for an action at the time when the exchange rate approaches the limits of the margin (0,10% for example).

6. Any decision should take into consideration:

   a) the speed and the scale (%) of accumulation or loss of reserves;

   b) balance of payments situation of the Community as a whole.

7. Some technical matters require urgent treatment:

   a) Creation of a communication-network which should allow for direct and permanent contact between the central banks;

   b) Coordination of the methods of intervention on the exchange markets;

   c) Harmonization of the opening hours of the markets.

C. <u>The concerted action by means of a Community institution</u>

I. <u>The reasons</u>

1. In the final state of development of the Economic and Monetary Union one will have to provide to carry out the following steps:

   a) Elimination of the fluctuation margins between community currencies;

   b) Pooling and administration of reserves of the Community;

   c) Instauration of a Community authority similar to that known as "Federal Reserve Board" which should be empowered to take decisions in monetary policy as far as discount rates, liquidity of the banks, credits to the public and private sector and demand management are concerned.

2. Once a certain stage of development has been reached, it would be much more efficient to have a Community institution, - administrated by the Central Bank Governors -, than the much looser for concerted actions carried out by the central banks. Once the creation of this institution has been agreed upon, it would be convenient to realise and establish it in the four, following stages.

II. Establishing of a Community institution

1st phase: The concerted action will take place directly among the central banks which report daily to an agent the balance of foreign exchange operations. The agent would then inform each central bank. This information facilitates the concerted action if necessary.

2nd phase: The agent would then suggest the possible transfers between the central banks, in Community currency and in dollars; a central bank A in possession of currency B, exchanges the latter money with another central bank C for money D or dollars.

3rd phase: The agent would then favorize the intracommunity mobility of accumulated dollars within the Community: he would operate in such a way that dollars, being accumulated by one or several central banks, would be held at the disposal of central banks which are in deficit.

4th phase: Establishment of a Community institution, administered by the Governors ("Fund").

III. Functioning of the Fund

a) The Fund would operate in "Unit of Account" based on gold in such a way that it would mark the individuality of the Community;

b) The Fund would dispose of dollars or other reserves transferred by the central banks which in return would be credited with "Units of Account";

c) Central banks would operate on the foreign exchange market in dollars or Community currency within the framework of guidelines issued by concerted action;

d) The balance resulting from the operation on the markets – in dollars or community currency – would be transferred at the end of the day to the Fund. Central banks are credited or debited in units of account;

e) The position of the Fund would be examined at regular intervals (daily, monthly or quarterly), according to regulations;

f) The Fund would be administered by a Council of Central Bank Governors.

V. COUNCIL DECISIONS ON ECONOMIC AND MONETARY UNION (22.3.71)

1. The final objectives

   E.M.U., ten years, beginning 1^{st}-1-1971.

a) Definition of the E.M.U.

   i) internal aspect: an area within which products and production factors circulate freely;

   ii) external aspect: an individualised monetary unity inside the international monetary system;

   iii) institutional aspect: a community which is responsible for the management of the union; decisions of economic policy are taken at Community level and powers are allotted to Community institutions. Instruments will be created every time they will appear as necessary for the Community.

b) Distribution of competences and responsibilities between member states and Community Institutions: "According to the needs"

   – The Community policy will be submitted to the Assembly Control

   – Common organization of Control Banks.

These principles are compulsory for:

- the internal monetary policy
- the external monetary policy
- the policy of the united capitals market and for the capital movements with the third countries
- the fiscal policy. Federal budgets: determination on Community level: variation of total expenditure and total receipts, the magnitude of the deficit and the way it will be financed
- structural and regional policy

2. Common instruments will be created if necessary. Principle of parallelism; convergence of economic and monetary policy will lead to unification of economic policy.

3. First stage: three years

a) Intensification of the coordination of short term economic policies (related to the third programme of MTEP). The Council will determine the guide lines of economic policy at Community level. These guide lines will be expressed in a quantitative manner so far as budget policy is concerned (see Council Decision).

Three Council sessions a year

- February: Economic policy: annual review
- May: quantitative trends of state budgets before the preliminary budgets are definitively settled
- September: annual report sent to national Parliaments so that it can be taken into consideration when budgets are discussed by the Parliaments.

Harmonization of the instruments of economic policy especially the calendars of the budgetary procedures.

b) Acceleration of the free circulation of persons, goods, services and capital. The council will decide on policy as regards the harmonization of fiscal systems:

– rules relative to the unified basis of the added value tax (AVT);

– harmonization of the area of application and of the basis (“assiette”) of indirect taxes;

– harmonization of specific taxes (fiscal system applied to interests and excises);

– harmonization of the system of company taxation;

– enlarging of fiscal exemptions granted to private persons;

– harmonization of the rates of AVT: the Council will decide of it before the end of the first stage (16-18%);

– free capital movements: the Council will adopt a Third Directive.

- Gradual liberation of stocks and shares issues (issues from other Member States);
- Coordination of policies with regard to capital market;
- Introduction on the stock exchanges without discrimination of securities, issued in other Member States.

– regional and structural policies. The Council will decide the necessary actions in order to give "a beginning of solution for the major problems".

c) Coordination of the internal monetary policy

– Reinforcement of the procedures for prior compulsory consultation within the Monetary Committee and the Committee of Governors of the Central Banks (CGCB) (Council Decision);

– The Central Banks are invited to coordinate their policies within the CGCB and to establish general lines of conduct especially as regards bank liquidity, domestic credit expansion and the level of interest rate (problem: distribution of competences between Governments and Central Banks);

– Harmonization of monetary policy instruments;

– "Progressive" adoption of a common position in international monetary affairs and more specifically international organisations;

– Narrowing of margins;

– Report before 30th-6-1972 (by MC and CGCB) relating to the European Monetary Cooperation Fund; possible institution of the Fund during the first stage;

– Medium term financial aid.

Validity of the last three elements is limited to 5 years (prudence clause).

4. Review over the first stage and transition to the second stage

– The Commission will present a report to the Council not later than 1 May 1973 containing

- a progress report covering progress made during the first stage;
- suggestions on the distribution of responsibilities between member states and Community institution.

– At the end of the first stage, the Council will decide on the necessary measures to pass on to the next stage

  - either on the base of the Treaty provisions
  - or on the base of Art. 235
  - or on the base of Art. 236.

VI. THE EXCHANGE RATE POLICY OF THE COMMUNITY: TOWARDS MORE FLEXIBILITY ?

Under the present system of normally fixed, but in the last resort adjustable, exchange rates, disequilibria are likely to occur more frequently in the years ahead as a consequence of fast growing interdependence between nations which remain free to deviate from the trend of prices and interest rates of their competitors. The choice of which type of flexibility to adopt is partly a technical question and partly a matter of political judgement about attitudes and behavior of Governments in different circumstances and more particularly about the degree of disequilibria considered politically and economically is undeniable. The more one were to think that governments will not be exercising, out of wishful thinking, their option of moving the exchange rate until a very substantial disequilibrium is emerging, the more one tends to be in favour of floating rates.

Floating exchange rates however is a departure from the system of Bretton Woods and cannot be regarded as compatible with the basic philosophy of the par value system. It leaves decision making on the appropriate pattern of exchange rates exclusively to automatic forces of the market and goes therefore much further than a more or less technical improvement in the mechanism of exchange rate adjustment[1].

Proposals for changes that have been given serious attention fall into three categories:

[1] It is interesting to note the critical remarks that KINDLEBERGER has made in this regard: « It is implicit in the case for floating rates that the "external equilibrium" which comes from allowing the supply to equal demand for foreign exchange in a free market is equilibrium not only for the balance of payments but also for other macro-economic parameters – prices, wages, employment, interest rates, etc… There is no justification for this view. A foreign exchange rate may clear the market but exert pressure upward or downward on prices, employment, and so on" (C.P. KINDLEBERGER, The Case for Fixed Exchange Rates, International Monetary Seminar, October 8/9, 1969).

- Slight widening of margins
- Prompt adjustment of parities
- Temporary deviations from par value obligations.

Outside ? Perhaps E.E.C. as a currency bloc. However, the basic elements of Bretton Woods should be maintained. All plans that go beyond a modest increase in flexibility – wider bands up to 3%, small and frequent changes in the parity and "transitional floatings" should not be given serious consideration. However this may be, let us first take time for the construction of the internal monetary structure[1] or, if this would not appear possible, let us adopt simultaneously a modest degree of flexibility of the Community as a whole and a firm commitment to install more rigidity (or at least to maintain the same degree of rigidity) in the intra-EEC exchange rate relations.

Inside ? No more flexibility but less flexibility. The maintenance of stable exchange rate has probably contributed in the past to the extremely rapid growth of international trade and to the international flow of capital. When this is true on a world scale, it holds a fortiori for an integrated area.

More exchange rate flexibility within E.E.C. is inconsistent with the philosophy of integration.

a) It will not improve the performance of economy but is likely, in most cases, to result in more relaxation of discipline in national economic policies.

b) The impetus towards strict coordination of policy objectives and of policies will be weaker and the "return road" will prove very difficult.

c) Larger flexibility does not cure the internal causes of balance of payments disequilibrium but will simply alleviate the external symptoms, i.e. changes in reserves.

As far as wider margins are concerned, it is quite evident that this offers no solution for the most crucial problem that the Community has experienced in the past i.e. fundamental disequilibria among the Six.

[1] M. Giscard d'Estaing stated at the IMF meeting in Copenhagen (September 1970) that France was not opposed to some widening of support margins against the dollar providing that the Community moved as a monetary block.

If disequilibrium would again emerge, the market rates would stay soon at the extreme limit of the new margin, which does not conform to the principal underlying the band proposal which should permit larger fluctuations within the band in order to reduce movements in external reserves and to provide a larger freedom of manoeuvre for domestic monetary policy.

VII. THE MONETARY CRISIS OF MAY 1971

The crisis originated in May 1971 with massive flows of short-term capital into several countries of the Community and more particularly into Germany and the Netherlands. Both countries have adopted temporarily a floating exchange rate. The BLEU has adapted the mechanism of the free exchange market in such a way as to be able to use it as a weapon against inflows of capital.

1. The origin of the crisis

(a) Time lags in short-term economic development between the US and Europe

The real origin of the crisis goes back to 1969. In that year the American monetary authorities pursued a very restrictive policy which induced a large inflow of short-term funds to the US, amounting to about $ 8 billion. Most of this represented borrowings by US banks from their foreign branches and was a consequence of regulation Q, which imposed on the banks an uncompetitively low interest ceiling. This left to monetary policy too much of the burden of combating the boom. In addition, the choice of instruments was made without due attention to their international repercussions. As a matter of fact, when funds were flowing so massively from the Euro-currency market to the US banks, it should have been realised that the subsequent outflow – which was bound to occur once the US boom was over – would cause difficulties on Europe’s exchange and monetary markets.

Since the beginning of 1970, US monetary policy has become far less restrictive, but inflationary tendencies in Europe still made it necessary to maintain severe domestic monetary restraint.

The consequences of three divergent trends in monetary policy were:

(i) Repayments of Euro-dollars to European branches of American banks and a sudden fall in interest levels on the Euro-dollar market;

(ii) Inflows of funds into Europe;

(iii)
- Borrowing by national enterprises abroad
- Constitution of deposits by non-residents in European banks
- Repatriation of assets and more particularly of credit balances at foreign banks by residents of the Community.

These inflows of funds accelerated in the course of the first quarter of 1971, as the gap between the interest level in the US and Europe tended to increase. From April onward, however, capital movements on a purely speculative character substantially aggravated the problems facing European authorities. While there have been suggestions in the press concerning the floating rate for the DM, this cannot be considered the real cause of the crisis. Having for more than four months failed to stop the boom or the inflow of funds from abroad, there was little the German authorities could do on 5th May but close the exchange market and let the DM float.

(b) Structural factors responsible for short-term capital movements

Although a number of factors have for more than a decade been increasing the potential scale of short-term capital movements, these factors have gained greatly in importance since the period of excessive inflation on a world-wide scale. The most important are:

(i) Increased interdependence of the national economies (substantial increase in the risk of swings between leads and lags);

(ii) Enormous development of the multinational corporation;

(iii) Extension of banking business across national borders, which gives firms in one country easier access to the funds of another;

(iv) The spectacular development of the Euro-currency market;

(v) The improvement and wider use of means of communication and information.

(c) Reduced efficacy of monetary policy

It is now generally accepted that the monetary authorities no longer have at their disposal instruments that can effectively cope with the problems caused by the massive flows of short-term capital. Monetary policy, in particular, has lost much of its efficacy. But the degree of protection that the central banks can or will give varies from country to country. Solutions will have to be found and they should not be worked out on a national but rather on an international scale.

To sum up, the monetary structure will be under increasing strains in a world that is becoming increasingly sensitive to differentials in interest rates and exchange rate risks. In an international monetary system, characterised by fixed exchange rates, general convertibility of currencies, a vast supply of privately held international liquidity and differences in the level of interest rates and in rates of inflation. These strains should not be considered as causes but as symptoms of domestic and international monetary disturbances and uncertainties. Given these circumstances, the solutions to work out for this problem should not exclusively be sought in the imposition of controls (limiting the freedom with which short-term funds can move from one market to the other) but also in introducing a moderate degree of flexibility in the exchange rate system. Let us examine the various possibilities that have been envisaged.

2. Possible solutions

(a) The most effective way to reduce the levels of capital flows would undoubtedly be closer coordination among national authorities on their domestic monetary policies. Although there is clearly room for improvement, the degree of world economic integration will not permit synchronization of business cycles and monetary policies. This would perhaps even not be desirable.

(b) Changing the policy mix as to mitigate their international consequences. This would generally require that the US and European countries rely more heavily on fiscal policy to control the overall level of aggregate demand.

However, fiscal policy is often not the appropriate tool for coping with short-term economic problems. Fiscal policy changes take considerable time to work their way through the domestic economy. In addition, the decision process for both taxes and expenditures takes considerable time.

(c) Regulation of international capital flows and measures to offset their undesirable effects on internal liquidity (Community proposal for Council directive, document COM (71)725 of 23 June 1971).

Under this proposal the monetary authorities would have to create (where not already available) instruments for:

(i) The regulation of international capital flows

- Regulation of investment in money markets and of remuneration of deposits made by non-residents;
- Regulation of borrowing abroad by non-banks, where this is not related to commercial transactions or the rendering services[1].

(ii) The offsetting of undesirable effects on internal liquidity

- Regulation of the net foreign position of banks;
- Imposition of minimum reserve ratio, particularly in respect of deposit made by non-residents.

These controls cannot be regarded as a satisfactory answer that settles the question. To the extent that they are effective, they limit international competition, raise costs and promote inefficiency in banking. In a kind of emergency situation, such controls may at times be effective and unavoidable, as they might have been for Germany in the May 1971 crisis. But as a permanent, long range, strategy for defusing short-term capital movements, they appear to be not adequate. The whole chain of control would be no stronger than its weakest link and activities that are carried out under circumstances of increased controls tend to be shifted to financial centres where controls are less burdensome.

(d) Double exchange market (free financial market)

This instrument can be regarded as a marriage between the control market and the free market. The Belgian experiment does not yet provide sufficient evidence concerning the efficacy of such an instrument in case of massive inflows of capital. Generally speaking, its efficacy appears to be more limited the more the free market rate differs from the official rate and the longer the period during which this difference exists.

Apart from considerations of efficacy, there are other arguments that raise doubts as to the appropriateness of this solution. Should each Member State adopt it individually, this solution will hardly have a Community character. In practice it is difficult to distinguish between Community residents and residents of non-member States. Furthermore, the fragmentation of the exchange market and the narrowness of the free markets are likely to provoke wide and irregular “deviations” between free market rates and official rates, and between the free market rates of the various Member States.

---

[1] The German Government has preferred a more flexible system. He will introduce to Parliament a legislation that would enable imposition of interest-free deposit requirements (possibly retroactively) on funds borrowed abroad by non-financial firms.

(e) Widening of exchange rate margins against the dollar, while maintaining (reducing) the intra-Community margins.

Such a system appears to combine simplicity with efficacy. It does not require cumbersome administrative controls and the uncertainties it introduces in the exchange markets tend to reduce short-term capital movements. A number of past crises have provided sufficient experience for it to be claimed that in most cases capital movements come in two stages:

(i) Movements originating from differences in interest levels;

(ii) Capital movements of a speculative nature anticipating parity changes.

A wider band would certainly limit the capital movements mentioned under (i), and by so doing it would also tend to reduce the movements indicated in (ii).

3. <u>Council resolution of 8/9 May 1971</u>

The Council adopted a resolution which contains the following four points:

(a) The balance of payments prospects of the Member States does not justify any change in parities;

(b) The Council is prepared to envisage that some countries should, for a limited period, widen the fluctuation margin their exchange rates;

(c) The Council will discuss before 1 July 1971 measures to discourage excessive inflows of capital and to neutralize their repercussions on the internal monetary situation;

(d) The Council will adopt appropriate measures, in accordance with Article 103, to avoid disruption of trade in agricultural products.

4. <u>Council session of 2 July 1971</u>

The Ministers of Finance and Economic Affairs did not reach agreement on the Commission's proposal for a directive on regulation of international flows of capital and the neutralization of their undesirable effects on internal liquidity.

The reasons for not adopting the “anti-speculation directive” cannot be found in disagreement over the content of the directive. On the contrary, all Member States would be ready to accept the directive, provided that it was linked with other issues.

Germany would give formal approval to the directive only if the Council at the same time agreed to a firm commitment in favour of a widening of the band.

France, although no longer opposed to such a widening, would accept a commitment to widen the band only on condition that Germany indicated precisely what its intentions were with respect to a return to a normal exchange rate system.

At the Council meeting, the Commission presented a memorandum containing guidelines on a whole package of monetary problems. These guidelines have in general been given a favourable reception by the Ministers and by the Governors of the central banks. Five delegations could accept it; the refusal of France was due not to disagreement with the content but to the fact that it did not contain a precise indication on the termination of the period during which the DM would float. The Council has been very close to a situation in which the Community could have come out of the monetary crisis strengthened and with a greater degree of cohesion than ever before.

The Commission’s memorandum contained in particular the following points:

(a) The various monetary problems should be tackled not individually but in a comprehensive and coherent manner;

(b) The Euro-currency market should be regulated (some decisions have already been taken by the central banks);

(c) There should be regulation of internal liquidity (Commission proposal for a directive);

(d) The system of double exchange markets should be thoroughly examined;

(e) There should be a modest widening of the band;

(f) In view of the possible need to supplement the reserves of Member States, there should be a short-term monetary support scheme and a European Fund for Monetary Cooperation;

(g) Changes in exchange rates are certainly possible, but small and frequent changes in parities, intended to avoid the development of disequilibrium, should be regarded as extremely harmful;

(h) Deficit financing of the US. The balance of payments deficit of this country should be financed, at least in part, by using its drawing rights in IMF.