CONFIDENTIAL File EMS

25 October 1984

MR POWELL c Mr Turnbull

I see from the 9 October telegram No.124, and other comments, that there is now a revival of interest in the UK joining the EMS.

There is still absolutely no case for the UK to join this mechanism on economic grounds. It is not possible to run an exchange rate policy and a monetary policy at the same time, as other members of the EMS will pursue inconsistent monetary policies.

We should not get back to the position where we have to spend the reserves to try and smoothe the relationship between our currency and EMS block currencies. This can often lead to the speculators enjoying putting pressure on a currency, forcing its central bank to spend too much, only in the end to have the ignominy of a realignment. People would not see this as a technical adjustment, but would see it as a return to good, old-fashioned, crawling peg devaluation.

Similarly, we do not wish to put any more pressure on our interest rate policy, and in the EMS we would often be forced to raising interest rates for external reasons - even though there were no clear domestic monetary policy reasons

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for doing so. Against the background of unacceptably high unemployment in this country, we can live without any further pressures on interest rates.

JOHN REDWOOD

GRS 150

UNCLASSIFIED

FM UKDEL STRASBOURG 091830Z OCT 84
TO PRIORITY FCO
TELEGRAM NUMBER 124 OF 9 OCTOBER
AND PRIORITY UKREP BRUSSELS
AND SAVING TO BRUSSELS, COPENHAGEN, THE HAGUE, ROME, DUBLIN,
PARIS, BONN, LUXEMBOURG, ATHENS

FROM UKREP BRUSSELS

EMS

SUMMARY

1. IN DEBATE ON 9 OCTOBER ON THE EC MONETARY SITUATION ORTOLI AND ALL EDG MEMBERS WHO SPOKE SAID UNITED KINGDOM SHOULD BECOME A FULL PARTICIPANT IN THE EMS.

DETAIL

2. VON WOGAU (CD) ADDRESSING HIMSELF TO THE UK SPECIFICALLY SAID THAT THE EMS HAD PROMOTED MONETARY DISCIPLINE RESULTING IN EC INTEREST RATES BEING CUT BY HALF. NOW WAS THE TIME FOR THE UK, WHICH HAD BEEN A QUOTE SHY VIRGIN UNQUOTE FOR TOO LONG, TO JOIN THE SYSTEM . BEAZLEY (EDG) FOLLOWED BY BEMOANING OUR QUOTE CONTINUED FAILURE TO JOIN UNQUOTE. THE UK STOOD TO GAIN FROM A STRONG EUROPEAN ECONOMY WHICH WOULD REINFORCE OUR POSITION AGAINST A STRONG DOLLAR AND YEN. LADY ELLES AND WELSH (EDG) ALSO URGED THE UK TO JOIN THE EXCHANGE RATE MECHANISM. ORTOLI (COMMISSION), AGAINST APPROVING BACKGROUND NOISES, SPOKE OF THE NEED TO ANALYSE THE POSITIVE ECONOMIC ADVANTAGES FOR THE UK. IN HIS VIEW OUR ARGUMENTS (POUND STERLING BEING A RESERVE CURRENCY, PETRO-CURRENCY ETC) DID NOT HOLD. IF THE POUND JOINED THE EMS THE UK WOULD BENEFIT FROM (UNSPECIFIED) EUROPEAN ADVANTAGES AND WOULD BRING A LARGER DIMENSION TO THE EMS. IN CONCLUSION HE EXPRESSED STRONG SENTIMENTS IN FAVOUR OF UK PARTICIPATION ADDING THAT HE WAS OPTIMISTIC THAT THIS WOULD HAPPEN.

/ FCO

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STODDART

Frame Economic

ECD(I)

(ADVANCED AS REQUESTED)

[REPEATED AS REQUESTED]

W. Greenwell & Co.
Bow Bells House, Bread Street, London EC4M 9EL
Telephone: 01-236 2040 Telex: 883006
W. Greenwell Inc.
535 Madison Avenue, New York, N.Y. 10022
Telephone: 212 702 5480
Facsimile (Groups 1, 2 & 3) 212 702 5490

EMS file

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EMS MEMBERSHIP & UK MONETARY POLICY

The possibility of sterling becoming a full member of the EMS is being widely canvassed once again. Any decision to join would affect the conduct of monetary policy, to a limited extent, and the environment in which monetary policy operates.

Membership of the EMS would place limits on the movements of sterling against European currencies (summarised as the European Currency Unit - ECU) where none existed before. (The technical appendix at the end of this note includes a description of the operation and technical arrangements of the EMS.) There would be no explicit restraints on the movement of the dollar/sterling rate. However, sterling could only be allowed to fluctuate against the dollar in line with the bloc of EMS currencies as a whole. In effect, European countries would have a common dollar policy either by design or de facto.

The attempt by the authorities to persuade the markets to pay less attention to the sterling/dollar rate and focus on sterling's overall performance has been enhanced by the recent innovation of publishing sterling's effective rate on an hourly basis. Entry into the EMS should further this process in two ways. First, the absence of formal limits on dollar/sterling fluctuations will focus attention on the intervention bands vis-a-vis other EMS currencies. Secondly, the operation of the divergence indicator in the EMS will elevate in importance the ECU value of sterling. In effect, should sterling cross its divergence limit expressed against the ECU, the rules of the EMS presume that a policy response will follow. Such a development will make explicit the downplaying of the importance of movements in the sterling/dollar rate that are due purely to generalised movements of the American currency itself.

Events in July

In early July, pressure built up for higher interest rates from the worsening industrial situation (including the start of the first dock strike), the weakness of the price of oil, an increased short-term interest rate differential in favour of the US and, decisively, a 2% increase in Sterling M3 in banking-June, announced on July 5th. Sterling's effective rate had been declining, prior to this period, as the dollar strengthened. However, the trigger for higher UK rates was a sudden depreciation against European currencies which led to a sharp fall in sterling's effective rate.

These pressures for higher rates would have been similar in force had sterling been a member of the EMS. In one sense, in fact, the authorities behaved as if this were already happening, given their acquiescence in the gradual depreciation of the dollar/sterling rate and the reaction only when a broader decline began. However, there would have been additional support for the authorities in the EMS to cope with the market pressure for higher rates. First, although sterling fell against the ECU by 2.2% in the two weeks to July 10th, it had been fairly steady against the ECU since the rates settled down after the last realignment in March 1983. Even at its crisis level in early July, sterling stood higher against the ECU than the average of daily observations in April last year, the first full month after the realignment. This amounts to saying that sterling, prior to the July pressures, would have been a 'strong' currency in the EMS and the fall that did occur may well have been able to be absorbed without triggering sterling's divergence indicator. (The question of how much further sterling may have fallen against the ECU had interest rates not been raised is an open one.)

Secondly, given the type of selling pressure on sterling that developed in July, the EMS arrangements would have helped this pressure to be resisted. In general, two types of selling pressure on sterling may be distinguished:

i) Speculation which builds up when there are strong expectations of a major movement in sterling. This sort of pressure was suffered by sterling in late 1982; given that a major movement in sterling is anticipated and there are no official limits to the movement, this type of pressure is associated with floating exchange rates.

ii) Pressure, perhaps of a transient nature, may develop which forces sterling towards some limits, below which the currency should not be allowed to fall. This limit may be in a clearly-defined fixed rate system such as the EMS or may be implicit, as in the case of the supposed limit of 78 on the effective rate that the authorities were assumed to be adhering to in the first half of 1984.

The response to the first type of selling pressure should not be to smooth the currency's decline. Such action would not alter the expectation of further declines to come and so creates a one-way bet against the currency. The act of intervention itself may actually add to the speculative wave against the currency, with the authorities being the losers. Further, if the fall in the currency is expected to continue, belief grows that the authorities will in time withdraw from the market, so justifying the speculators' selling tactics. In this case, all the authorities achieve is to alter the profile of the currency's fall and by doing so waste tax-payers money.

The correct response to a long-term decline in sterling, in a system with no parity limits, should be for the authorities to allow the fall in the currency to run its course, before intervening heavily to buy sterling just after the market has turned. This tactic squeezes the speculators and encourages a rapid rebound in the exchange rate. Further, any expectation in the market that the authorities might intervene in this way would make speculators very wary about selling the currency when they believe the turning point is imminent. Such a bear squeeze would mean any losses would be suffered by the speculators and not by the authorities.

Intervention in the EMS

The crucial question is which sort of intervention is likely in the EMS. Given the bilateral limits and the function of the divergence indicator in the EMS, a substantial adjustment in the value of sterling would not be feasible without a realignment of the parity limits. In effect, the EMS is a fixed parity system. Given the design of the EMS, neither of the alternatives of smoothing a long-term fall or imposing a bear squeeze when the market turns is likely to apply in exactly the same way as outside the EMS. The best strategy would be for the Bank of England to refuse to smooth any fall (by intra-marginal interventions) and then enter the market decisively when the constraints of the EMS dictate. This approach would be likely to discourage speculative pressure. However, the uncertainty over the rate at which the market would turn of its own volition, so that a bear squeeze could be imposed, would be largely absent. The only doubt in the speculator's mind would be whether intervention would begin when the divergence limit is crossed or when the bilateral limits are reached, assuming these events occur at different times.

The weight of intervention in the EMS at parity limits would be enhanced in at least one further way. Access to the support facilities in the EMS (see technical appendix) would give the authorities a larger pool of funds to draw upon. The existence of this larger support (even if it is not drawn) may be sufficient to convince the speculators that the authorities would resist the pressure for higher rates such that the resultant pressure would be substantially less. Further, in circumstances where more than one EMS currency is divergent (as defined by the divergence indicator on parity limits), intervention by the other central bank under pressure would be forthcoming. This would not have been expected in July, or in the current bout of sterling weakness however, when there have been few signs of other EMS currencies being under pressure. Despite this, the possibility of intervention by more than one central bank at times of general EMS strain is a clear benefit from membership of the system.

Effects on UK monetary policy

It is unlikely that the techniques of monetary policy in the UK would need to be altered as a direct result of EMS membership. The immediate effect of sterling becoming tied to the exchange rate mechanism would be that the gradual drift away from rigid money supply targetting, as pursued in 1979-82, towards more stability of the exchange rate would be formalised. In this respect, it may be fair therefore to conclude that EMS membership would have little significant impact on the freedom of monetary policy, as currently pursued.

This argument is consistent with the view that the extreme theoretical distinction between completely fixed exchange rates, under which domestic money supply control is lost due to foreign exchange market intervention, and perfectly floating rates, under which the absence of external influences on the money supply allows it to be controlled by the authorities, is not relevant to this discussion. First, some monetary control may be retained under fixed exchange rates by the sterilisation of the effects of, for example, a balance of payments surplus on monetary growth through increased debt sales. However, the rise in interest rates that may follow this increased funding would lead to new capital inflows. The process becomes self-feeding so that the sterilisation option is a short-term one. Nevertheless, some monetary autonomy may be retained even under fixed rates. At the other extreme, complete autonomy may not be guaranteed by floating exchange rates if substantial fluctuations in interest rates and overshooting exchange rates make monetary control difficult. Even with floating rates, external shocks may push monetary growth off target.

Secondly, the EMS includes a number of features inconsistent with a system of completely fixed parities. First, the value of each member currency is permitted to vary by $\pm$ $2\frac{1}{4}$% from its central rate. Secondly, the system includes transitional arrangements (currently being used by Italy) allowing variation of a currency of $\pm$ 6% from its central rate. For example, should the Italian lira move from one end of its band to the other at the same time as another EMS currency moves in the opposite direction, again to its limits, the cross-rate movement between the two currencies would be $16\frac{1}{2}$% (2 x 6% + 2 x 2.25%). Thirdly, central rate realignments have been frequent, such that the system has, at times, tended to function as a sophisticated form of 'crawling peg'. The conclusion from these two arguments is that considerable independence of monetary policy is retained in the EMS.

The debate on the techniques of monetary control would not, therefore, be significantly altered by EMS membership. However, should sterling reach its lower divergence indicator a policy response would be expected from the authorities, where previously benign neglect towards the exchange rate might have been pursued. Should the authorities intervene, the money supply would decline, so limiting the freedom of the authorities to some extent. In effect, what is required in the long-term is a monetary stance broadly consistent with that of Germany, which has become the focus of the EMS, much as it was in the previous 'snake' scheme. This is likely to be much less difficult at present, with UK inflation only a little above that in Germany, than it would have been in the mid-1970s or in 1980-1, when the degree of divergence of inflation rates was much greater. In essence, the monetary discipline involved in closer ties to German economic performance would be beneficial.

Summarising, our conclusions for the effect of EMS membership on UK monetary policy are:

i) Basic monetary policy techniques would not need to be changed as a result of membership.

ii) Broad consistency between UK monetary policy and that in Germany would be required.

iii) Speculative pressure on sterling may be lower due to the EMS credit facilities that may be drawn on, so reducing the incidence and strength of market pressure. However, the timing of a bear squeeze in the market may be able to be predicted by the speculators.

iv) The dollar/sterling parity would be reduced even further in importance, to be replaced by sterling's ECU value.

<u>22 October 1984</u> <u>Geoffrey Dennis</u>

Technical Appendix - The Mechanics of the EMS

The European Currency Unit (ECU)

The ECU, which lies at the heart of the exchange-rate mechanism of the EMS, is a basket of all ten community currencies, in which each currency has a fixed weight in terms of actual amounts of the individual currencies. The currency amounts are set according to the relative importance of member countries in terms of national products, intra-EEC trade and other macroeconomic variables; they are set out in Table 1, on page 6. While the actual currency amounts have only been adjusted once (in September of this year) since the EMS began operation, the percentage weights of each currency have necessarily changed as a result of day-to-day exchange-rate fluctuations. For example, the weight of the Deutschemark rose from 33% in March 1979 to over 37% before the readjustment of the currency amounts in September reduced this to 32% again. The ECU value of any currency may be calculated using an outside currency, such as the US dollar, as a reference point. To establish the exchange-rate mechanism of the EMS, each currency was given a central rate against the ECU.

The Parity Grid

Each member currency's ECU rate is then used to form a set of cross rates, which have become known as a 'parity grid'. Around these bilateral central rates, fluctuation margins of $\pm 2\frac{1}{4}\%$ are defined with the Italian lira having availed itself of a 'transitional' $\pm$ 6% band.

This parity grid will change whenever a realignment of exchange rates in the EMS occurs. The procedure (for the currency to be realigned) is to alter that currency's bilateral central rate against all other currencies. However, given that all currencies in the EMS are part of the ECU, any such change in one country's set of bilateral cross-rates will, by definition, alter the ECU values of all member currencies. For example, suppose the Deutschemark is revalued by 8% in terms of its bilateral central rate and its weight in the ECU is 32%. The rise in the ECU parity of the Deutschemark is given by:

Increase in ECU parity of DM
$= 0.08\,(1.00 - W_{DM})$

where W_{DM} is the weight of the Deutschemark in the ECU

$= 0.08\,(1.00-0.32)$
$= 0.0544$
$= 5.44\%$

Accordingly, the ECU parities of all other currencies decline by 2.56% (0.08-0.0544). As a result, any EMS realignment, which in practice is likely to involve more than one adjustment in bilateral rates and therefore to be more complex than the above example, will lead to a new set of ECU central rates being defined. Table 2, on page 7, sets out the bilateral central rates and the upper and lower intervention points in effect since the last realignment on March 22, 1983.

A key feature of the parity grid is that any crossing of intervention points necessarily involves at least two divergent currencies (one being strong and the other weak). Typically, the history of fixed rate systems, including the previous 'snake' scheme in the EEC, has been for the weak currency country to carry the burden of adjustment. Adjustment was therefore generally asymmetrical.

TABLE 1

COMPOSITION OF THE E.C.U.

	Currency Amounts	Approximate (%) Currency Weights (30.9.84)
Deutschemark	0.719	32.1
French franc	1.31	19.1
Pound sterling	0.0878	14.9
Dutch guilder	0.256	10.2
Italian lira	140.0	10.1
Belgian franc	3.71	8.2
Danish krone	0.219	2.7
Greek drachma	1.15	1.3
Irish pound	0.00871	1.2
Luxembourg franc	0.14	0.3

The Divergence Indicator

To assuage the fears of certain members that asymmetrical adjustment would be a feature of the EMS also, the divergence indicator was designed as a warning signal when any one currency moves significantly out of line with all others. This indicator is based on the difference between the market value of a particular currency against the ECU and that currency's ECU central rate itself. The threshold of divergence defined amongst the EMS currencies was 75% of the maximum allowable deviation (under the ± 2.25% rule) between the ECU central and market rates for a particular currency. Due to the different weights of the currencies in the ECU, an adjustment is needed to the divergence indicator to allow for the fact that the larger currencies would take longer to reach their divergence limits as they pulled the ECU itself along with them to a greater extent.

For example, the maximum allowable movement of the Deutschemark against the ECU of 2.25% will (as the Deutschemark was 32.1% of the ECU at the time of the redefinition of the basket) cause the market rate of the Deutschemark to increase by only 1.528% (2.25 x [1-0.321]). The divergence indicator is therefore 75% of this permissible variation and so is equal to 1.146 per cent. In Table 3, on page 8, the current divergence limits are set out in Column 4, with Columns 1 and 2 containing the current ECU central rates and the market rates on October 18th, respectively. It is clear that the greater is the weight of a particular currency in the ECU, the smaller is that currency's deviation from its central rate for the ECU (which has been pulled in one direction or another by a currency with such a large weight) and therefore the narrower are the defined divergence limits in the table.

TABLE 2

BILATERAL CENTRAL RATES (PARITY GRID) AND INTERVENTION MARGINS IN EMS
(AS FROM 22.3.1983)

	AMSTERDAM	BRUSSELS	FRANKFURT	COPENHAGEN	DUBLIN	PARIS	ROME
DUTCH GUILDER (100)	100	1818.- 1777.58 1738.-	90.770 88.7526 86.780	329.63 322.297 315.13	29.3832 28.7295 28.0904	278.35 272.158 266.10	58997.- 55563.- 52329.-
BELGIAN/ LUXEMBOURG FRANC (100)	5.7535 5.62661 5.5005	100	5.106 4.99288 4.882	18.543 18.1312 17.727	1.6530 1.61621 1.5803	15.659 15.3106 14.97	3318.9 3125.76 2943.8
DEUTSCHE MARK (100)	115.235 112.673 110.1675	2048.35 2002.85 1958.50	100	371.40 363.141 355.06	33.1015 32.3703 31.6455	313.63 306.648 299.85	66473.- 62604.3 58960.-
DANISH KRONE (100)	31.7325 31.0273 30.3375	564.10 551.536 539.30	28.165 27.5375 26.925	100	9.1168 8.91396 8.7157	86.365 84.4432 82.565	18305.- 17239.7 16236.-
IRISH POUND (1)	3.5600 3.48075 3.4030	63.2810 61.8732 60.4965	3.160 3.08925 3.021	11.4735 11.2184 10.9687	1	9.6885 9.47313 9.2625	2053.53 1934.01 1821.45
FRENCH FRANC (100)	37.58 36.7434 35.925	668.- 653.144 638.60	33.350 32.6107 31.885	121.11 118.423 115.78	10.7964 10.5562 10.3214	100	21677.- 20415.7 19227.-
ITALIAN LIRA (1000)	1.911 1.79976 1.69500	33.970 31.9922 30.130	1.696 1.59733 1.504	6.159 5.80057 5.463	0.549015 0.517061 0.486968	5.201 4.89819 4.6130	1000.-

TABLE 3

EMS EUROPEAN CURRENCY UNIT RATES

(as at October 18th)

	Ecu central rates	Currency amounts against Ecu	% change from central rate	Divergence limit (%)
Belgian Franc	44.9008	45.1232	+0.50	+1.5428
Danish Krone	8.14104	8.05402	-1.07	+1.6421
German D.Mark	2.24184	2.23459	-0.32	+1.1463
French Franc	6.87456	6.84387	-0.45	+1.3659
Dutch Guilder	2.52595	2.51940	-0.26	+1.5165
Irish Punt	0.72569	0.719740	-0.82	+1.6671
Italian Lira	1403.49	1376.62	-1.91	+4.0511

Two other factors should be noted about the operation of the divergence indicator. First, the divergence limits for the Italian lira of ± 4.0510% reflect the wider margin of ± 6% applying to this currency. Secondly, these movements of the lira outside the ± 2.25% bilateral limits available to all other EMS members and the fact that sterling and now the drachma are part of the ECU, but because they are outside the exchange rate arrangement may (and indeed have done so) move in a much broader range vis-a-vis EMS currencies, create further potential distortions of ECU values of other member currencies. These are eliminated by calculating, when necessary, an adjusted divergence figure of a currency from its central ECU, which ignores the effects of any bilateral fluctuations greater than 2.25% on either side of the parity. In effect, in this adjusted figure, the wider fluctuations of the lira, sterling and drachma are sifted out.

Once any currency has crossed its divergence indicator, there is a presumption that corrective action will be taken by official authorities in the divergent currency country. This action may consist of:

(a) Diversified intervention (i.e. involving more than one other Community currency),
(b) Changes in central rates,
(c) Measures of domestic monetary policy,
(d) Other measures of economic policy.

As a result of such actions it is assumed that the divergent currency will move back within its divergence limits, which may (if the option of a change in a currency's central rate was chosen as one of the policy responses) be newly-defined limits. One problem with the indicator is that the EMS rules state that such policy responses are not mandatory.

Intervention Arrangements

The rules of the EMS state that intervention should be:

i) effected, in principle, in participants' currencies,
ii) compulsory without limit at the bilateral intervention points,
iii) optional when a member currency crosses its threshold of divergence and
iv) subject to prior consultation among all participants in the case of intra-marginal operations.

The new elements of these arrangements, compared to those in the previous snake scheme, are the intervention arrangements linked to the divergence indicator. However, as noted above, intervention, or any other policy response, is not mandatory when the divergence indicator is crossed.

In practice, the history of the EMS has seen significantly greater interventions than would have been dictated by the positions of individual currencies relative to their bilateral limits and divergence indicators. Further, despite an increase in interventions in EMS currencies, there have been significant gross interventions in dollars. At times, these have been in opposite directions, with different central banks buying and selling dollars simultaneously. For the EMS intervention rules to be followed, the need for dollar interventions must be removed. This could be done by the adoption by EMS members of a common dollar policy, involving a joint float of the EMS bloc against the dollar. In this case, intervention in EMS currencies to maintain the EMS parities would be needed, with the dollar rate of the bloc of currencies left to market forces. While a common European policy for the dollar, involving, for example, a target $/ECU rate, would be helpful to the cohesion of the EMS, it would not remove the need for dollar interventions.

European Monetary Fund

An important institutional element of the EMS was the proposed translation, within two years, of the European Monetary Co-operation Fund (EMCF) into the European Monetary Fund (EMF). In the event, due to the worsening economic climate and argument over the appropriate route to this institutional reform, this phase has not yet been completed. Notwithstanding this, the EMCF did receive (in April 1979) 20% of the value of each member's gold and foreign exchange reserves and in return each member was credited with a corresponding amount of ECUs. These transactions were completed in the form of three-month revolving 'swaps' with final transfer of the funds to the EMCF to be made when the transitional phase was completed and the EMF in operation. These swaps were valued on the basis of certain formulae related to dollar and gold market values and at the beginning of the EMS stood at ECU 23 billion.

With these funds, the EMCF administers three separate types of credit mechanism. The very short-term financing facility (for forty-five days) operational under the snake has been continued; in principle, the volume of such short-term resources callable by individual members is unlimited. In addition, a further ECU 25 billion has been made available in both short-term monetary support (ECU 14 billion), with a maturity of nine months, and medium-term financial assistance (ECU 11 billion), which is drawable for periods of between two and five years.

22 OCT 1984

1. Andrew Turnbull
To read section on EMS, which I find persuasive
2. File EMS

Mr. Robin Butler

Here are the final chapters IX and XI of my M/S for your vetting.

Done / Would you also forward them to Peter Middleton for his review?

The Prime Minister may like to look at parts of it. But she will not have the time to read it, so perhaps you could summarize the salient points for her, if you think it worthwhile. At least it may be useful for speech material.

I gather that the Governor has expressed some enthusiasm for Britain's joining the EMS. I examined the arguments and evidence afresh in my chapter on exchange rates, etc. I am quite convinced that all the evidence suggests that it would be a most retrogressive step. If the issue is a lively one, I would like the Prime Minister to see my critique - it is marked MP33-48D.

AW

Sept 10th 1984

MP. 53

Monetary Policy and the EMS

There have long been aspirations to form some monetary union of the European Community, which would correspond to the trade and fiscal harmonization implicit in the Treaty of Rome. The breakdown of the Bretton Woods system of more or less fixed exchange rates and the erosion of confidence in the stability of the dollar, added to the European view that there should be some substitute for the role of reserve currency. The initial "snake", introduced in early 1972, was modelled on the late lamented Bretton Woods, with exchange rates "fixed but adjustable".[1] The EMS was introduced in early 1979 and included all the major currencies of Europe except sterling.

[1] The snake had a checkered history, with the early defection of three of the four major currencies, leaving only the German mark and its satellite currencies. However, by the time of the introduction of the EMS, the snake had become bloated and very permissive indeed and had few pretentions to be a fixed rate system; adjustments were large and frequent.

The essence of the EMS consists of agreeing central rates with respect to the European Currency Unit which obtain until the next "realignment". The member countries then use policies of intervention and monetary control in order to keep their rates within a band ± 2-1/2 percent, except Italy where the band is ± 6 percent. In practice, however, the rates are usually maintained fairly close to the central value. Although the system has many of the features of a mini-Bretton Woods, there is no systematic relationship of any currency, including the D mark, to the U.S. dollar. The most important exchange rate in the trading world, the D mark/dollar rate, was excluded from the EMS.

In assessing the effect on monetary policy of membership of the EMS one must initially draw a sharp but essential distinction between the ideal system and the real system. First the ideal. If the objectives meant anything, then they required the exchange rates to be virtually fixed with respect to one another for a specific period (say one year) before the next realignment. If this is the case, and assuming there are no oscilations around the central values, the markets can expect periods of up to one year when the exchange rate between the Italian lira and the D mark are fixed.

But if the exchange rate is fixed for an average of six months, then this will imply that the rates of interest on financial assets with those maturities will be roughly the same. If, after six months, I can exchange my lira for D marks at the same rate at which I bought them, I will find it proftable to switch into lira deposits if the interest rate in Italy is a tithe above that in Frankfurt. Thus nominal interest rates for those maturities must be approximately equal; portfolio arbitrage will ensure the outcome.[1/] It follows that by joining the EMS, as in any fixed exchange

[1/] There will be some transmission of this effect to other maturities so the level of the yield curve will be largely determined by this arbitrage, but we leave that aside for this argument.

rate system, Britain would have to forego a substantial degree of sovereignty over her monetary policy.[2/]

[2/] The government would have a number of other monetary instruments -- such as reserve ratios and varying the maturity structure of public debt -- which could be used, but there is no doubt that interest rate policy is the primary weapon.

This interest rate equality illustrates one of the main difficulties -- an inherent contradiction no less -- with the EMS. One of the objectives of the EMS was to produce "convergence" of the rates of inflation of member countries -- and in these terms it meant converging on the inflation rate of Germany. Thus it was hoped that Italy, with an inflation rate of about 15 percent, would eventually converge to the German inflation rate of about 3 percent. But the requirement that, under a fixed exchange rate, Germany and Italy have the same nominal interest rate -- say 9 percent -- means that the real interest rate in Germany is high and positive (6 percent) whereas the real rate in Italy is negative at minus 6 percent. If the monetary authorities operate an interest rate regime in controlling their domestic money supply, there will be a great pressure to expand money and credit in Italy, whereas in Germany there will be a substantial financial squeeze.

This is precisely the opposite monetary policy to that which would move towards "convergence". Monetary policy has not been merely neutralized by the fixed exchange rate system, it has been made perverse. If countries still seek convergence, then this must be achieved mainly through fiscal policy, and indeed fiscal policy will have to offset the malignant effects of the EMS monetary policy. It is often claimed that the EMS has had a substantial effect in inducing member countries to take stringent fiscal action which they would not have entertained had they not been members of the EMS. This is true. But it is odd to credit the EMS with discipline that arises from its distortions.[1]

[1] Am I alone in finding it odd that exchange rate fixity and the concomitant equality of interest rates is described as "closer monetary cooperation

. . . in Europe"? ("Five years of Monetary Cooperation in Europe", EEC, COM (84) 125 final, March 1984.) Fixing exchange rates and interest rates will produce divergent monetary policies.

In reality, however, the EMS diverges substantially from the fixed exchange rates with free capital markets that we have outlined above. First, there are substantial restraints on the free flow of capital -- particularly by France and Italy -- so that arbitrage is nowhere near perfect. Indeed, in the case of France and to a lesser extent in the case of Italy the capital constraints have become considerably more stringent since France has been a member of the EMS. One must be wary of post hoc, ergo propter hoc, but this evidence is not inconsistent with the fact that France would not have needed such controls if she had not been constrained by the psuedo fixity of exchange rates. Willy nilly, regulation of capital flows has enabled considerable deviations in interest rates between member countries, so the countries have been able to pursue more appropriate monetary policies than those which were implied by a strict EMS.

Secondly, even over quite short time horizons, the exchange rates have not been fixed. This is partly because of the width of the band within which currencies can move -- up to 5 percent for all except Italy which can move as much as 12 percent.[1] But the main reason is that changes in the

[1] It must be noted that the practice of countries was to attempt to keep their exchange rate on the average close to the central value and not to bump against ceilings and floors.

have been frequent and sometimes quite sudden. The average percentage change (ignoring sign) from month to month (end) in the exchange rate of the French franc and the Italian lira from 1979 to 1983 was 0.8 percent.[1/]

[1/] See Five Years of Monetary Cooperation in Europe, Table 1.

If the movement is all one way, as it was substantially in the case of Italy, this represents about a 10 percent depreciation of the lira during a year. Although currencies outside the EMS exhibited greater month to month variability, on this measure, there were many more negatives cancelling out positives, rather than the more-or-less steady downward drift of Italy and France.

The forward markets reflect all these uncertainties about future rates of exchange. And it is noticeable that the forward discounts for France and Italy in the EMS group, with respect to the D mark, were and are usually larger than the ones pertaining to the United Kingdom.[2/] Being inside the

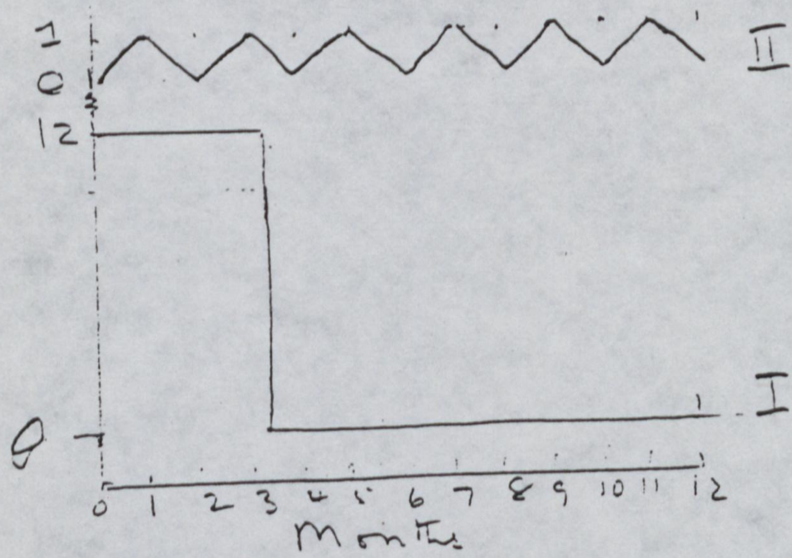
[2/] Thus on March 27, 1984 three month forward dollars commanded a 5 percent premium in D marks, and a 6 percent discount in the lira. This corresponds to the annual 10 percent draft of the lira against the D mark in 1983. Sterling, however, was at a premium of only 1.74 percent. And, of course, three month inter-bank rates ~~in the bank~~ reflected these at 5.85 in Germany, 17.4 in Italy, and 9 in London.

EMS did not seem to reduce the insurance premium one had to pay to avoid exchange rate risk. On the contrary, insuring against exchange risk cost more if you were in Italy, France or Eire than if you were outside in the

United Kingdom or the United States. Although the EMS has removed some of the short-term, month-by-month unsystematic "random" variations in exchange rates, it has not reduced significantly the systematic variation which can be forecast by the market.[1] This variation in EMS exchange

[1] The ECE Study, "Five Years of Monetary Cooperation in Europe", measures exchange rate instability by the size of the average monthly absolute change in percentage terms. It is worth noting therefore that the same measure of variability (i.e., 1 percent a month) would apply to the following two series. In series I there is one big 12 percent fall (not

Figure No.



atypical of the EMS realignments), whereas in the other series II there is a plus one minus one pattern for each month. Additional unemployment in series I arises from the fact that no one known <u>when</u> the big fall will take place. Thus, the same measured result masks a very distinct and different reality.

rates together with capital controls has enabled the countries to pursue monetary policies, as manifest in their interest rates, which were not entirely counterproductive in inducing "convergence". The basic inconsistency between fixed exchange rates and convergence remains.

In the rather messy EMS system, there has been no evidence of convergence. As the ECE paper admits, the mean absolute deviation between annual price inflation <u>increased</u> slightly from 4.2 percent in 1979 to 4.4 percent in 1983, although as always great things are expected for the years to come. The record on convergence so far is rather dismal, but more important is the fact that the EMS has butressed the latent argument for greater capital controls and reductions in the degree of convertibility. It has also provided a rationalization for trade restrictions.

The EMS was also presented as a step in the grand process of monetary integration of Europe -- perhaps ultimately towards one central bank, one currency, and one economic policy. If one entertains such ultimate goals, then the EMS seems to me to be a step backwards. Fixing prices (like exchange rates or, indeed, agricultural prices) creates centrefugal forces and divergence, not centrepetal forces and convergence. The road to convergence is to harmonize the great <u>quantity</u> determinants of monetary conditions -- namely, the rate of growth of money, and the budget deficit. If the members each pursued policies of similar low monetary growth then there would be the basis for eventual convergence. A medium term financial strategy is the right approach.

It has been claimed that the EMS is one way in which member states will accept the fiscal and monetary discipline required for convergence. The policies of France in the period of the socialist government 1981-1984 are presented as an example of such discipline. And it is true that the expansionary program of the Mitterrand government from the assumption of power in 1981 ran only until March 1983. Then after successive devaluations in October 1981, June 1982, and March 1983, the government instituted an austerity program, aimed at reducing the budget deficit to 3 percent of GNP and monetary growth to 9 percent. Of course one cannot be sure what policy the French government would have pursued if they had not been members of the EMS. But we do know that the behavior of the British Labour government in the period 1974-1976 was quite similar.[1/] Unbridled expansionism in 1974-1975 was followed by substantial squeeze in 1976. Ironically, in spite of the fact that Britain was not in the snake, the exchange rate against the dollar was pegged over this period! Thus protestations that the French government were largely or even significantly induced to the austerity of 1983 by membership of the EMS must be viewed with skepticism. It is entirely understandable that the supporters of the EMS should claim such credit as falls their way.

The conclusion is that it is difficult to see what the United Kingdom would gain from joining the EMS. Certainly under the Thatcher government, and conceivably under alternative governments, there is no need to bolster the anti-inflationary policies with psuedo fixed parities of the kind practiced in the EMS. At most the EMS might reduce the very short-term weekly, or monthly, variations in the exchange rate against the EMS currencies. But research suggests that because of thick and almost perfect forward markets such short-term movements have little if any effect in inhibiting

[1/] The main exception is that Britain did not devalue until 1977.

trade.[1] On the other hand, those who seek eventual monetary union of

[1] A survey of firms by the British North American Association showed little concern with the short-term variability of exchange rates, and firms were apparently well versed in buying forward cover. Under floating conditions the firms could either buy certainty in the forward market or take their chances on the spot market. With a real fixed rate system that choice is denied them. For a contrary view, however, see M. A. Akhtar and R. Spence Hilton, "Effects of Exchange Rate Uncertainty on German-U.S. Trade", Federal Reserve Bank of New York, Quarterly Review 9, 1 Spring 1984, p. 7-16.

Europe had best pursue it through quantitative convergence rather than exchange rate fixity. Britain will best serve monetary union in Europe by urging the right policies rather than embracing the wrong ones.

Finally, the EMS failed, indeed it was bound to fail, in insulating policies from politics. One of the great attractions of fixed parities of the past, such as the gold standard, is that the rules determined policy. If, for example, there was a run on the gold stock, then no one doubted that a monetary squeeze was on the cards, as manifest in the Horsley-Palmer rule. The room for political discretion and dissembling was small.

It would be nice if the great nations of Europe periodically discussed the existence and rationale for the fundamental disequilibria in exchange markets, and then proceeded to a rational conclusion. Such ideals are far from reality. In the EMS the periodic realignments are grand political events which present many opportunities for horse-trading, threats, counterthreats, bluff, etc. Quid-pro-quos are extracted for any "concession" on exchange rate parities. And exchange rates become another pawn in the grand game of Europe. Indeed, it would be naive to expect anything else. (The same characteristics emerged in the Bretton Woods system, and eventually led to its demise.) At the very least one may claim that it is not clear that the psuedo-fixed rates and other policies that emerge from this political bargaining process are "superior" to the free market solutions.

An Exchange Rate Target

Of course it would have been possible for the government to pursue an exchange rate target without joining the EMS.[1] The set of possible

[1] Logically it could have pegged at a central rate with respect to the EMS currencies and behaved as if it were in the EMS, without the political hassle of the realignments, etc.

exchange rate targets is virtually infinite. However, if one is seeking stability, not merely in terms of ~~the~~ foreign currency but also in terms of domestic monetary-fiscal policy, one should choose that currency, or a combination of currencies, together with an appropriate rules of reaction, which is thought likely to give rise to such stability. If we restrict our search, for the time being, to particular currencies -- suppose it is the U.S. dollar -- then the targetting is an act of faith in the greater likelihood of the United States pursuing suitable stable policies.[2]

[2] The experience of pegging to the United States in effect through gold in 1925-1931 and in the Bretton Woods system after World War II to 1971 is not reassuring. In the period from 1947 to the 1960s it was complained that the United States was exporting deflation, whereas from the mid 1960s onwards, they were said to be exporting inflation. In the 1970s under the dirty floats they were said to be exporting both. And in 1984 few would claim that the United States is a paragon of financial prudence and stability.

The choice of the EMS is essentially a decision that the German economy is, in the future, likely to be managed in monetary terms so that it is a suitable model for the United Kingdom. Perhaps it will. The post-war years have certainly seen Germany pursue the most stable of monetary and fiscal policies. But things may change, especially with the transformation of the SPD and the emergence of persistent unemployment.

If there was a desire, however irrational and misplaced, for more stable exchange rates in the United Kingdom, then it would have been more sensible and consistent with the objectives if the exchange rate target had been expressed in terms of the effective rate rather than the EMS/ECU package.[1/] This takes the exchange rates and weighs them according to the composition of trade of the United Kingdom. Thus, targetting an effective rate, compared with the EMS regime, would enable us to avoid slavishly following the D mark as it depreciates (or appreciates) with respect to the dollar, and so, by stabilizing with respect to the D mark, introducing greater instability with respect to the dollar.

In the long run an effective exchange rate target would ensure that the United Kingdom inflated, with respect to the prices of traded goods, at roughly the same rate as her trading partners, whereas an EMS target that did not suffer periodically large one-way "realignments" in respect to the D mark would ensure that we inflated at the same rate as Germany.

Interpreting Exchange Rate Movements

One of the main criticisms of adopting either a fixed exchange rate, or an exchange rate target, is that the value of a currency reacts -- sometimes dramatically -- to many factors besides monetary behavior. The exchange rate is the relative price of liquid financial assets. Although the stocks and changes in the stocks of such assets are important determinants of the relative price, they are only part of the story. The exchange rate is much affected by anticipations, expectations and uncertainties, which are in turn affected by political events, rumor and report. In effect the exchange rate has many of the characteristics of the price of an ordinary share of a corporation. One must expect a fair degree of volatility in free markets for the foreign currencies.

Consider, for example, the effects of targetting an exchange rate during the periods of particularly large political uncertainty such as the run up to the general election. A conservative government committed to a policy of sound finance will find the exchange rate coming under increasing downward pressure. The markets will take a view of the likelihood of Labour government and the consequential fall in sterling (or combination of exchange controls and regulations). Provided there is a high enough probability of a Labour government being relected, the markets will anticipate the event.[1/]

[1/] In the 1983 general election the chances of a Labour government, as reflected in the polls, was virtually zero.

The higher the likelihood of a Labour government being elected, and the greater the differences between the expected monetary and fiscal policies of the two parties, the greater the depressing effect on the exchange rates in the year or months before the date of the election.

Suppose the authorities were pursuing an exchange rate target for monetary policy. Then in the year before the election the authorities would increase interest rates and induce a monetary squeeze in order to maintain the parity. This is likely to result in a decline in real growth, and perhaps a decline in real output, together with other effects such as an increase in enemployment -- hardly the sort of policy which any government would wish to impose during the election year. Furthermore, the greater the difference between the parties -- the Conservative "sound policy" and the Labour "profligate policy" -- the tighter the squeeze. Worst of all, the greater the likelihood of a Labour government, the higher must interest rates go to deliver the exchange rate target, and so the policy will increase still further the probability of a Labour government being elected. Thus a good chance of a Labour government may be turned into a sure thing.[1/]

[1/] The bias induced by this policy to elect profligate governments is still present in the case where the existing government pursues an inflationist policy. If the alternative Conservative government were believed to be in favor of sound finance, then if they had a good chance of being elected, this would have a favorable effect on the exchange rate of the Labour government and so enable them more easily to pursue an appropriate expansionist policy in the run-up to the election.

Clearly the exchange rate target for monetary policy is bad political economy.[1/] But even if it were not, there are strong objections to a

[1/] It is, of course, conceivable that an exchange rate target may be proposed precisely to offset the normal temptations of governments to expand and inflate during the run-up to the general election. But, according to the argument in the previous footnote, it would have the <u>opposite</u> effect on an incumbent profligate government, making it yet more inflationary on the approach to the election. It will restrain only the government that pursues, relatively speaking, a sound monetary policy.

monetary policy that routinely reflects all the alarms and excursions that affect exchange rates. If, for example, the United States, in order to contain the inflationary impact of the large Federal deficit, induces a very tight monetary squeeze so that the dollar-sterling rate comes under great pressure, why should the United Kingdom respond in a like manner, in order to defend the parity? It may well be that the domestic monetary conditions in the United Kingdom are entirely satisfactory and do not call for any such squeeze. The exchange rate target will induce artificial oscillations and additional instability in monetary conditions in order to preserve stability of exchange rates.

Granted that it is undesirable to make monetary policy a consequence of the vagueries of exchange rate movements, it is worthwhile considering whether the movements in exchange rates can be used to interpret and get useful assessment of prevailing monetary conditions. If, for example, a high exchange rate meant that monetary conditions were "tight" and a low exchange rate implied that monetary conditions were "loose", then the exchange rate could rank along with interest rates, both nominal and real, as a measure worthy of close attention but not targetting. The exchange rate could provide corroborating evidence for our main targets, the monetary aggregates.

The difficulty with this subsidiary role for exchange rates is one of interpretation. One would need to identify the causes of movements in the exchange rate before it could be used safely for monetary analysis. One would need to filter out those movements which are due to political factors, changes in the policies or prospects of our trading partners, accidents and the vaguries of nature, market "confidence", etc., which account for a substantial fraction of the variation of the exchange values. This is difficult. There is no repetitive historical record so that one can isolate such effects.

Exchange rate movements must, therefore, be considered as generally rather dubious indicators of monetary conditions. There are exceptional circumstances where very large exchange rate movements, combined with other evidence may be used as a clinching argument. (I shall argue that this was the case in the winter of 1980-1981.) But one whould not look to exchange rates for any subtle interpretation of monetary conditions.

Although the authorities may decide to eschew exchange rate targets and to concentrate on delivering a target for monetary growth, it will be difficult to ignore the exchange rate effect if the market still believes that the authorities will react to exchange rate changes. The authorities will be driven by the market. Again one finds that the critical element in the policy is its "credibility."

Consider for example conditions which, as we shall see, broadly apply to the United Kingdom. The authorities announce that the level of short-term interest rates will depend primarily on the assessement of the movements in the monetary aggregates. The exchange rate is to be the object of benign neglect. However the markets are not convinced that the politicians and central bankers can so readily jettison their concern for the level of the exchange rate. (There are many in the Bank of England who have made no secret of the fact that they believe it would be appropriate to pay much more, not less, attention to the exchange rate). The question will be put: "Can ministers stand idly by as the exchange rate sinks (or rises) with all that that will entail?"

Whatever the reasons for the markets distsrust, portfolio managers will act on the basis of these beliefs. Thus suppose that there is a rise in the United States dollar brought about by some draconian tightening of monetary conditions in the United States. The authorities, surveying domestic monetary conditions, observe no surge of monetary growth and broadly believe that monetary conditions are ´right´. The market however sees sterling sinking against the dollar and anticipates that there is a good chance that the authorities will be driven to raise interest rates to stop the precipitous fall. The expectation of the authorities increasing interest rates substantially will be enough to generate falls in the price of financial assets. Portfolio managers will be induced to sell gilts in the expectation that they will be able to buy in later at a lower price. Similarly the discount market will reduce the price that it offers for new bills. Thus there will be all the appearances of a 'gilt strike'!

Broadly speaking the authorities have two choices. First they could stick to their announced policy and not ratify the market moves, or secondly they could follow the lead of the market and behave as if they were defending the parity of sterling. The first path is a difficult one. Changing ingrained expectations is a harrowing business. The authorities would have to sit out the funding strike and use other sources of funds - such as running down foreign assets or borrowing from foreigners.[1/]

It would be wise to avoid monetizing any of the borrowing requirement and so inflating the monetary aggregates, but as a temporary measure this might be a last resort. The dangers of such a policy choice - the possibility of inciting inflationary expectations, and indeed the fact that the authorities may lose the confrontation - are clear and present.

1/ The implications for the exchange rate are clear and need not be elaborated here.

The second choice seems to avoid all such risks. If the authorities raise interest rates so that there is no risk of them going up further, then the funding strike is over and the flood begins; and sterling will return to the range at which there are no market fears of authority reaction. The temptation to follow this seemingly obvious path is clear.

But this will simply validate the markets expectations that there is an exchange rate target. The next time the rate comes under pressure, the authorities will be locked ever more closely into the exchange rate target by the more certain expectations of the market. Believing it is so makes it so. All that is needed for an exchange rate target is the belief, however acquired, in the market thta the authorities just could not tolerate substantial depreciation of sterling. Then the authorities can argue that they cannot fight market pressure - or at least it would be foolhardy to do so. Thus does rumour beget policy.

In one sense the second alternative of capitulation to the market has many attractions for governments and monetary managers. The markets and foreigners can be blamed for the painful oscillations in interest rates as well as the instability of exchange rates. It avoids eyeball to eyeball confrontation of the authorities and the market, and the government is unlikely to get a bad press if it does what is expected. The older heads in the corridors of Whiehall and the City will recall that in battles between the authorities and the city (not to mention the gnomes, etc.) it is the latter that always wins.

But the markets may take the view that some pressures on the exchange rate cannot be countered effectively by feasible movements in interest rates. Portfolio managers may be convinced that, on fundamental grounds of purchasing power parity, the exchange rate must move. Their guess about the intentions of the authorities is reciprocated by the authorities trying to adduce what the market foresees or wants, and so on... As in all game-theoretic strategies, such behaviour~~s~~ defies any neat analysis. The extent to which the authorities were driven unwillingly by market expectations cannot easily be assessed from overt behaviour. The attempts to attribute causation in the following pages are tentative. The subject deserves more analysis and reflection.

FROM: Sir C Tickell

DATE: 13 February 1984

PS/PUS

cc Sir J Bullard
Sir P Cradock THIS COPY FOR
Sir W Harding
Sir J Leahy
Mr Wright
Mr Hannay
Mr Hayes
Mr Jenkins
Planning Staff
Research Dept
ECD(I)
ECD(E)
ESID

Sir M Butler, UKREP Brussels

EMS AND ECU

1. As requested in Mr Jay's minute of 19 January, I submit papers prepared with ECD(I) and ESID on the related themes of the European Monetary System (EMS) and the private use of the European Currency Unit (ECU) for consideration by DUSs at their meeting on 24 February. It would, I think, be right for DUSs to consider these questions at the same time.

EMS

2. The purpose of the EMS paper is to bring out the arguments for and against our joining the Exchange Rate Mechanism (ERM) of the EMS. Personally I believe that it may slightly understate the damage which instability in the currency markets has done to Western economies since the break-up of the Bretton Woods system in 1971. Uncertainty is the enemy of investment.

3. The fundamental political argument for full British membership of the EMS with participation in the ERM is similar to that which caused us to join the European Community itself: in short that it profoundly affects us; that it is better to have a guiding hand from within rather than try to influence it from without; and that we should play a full part in an institution whose future could determine the growth of the Community as a whole. At present we are in a kind of half-way house. Already now, and more in the future when the Community is again enlarged, there is a tendency for members to form operational groups for functional purposes. In such circumstances we would not want to find ourselves anywhere but in the central group - in effect the Germans and the French - on the key questions comprised in the development of the EMS, which could eventually evolve towards some form of economic and monetary union.

4. It will not be easy to choose the right moment to join the EMS if Ministers so decide. As we found when we eventually joined the Community itself, moving buses are hazardous to catch. Once we had failed to join the EMS at the beginning, there were always arguments to suggest that the time had not come. Sometimes sterling has been too strong, sometimes it has been too weak. We now confront the likelihood, discussed in the paper, that the Deutschmark will appreciate against sterling as well as the US dollar, and that if we were to join tomorrow, we might all too soon have to change whatever

/peg

peg we chose for sterling and anyway introduce instability into the system. This is something which will obviously need very careful discussion. At all events we want to be ready to move forward if and when the time looks right. I suspect that whatever the circumstances we shall have to accept some measure of risk.

5. At the DUSs's meeting we shall need to consider how next to proceed. I think myself that once we agree on the two papers, they should be submitted to the Secretary of State with a recommendation that he should talk to the Chancellor of the Exchequer as soon as possible after the Budget. You will recall that FCO Ministers meeting at Chevening in December agreed that this would be desirable. My own discussions with Treasury officials suggest that the Chancellor is keenly interested in the whole problem. There is also plenty of interest in Brussels and elsewhere. The Commission is already in touch with the Treasury on the subject. The annex to the paper on EMS suggests some of the points which require further study. The main burden of such studies would of course fall on the Treasury and the Bank of England, but I hope that the FCO could be involved.

ECU

6. The Secretary of State has asked about the advantages and disadvantages of our pursuing a more positive line than that encapsulated in the <u>nihil obstat</u> which describes the present position of the Bank of England. The second paper brings out the arguments clearly. The fact is that there are no obstacles to the use of the ECU for private transactions in Britain where there are no exchange controls. Were there similar freedom in other member states, the use of the ECU would probably grow faster than it already has. If the market has developed in a more leisurely way in London than in one or two other Community capitals, this mainly reflects special factors (for example exchange control in France and Italy) and the judgement of the market in London. Little can be done about this. Here you will wish to see the conclusions of the paper.

Crispin Tickell

13 February 1984 Crispin Tickell

THE EUROPEAN MONETARY SYSTEM

Introduction

1. The purpose of this paper is first to examine the advantages and disadvantages of possible British membership of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in the light of recent developments: and secondly to consider the implications for future British policy.

Historical Background

2. The EMS was set up in March 1979 with the aim of creating a "zone of monetary stability in Europe". The essential components of the EMS are:

(a) a European currency unit (ECU);
(b) an Exchange Rate and Intervention Mechanism;
(c) a credit mechanism
(d) measures designed to strengthen the economies of the less prosperous States in the EMS.

3. EMS was envisaged as the first step towards European Economic and Monetary Union (EMU). But the pre-conditions for EMU - the total elimination of internal barriers against trade and services, mobility of capital and labour, a Community-wide system of taxes, harmonisation on a Community basis of aids to industry etc - do not exist and are not likely to do so in the forseeable future, and the move to the second stage of EMS - the consolidation of the system through the establishment of a European Monetary Fund and the development of the ECU as a reserve asset - which was to have taken place two years after its setting up, has been indefinitely deferred.

4. The numeraire (denominator) of the existing system is the ECU, a composite monetary unit containing fixed quantities of each EC currency (except the drachma). Each currency participating in the ERM has a central rate against the ECU and, deriving from it, against other currencies. Central banks are obliged to intervene to keep their currencies within 2.25% (6% for Italy) of their

central rate against the ECU and against the other ERM currencies. The system implies fixed exchange rates but periodic adjustments have been made. The latest of these was on 21 March 1983 when the French franc was devalued and the DM revalued. These readjustments have been agreed by Finance Ministers meeting in a format similar to that of an ECOFIN Council; ie, under the Chairmanship of the Minister whose country holds the Presidency at that time.

5. HMG is formally a member of the EMS but decided in 1979 not to participate in the ERM. The change of government which took place soon afterwards did not affect this decision. The new government opposed full participation in the exchange and intervention mechanism on the grounds that it would have kept the pound sterling at an artificially high rate, hindering economic activity and requiring intervention at a rate that conflicted with the tight monetary policy being pursued by the British Government.

6. Nevertheless, the United Kingdom does play a part in the EMS. Sterling is assigned a notional central rate and this is adjusted to reflect its value at every realignment of the EMS. If of significant size, this adjustment can affect the central rates of all other ECU currencies. On occasions, due to sterling's wide fluctuations since 1979, the impact has been considerable. However, since sterling's central rate remains unchanged between realignments, these fluctuations have no implications for the intervention obligations of ERM members.

7. Sterling's detachment from the system has enabled the Chancellor to play an important role at realignment meetings. For example, Sir Geoffrey Howe presided over the meeting on 21 February 1982 during the Belgian Presidency when the Belgians were seeking a large devaluation of the FB and there was a need for impartial chairmanship.

8. The Government has kept the question of sterling's participation in the ERM under review and has stated publicly that

it would join when the time was right, both for Britain and for the system as a whole.

Recent Developments

9. There have been a number of developments relevant to the debate about British membership of the ERM since the subject was considered at a special meeting chaired by the Prime Minister's meeting on 22 January 1982 and at which the Chancellor, the Secretary of State and the Governor of the Bank of England participated. The EMS has demonstrated its durability and flexibility. Sterling is less obviously over-valued in relation to other EMS currencies than in previous years. Oil prices (to which sterling has been sensitive) are relatively stable. The British inflation rate has fallen below the Community average and to within two percentage points of the FRG's. The potential incompatibility of our monetary objectives with adherence to an exchange rate target within an essentially DM-denominated system is consequently less than hitherto. Indeed, in his Mansion House speech in November 1983, the Chancellor confirmed that the exchange rate had a role as an indicator of monetary conditions. It may be that full membership of the EMS could now begin to have attractions as a possible anti-inflationary discipline.

10. The House of Lords Select Committee on the EMS chaired by Lord O'Brien which reported in July 1983 concluded that the balance of advantage lay in early, though not necessarily immediate, British participation in the ERM. Professor Jim Ball of the London Business School also came down in favour of British membership in his recent report (with Michael Albert) to the European Parliament on economic recovery in the 1980s. Also in September 1983 a Commission paper on the Other Policies chapter of the post-Stuttgart negotiation (COM(83)578 Final) recommended that steps should be taken to promote the role of the ECU and that the ERM should be extended to all Member States. During his visit to London in November, M Ortoli raised the issue briefly and said that he would wish to come back to it with the Chancellor in 1984. A senior Commission official visited the Treasury in late January

1984 to follow up and discussions are now engaged.

11. The rise in the value of the dollar in recent months and the widespread expectation that this movement will sooner or later be reversed has led to growing interest in a co-ordinated European response. It is relevant to observe that the two major steps by which the EMS reached its present stage of development occurred at times of considerable turbulence in international markets. The seminal Werner Report was published in 1970 following the early signs of disintegration of the Bretton Woods system. The Jenkins/Schmidt initiative in 1977-8 which led to the establishment of EMS as we know it was in response to the international recession associated with the first oil price shock; to the growing belief that more monetary stability was desirable; and the feeling that the Community should take steps to ensure that Member States' economies were not adversely affected by a world monetary system dominated by a currency, the dollar, over whose management we had no control. A new bout of currency instability resulting from a rapid fall in the value of the dollar could conceivably lead to calls for the enhancement of the role of the EMS.

The Political Case for Joining the ERM

12. The main political factors in favour of joining are:

(a) The United Kingdom ought to be party to all activities regarding the development of the Community. We should never repeat our mistakes which led to our self-exclusion from the process which led to the signature of the Treaty of Rome. Other things being equal it is desirable that we should participate fully in the EMS. This would give us the chance to steer it in a direction consistent with British interests.

(b) So long as we are not in the ERM we strengthen the argument that we are not committed members of the Community. To join would be a telling demonstration of that commitment. This would have particular value in the post-Stuttgart negotiations which are designed to set the Community on a new course.

(c) Our line that we shall join when the time is right is less and less convincing to our partners. The longer we absent ourselves, the more difficult it will be to join as habits harden in other moulds.

13. But the political case cannot be assumed to be beyond question. Our entry could cause problems for the other members, and if the system were subsequently to collapse, whether or not as a result, we might attract the blame. More significant is the possible domestic political impact: if, as is quite possible, maintaining an EMS rate involved unpopular policy measures such as higher interest rates, this would scarcely enhance enthusiasm for Community membership. Indeed, its present unpopularity might reduce the effectiveness of a constraint expressed as a European obligation (by contrast with France, where the need to maintain the EMS parity is seen as reinforcing the case for tough measures).

14. On balance however, the political arguments in favour of British participation are persuasive. As economic circumstances become more favourable to our joining the political considerations could assume greater importance.

<u>The economic case for joining the ERM</u>

15. This can usefully be evaluated in terms of the effects on:-

(a) British economic policy;
(b) European integration
(c) external constraints on European economies; and
(d) development of the international monetary and exchange system.

These aspects are, of course, closely related. The policy debate in Whitehall has hitherto concentrated on various aspects of (a), but points (b) - (d) are also important, both in their own right and also because they impinge on (a).

British Economic Policy

16. The case in terms of British economic policy for joining boils down to the following:-

(a) provided we enter at a reasonably competitive rate, stability with regard to our main trading partners is desirable in its own right, primarily in reducing business uncertainty;

(b) large fluctuations ('overshooting') might be reduced by affecting expectations (because there is a presumption of action by the authorities both in Britain and in other EMS countries to limit them) and because of the practical provisions of the system (additional intervention resources etc);

(c) the link with what is, in effect, a DM zone reinforces anti-inflation policy;

(d) while there remains a possiblility of conflict between monetary and ERM objectives, the danger is much less than previously because British performance is now closer to that of the FRG. In practice monetary and ERM objectives may be mutually reinforcing; if conflict persists, there is always the option of realignment.

(e) joining the ERM at an early stage might complement the tighter domestic policies which would be necessary to combat the inflationary effect of any depreciation in the value of sterling consequent upon a realignment of the dollar.

17. At a technical level the issue would be now to reconcile a new exchange rate priority with our existing priority on monetary aggregation.

European Integration

18. Even if the theoretical importance of joining the ERM as a step which would lead towards EMU can be ignored (there is for the time being no impetus to move even towards stage two of the EMS), the more modest reality of the ERM could be helpful in promoting mutually profitable integration. The habit of consultation required *inter alia* by realignments has grown, and may help to promote consistency of policies. The operation of the CAP, and agreement on price restraint, might be easier if exchange rates were more stable. Inter-Community trade problems are more likely to be manageable in such circumstances.

External Constraints

19. One of the most pressing bones of international contention is the effect of US interest rates on the rest of the world. European governments complain that high US interest rates (generally attributed to the size and apparent persistence of the US Government's budget deficit) face them with the choice between keeping up their own interest rates to avoid currency depreciation and allowing their exchange rates to fall as the price of more acceptable real interest rates. The former inhibits recovery, while the latter increases inflationary pressures.

20. The latter course might be less damaging, and the dilemma less acute, if all the European currencies moved together. The increasing interdependence of EC trade (including Britain's) means that externally generated price pressures for any individual country would then be less significant, and recovery might be hastened at less inflationary cost. Moreover, the pressures on the US to put its house in order might be increased (although there is the hazard that it could be resolved by increased trade protection).

The International Monetary and Exchange Rate System

21. The recent strength of the dollar is but the latest of a series of sharp fluctuations in exchange rates since floating began in 1971. It is widely agreed that there have been severe

damaging misalignments ("overshooting"), and that efforts should be made to reduce them. There is also little dispute that the main ingredients for reducing these problems are policy consistency among countries and convergence of economic performance. This is not, however, inconsistent with measures aimed explicitly at exchange rates. These can take the form both of arrangements for intervention and on margins such as the ERM and of more general commitments by Governments to align policies in such a way as to keep exchange rates within broad target zones. Expectations in the market can be influenced by measures of the latter type, although the effects are likely to be stronger if they are complemented by relevant practical measures.

22. These questions, as well as wider issues of development of the international monetary system, are likely to be a major item on the agenda of the London economic summit. US reluctance to contemplate interference in the exchange markets may limit progress, although there have been signs that attitudes are changing. The point may be approaching at which these matters will at last be seriously examined; the influence of the European voice in such discussion will depend largely upon the coherence of the European monetary authorities and of their positions. This might be stronger after a period of British membership to the ERM. Moreover, our part in determining European positions may also be stronger in such circumstances.

<u>Economic arguments against Membership</u>

23. A reversal of the recent strength of the dollar is widely perceived as likely, if not imminent. Were this to happen the DM would almost certainly strengthen against sterling. The size and strength of the German economy would make it the major refuge for funds coming out of the dollar, driving the DM up also against EMS currencies and sterling. Because the mechanisms of the ERM would tend to dampen the former movement, sterling would probably fall relatively further. If this were the case it could be argued that HMG should wait to joint the ERM until at least some of this realignment had recurred. If sterling were to join earlier and

then be forced to devalue, this would be damaging for public opinion in Britain and perhaps for the system itself.

24. A second reason for caution is sterling's petro-currency role; although oil prices are unlikely to show as much instability as in the 1979-83 period, prospects remain uncertain. It is also worth asking whether membership of the ERM might not change expectations and hence the degree of coincidence between oil price movements and the sterling parity.

25. There are also domestic economic arguments against joining:

(a) although precautions can be taken to minimize the danger of inconsistency, there will always be the possibility of conflict between monetary and exchange rate targets, particularly in the face of unforeseen shocks. Manifestly, those most closely involved judge that we should give priority to monetary objectives in such circumstances. Committed membership of the ERM would require interest rate policy to be linked to exchange rate objectives with the possibility that monetary aggregates could be relegated to secondary importance.

(b) Understandably, those who would have to execute a policy which contained the possibility of inconsistency do not relish the idea of blame for failing on one count or the other: hitting one target is difficult enough.

(c) The possibility of holding a fixed exchange rate in the face of powerful market movements is questioned. Taking the strain partly on the exchange rate and only partly through intervention has long been preferred.

(d) There is a strong aversion among some of those most closely involved to fixed rates, the EMS, and to interference in markets.

26. To these arguments might be added suspicion of proposals which involve sharing with outsiders decisions affecting management of the British economy.

Conclusions

27. A decision on Britain's adherence to the ERM must continue to rest primarily on the economic arguments. Although in recent months the economic arguments for an against membership have become more balanced; the expectation of a significant fall in the value of the Dollar remains a powerful argument to suggest that the time is still not right. Considerations of competitiveness and the difficult of managing entry when exchange rate relativities are changing rapidly mean that the arguments for joining would be stronger once this expected readjustment (which seems likely to involve the relative parities of DM and sterling) had taken place. On the other hand those who give primacy to price stability could argue that entry ahead of any thoroughgoing realignment would assist in maintaining the current policy stance.

28. The interest of the Foreign and Commonwealth Office is to ensure that the political case for joining, and particularly the need to ensure that we are not left out of important EC developments, is never lost to view. We also need to guard against the possibility that we might miss a chance to join at a propitious moment because the essential preparatory work had not been done. This is an argument for a study of the technical issues both within Whitehall and with the Commission. (The annex to this paper suggests some points for study.) This could lead to a more open debate on the fundamental issues and might convince our partners of our sincerity when we say, as we are bound to go on doing if we are not to be thought to be going backwards, that we will join when the time is right. These studies could also lead us to adopt a more collaborative and European approach to the problems of establishing a greater degree of exchange rate stability which could be threatened in the not too distant future by the fate of the dollar.

Annex

POSSIBLE PREPARATORY STUDIES ON UK MEMBERSHIP OF THE ERM

1. We need to consider the implications for the ERM of British adherence. Strains could rapidly reappear within the system if sentiment turned against the dollar and capital flowed towards the DM. Could the ERM cope with a DM and a £ which tended to diverge?

2. If this were to happen, the burden of adjustment would not fall upon the United Kingdom alone. We need to consider the consequences for both the United Kingdom and the Federal Republic of a serious effort to hold their rates together.

3. In the longer term we need to have a clearer picture of what we are trying to achieve. Do we wish to see target zones for exchange rates? Do we wish to see practical measure to introduce 'viscosity' into exchange rate movements? Do we regard decoupling Europe from the influence of US interest rates as a desirable or practical

4. The issue of how best to bring about permanent parity changes. A "market-determined crawling peg" in which central rates change gradually and mechanically in response to past divergences from the central rate is a possible alternative to large step changes.

5. A separate though related question concerns the role of the ecu. We need to consider whether there is anything which can legitimately be done without interference in the market to influence or encourage the use of the ecu, which is increasing of its own volition.

(See separate paper)

THE PRIVATE USE OF THE ECU

1. The growing private use of the European Currency Unit (ECU) is perhaps one of the surprises of the European Monetary System (EMS) experience. In terms of an eventual Economic and Monetary Union (EMU) the development of a parallel European currency is a long term goal. But the European Commission has always been keen to encourage private use of the ECU in the meantime, and originally believed that such would follow from greater official use of the ECU. Instead private use now seems to be ahead of official use, involving a number of non Community agents and in spite of capital and currency controls across the Community.

2. These developments have taken the form of accelerating growth of Eurocurrency markets based on the ECU. In the main these have been bond markets but during 1983 bank and official medium term credits began to catch up. During the first ten months of 1983 total bonds and credits issued amounted to 3.3bECU which compared with 2.1bECU in 1982, 500mECU in 1981 and 20mECU in 1980. The main countries involved in these markets are Italy and France, but Ireland, Denmark, Greece, Belgium and the United Kingdom (via an issue by Rank Xerox) have also been the source of smaller issues. Outside the Community, American, Canadian, Japanese, Spanish and Scandinavian institutions have also issued bonds or credits. Nonetheless the ECU market share remains small, amounting to only 4% of total Euro bond markets.

3. There is also evidence that the ECU is being increasingly used to invoice foreign trade within the Community and by some traders outside it.

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4. The underlying reason for lenders, borrowers and traders using the ECU or any currency bundle is risk avoidance. Any transaction must offer both sides some advantage in terms of expected stability of value or level of interest rate over dealing in domestic currency or other foreign currencies (including the constituents of the ECU basket).

5. The relative fixity of exchange rates of the currencies within the ERM gives the ECU some of its attraction but in principle the same considerations apply to the individual currencies as well as the basket. Another advantage at least for citizens of member states is that their domestic currency forms some proportion of the basket and hence bears no exchange risk; but again in principle the difference in interest rates obtainable on domestic and ECU instruments ought to compensate for any expected change in exchange rates. The reality is that exchange rate changes can be sudden and particularly in high inflation countries interest rate differentials may be difficult to interpret and fears of a sudden collapse of the currency greater than reflected in foreign exchange markets. It is certainly suggestive that the main growth in the market has been in high inflation, weak currency countries, Italy and France in particular.

6. There may also be specific institutional reasons. Italian firms felt themselves over exposed to dollar risks and hence began to borrow in ECU. Italian investors, because of a relaxation of currency laws in favour of the ECU, had the opportunity to lend in ECU, thus hedging against Italian inflation. Both sides were in effect setting up a domestic bond market which did not previously exist. Non-EC institutions probably raised money in ECU simply to diversify the exchange risk on their debt, or to allow themselves to borrow currencies such as French Francs which they were otherwise not allowed to hold.

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The private use of the ECU in Britain

7. The United Kingdom has taken a relatively small part in the market, with only one bond issue originating here. Lloyds Bank International is one of the major European banks taking deposits in ECUs, which are second only to their US dollar holdings. Nonetheless, and in spite of rapid growth, by the end of September 1983 British Bank ECU liabilities were only one quarter of one percent of British dollar claims, and 2% of British deutschmark liabilities.

8. There have been, subsequent to the abolition of exchange controls in 1979, no obstacles to British citizens or institutions holding ECU or carrying out any transactions they wish in ECU. This is the basis of the Bank of England declared policy of Nihil Obstat. It needs to be recognised that the absence of exchange controls by itself is a more positive policy than in other member states where exchange controls or, in Germany's case, domestic currency laws may prevent nationals holding ECUs. It is also worth noting that the Treasury is willing to accept loans from the EIB denominated in ECU.

9. So why has development been slow in Britain? Ignorance must certainly be a factor. But the underlying reasons are probably in the current balance of payments/exchange rate position.

10. First, the strong balance of payments has meant that Britain has been a net capital exporter in recent years; a feature emphasised by the portfolio adjustment which took place after the abolition of exchange controls. Second, the decline in both inflation and the public sector borrowing account may have increased demand for sterling assets while reducing supply. Thus there has been no need of official financing in ECU or indeed other foreign currencies, as there

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was for instance in the late 1970s when the budget deficit and the balance of payments deficit were both large.

11. British absence from the Exchange Rate Mechanism (ERM) of the EMS has meant that potentially the ECU rate fluctuates more against sterling than against other member currencies, thus negating some of the apparant advantages to traders of invoicing in ECU. In any case for private individuals and firms, the strength of sterling against European currencies in recent years has probably argued against the ECU as a currency hedge of any importance in trade.

<u>Outlook for future use of the ECU</u>

12. In general, a bout of dollar weakness might prove helpful to the future development of ECU based Euromarkets but the main structural improvements would come from a general dismantling of barriers to capital movements within the Community, and in particular a change in attitude by the German central bank towards the ECU. Currently it prevents German citizens holding ECUs. Against these, the possible entry of Greece, Spain and Portugal will reduce the attractiveness of the currency basket to traders in particular.

13. There is also need for a general clearing mechanism for ECUs. Currently banks with small deposits are forced to split them up into constituent currencies at the end of each trading day. Such a mechanism is under active consideration.

14. In Britain a shift from a surplus on the current balance to a deficit would increase demand for loans in foreign currencies. The fact that around 14% of the ECU is in sterling and that there are weak as well as strong currencies in the basket would reduce the exchange risk on ECU denominated borrowings and hence make them more attractive. A weakening of sterling might also increase the demand by exporters to

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Britain for ECU invoicing and hence for ECU accounts.

15. The Commission is currently looking for three positive steps to improve the use of the ECU - none of which provide any substantive difficulty for Britain:-

a) that all member states recognise the ECU as a foreign currency. Effectively this is aimed at the Federal Republic;

b) that the ECU is officially defined and copyrighted;

c) that ECU issues are open to EC citizens wherever they reside, thus giving ECU an advantage particularly where exchange controls operate.

(a) and (c) are already operational in Britain, and (b) is dependant on (a) happening in other member states.

A more positive British policy

16. British membership of the ERM might encourage the use of ECU in Britain particularly if sterling were expected to be among the weaker members. Short of membership of ERM there are a number of possible policy initiatives HMG could undertake to increase use of the ECU:-

a) instruct the Bank of England to use the ECU among its reserve assets and to intervene in the market for it;

b) issue Government borrowing instruments in ECUs;

c) encourage local authorities and nationalised industries to make foreign borrowing in ECUs, particularly loans protected by the Public Sector Exchange Cover Scheme;

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d) publicise the ECU as a monetary asset for trade and investment purposes to raise consciousness of the ECU in Britain.

17. On (a), at present the market would probably be very thin and such a facility would do little good by itself. In any case in circumstances where there was the possibility of differential movements against EMS currencies (eg the DM and the French Franc) it would probably be more efficient to trade direct. Only the Italian Central Bank is currently doing this, against a background of 10% of trade invoiced in ECU and a substantial domestic credit market denominated in ECU. Starting with the Central Bank hardly seems sensible for the United Kingdom.

18. On (b) the issue of government borrowing instruments in ECU would probably be strongly resisted by the Treasury and the Bank of England. There is currently no problem in funding Government borrowing on the Gilt Edged market and some sterling bonds are bought by foreigners. Nor is there any need to finance a balance of payments deficit. Hence the issue of a foreign currency bond could be interpreted as HMG signalling a wish or an expectation that sterling should fall.

19. On (c) there might be less resistance to other Public Sector bodies, who are in any case borrowing overseas, directing their borrowing to ECU. This would give an extra hedge to the Exchequer for those loans insured against exchange rate movements under the Public Sector Exchange Cover Scheme. But even this route would not be very attractive unless there is a substantial risk that sterling would depreciate less against the ECU than - say - the US dollar.

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20. On (d) it would hardly be for HMG directly to undertake publicity to promote the private use of the ECU, although it might let it be known that it had a benevolent attitude towards it. The Eurocurrency markets are largely based in London and the operators on them are sophisticated. It is unlikely that there is anything that HMG could tell them that they do not already know. With private individuals, government advice to hold ECUs might be seen as encouragement to speculate against the currency or at least an indication that British inflation was likely to rise above the EC average. It is possible that the Commission might wish to undertake a Community-wide publicity campaign, aimed at traders in particular but also perhaps covering private individuals, to encourage the use of the ECU. As HMG has no exchange controls this would do no more than recommend what is already allowed. Any campaign would probably founder on German opposition.

21. The European Parliament has suggested the issue of a one ECU coin as publicity and to give substance to the ECU. Given that no prices are set in ECU (beyond the CAP) and that Banks are reluctant to accept even high value coins in foreign exchange dealings, this would look like a gimmick and in the short term could be counter productive. Any commercial initiative to issue ECU travellers cheques is much more realistic. It is possible that such papers as the Economist may be launching campaigns of their own to propagate the use of the ECU as something the City might exploit in order to develop its role as the main European financial centre.

Conclusion

22. HMG has placed no barriers against the private use of the ECU, and has preferred to leave its development to market forces. It would be hard actually to promote it without raising doubts about the governments intentions, but in

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certain circumstances HMG might look favourably on ECU denominated borrowings under the Public Sector Exchange Cover Scheme. Publicity from whatever quarter might alert dealers and traders to the opportunities for greater use of the ECU, but the responsibility for such use and the advantages it might bring to the City must be for the judgment of those concerned.