POLICY CHALLENGE

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JOINING THE EMS FOR AND AGAINST

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PART I

FOR

by Harold James

European Monetary System: The Way Forward

Discussions of possible British membership of EMS have unfortunately become highly politicised. Both supporters and opponents frequently claim that such a move is far more than it appears to be on the surface -- that it is a stepping stone on what may be either a more glittering, or a more sinister, path. Is the eventual target not European Monetary Union, or perhaps even a political fusion? The remarkable feature of the public debate so far has been the extent to which it has avoided a concrete discussion of the likely consequences, of the costs and benefits of membership, and has concentrated instead on something else and much larger.

In fact, EMS is not a monetary union, but is rather a commitment to a more rigid system of exchange rates than that which has prevailed since the Bretton Woods era ended in 1972. It is, when all is said, a fairly humdrum institution. But it may offer particular advantages when it comes to making British economic policy -- especially when coping with such problems as obstinately high rates of interest or of inflation.

A more sceptical view about the long term, and perhaps a more sophisticated one, sees EMS as representing an unacceptable loss of national sovereignty. Such a conclusion obviously depends on a definition of sovereignty. If we take the British answer in its most classical form -- that sovereignty is the power of a monarch in parliament to make national law -- it is difficult to see that EMS constitutes any hazard. Instead of the price of sterling being set by supply and demand on volatile international currency markets, with or without systematic interventions of central banks (including the Bank of England), if Britain joined the EMS the exchange rates between sterling and all other currencies would be fixed, within a narrow range, by agreement between Britain and the other member states. EMS exchange rates are permitted a latitude of movement of 2.25 per

cent except those involving the Italian lira and the Spanish peseta which may move within a 6 per cent band; but the parity can be changed relatively easily. Accordingly, entry into the EMS would only formalise a commitment by British government to intervene so as to maintain a certain range of sterling values against the currencies of some of Britain's most important trading partners -- countries which take an increasing share of our trade. Monetary authorities may be compelled to intervene so as to keep EMS exchange rates within the specified limits; but the existence of publicly declared goals helps the market to remain within the limits without intervention.

Why then all the fuss? Partly just because the EMS has been very successful in achieving its declared goal of greater currency stability. In the initial period after its creation in 1979, relatively frequent rate adjustments were required. There was a long decline of the French franc, with formal devaluations within EMS in October 1981, June 1982 and March 1983, in the disastrous first two experimental years of M. Mitterrand's new socialist administration. But by now two and a half years have passed since there has been an adjustment. Inflation rates in the member states have moved closer together. These are indications that the trick of convincing markets to accept stated goals of exchange rate policy has worked, that central bank intervention is less frequently needed within the EMS, and that a system has been created which has acquired an institutional effectiveness and legitimacy. That is to say, it is capable of running on its own. It has become more and more a `hands-off' device, and less and less a mechanism for government interference or attempts at so-called 'management'.

But yet it runs into three major kinds of objection (all of which have fundamental flaws).

1. The political objection: that EMS is only a means of achieving European political integration.

2. The economic objection: that international systems of fixed exchange rates are undesirable and damaging, and that a general free-for-all of fluctuating rates is to be preferred.

3. The utopian objection: that there are better ways of bringing down inflation in Britain than entering EMS, which will tie us permanently to unacceptably high West German levels of two to three per cent instead of a (much more desirable) complete stability of prices.

These arguments will be examined in turn, before presenting the case why British membership of EMS is so desirable at precisely this stage in the development of our monetary policy.

1. A Concealed Plan for the United States of Europe?

Will EMS lead inexorably to European Monetary Union (EMU) and then to political unity? The recent Delors Report, with the ominous title `Economic and Monetary Union in the European Community', does its best to present just such a vision of EMS as simply one of a set of stages on the road to the creation of common European institutions. The second stage would be the creation of a European System of Central Banks; in the third, exchange rates would be locked together, the key thrown away, and the member states compelled to coordinate their fiscal and economic policies. This would certainly amount to an erosion of national sovereignty.

The Delors view ignores both the political realities of present European societies, which remain fundamentally committed to national sovereignty and the nation-state, and the experience

of the historical relationship of customs unions and monetary coordination to political integration. The result is much factual and logical confusion. Matters are not as simple as the Delors report would suggest. But since the view that `large steps towards monetary union can and did precede political unification' (Financial Times 18 August 1989, p.2) is so widespread, it is worth briefly examining the historical record.

The example commonly cited is that of German political unification in the nineteenth century, frequently said to have grown from the seed of the customs union or Zollverein of 1834. In reality, the customs union repeatedly came close to disintegration; and three wars in the 1860s were needed to unite Germany around Bismarck's Prussia. This was far from a simple peaceful process following inexorably from economic facts. Only after a single German state had been created in 1871 did a national central bank and monetary system emerge in 1875. Thus the order of events in Germany was very different from -- in fact the obverse of -- the one envisaged by Delors.

Customs unions and particularly monetary unions usually create more hostility than harmony. The Habsburg Empire worked well as a customs and monetary union, but the union intensified rather than diminished quarrels about distributional policy among the various nationalities of a multi-national state. If we wish to see the operation of a more recent currency union, we should look at one of the most long-lasting examples, which continued for over fifty years during this century. Irish currency remained linked to the British pound lasted through the Second World War although one country was a combatant, and the other remained neutral: the link endured from 1928 until the Republic of Ireland joined EMS in 1979. Obviously this monetary union neither produced an integration of economic policies nor led to `steps to political union'.

If these are supposed to be encouraging precedents for

unifying Europe, the proponents of this path of integration against the national grain need to do some rethinking.

Systems such as EMS are logically quite distinct from monetary unions. They do not -- unlike monetary unions -- seek to impose constraints which require coordination of national monetary and fiscal policies so extensive as to damage the cause of cooperation. When we are forced to homogenize too much, we realise quickly that we differ greatly. Nothing could be more harmful to genuine European cooperation than the imposition of a completely rigid economic straitjacket: as is well known, straitjackets do not inspire thoughts of harmony and friendship.

Mr. Lawson made this point very clearly in January 1989 in a speech to the Royal Institute of International Affairs:

> The difference between full membership of EMS and economic and monetary union could not be more fundamental. The EMS is an agreement between independent sovereign states whose economic policy remains distinct and different. (Nigel Lawson, What Sort of Europe, Conservative Political Centre Pamphlet 1989, p.15).

2. Obsolete economic chains?

The economic objection to the EMS holds that fixed exchange rates impose needless limitations on national policy without producing corresponding benefits. By the early 1970s, as the Bretton Woods system disintegrated, this argument became an almost universal intellectual fashion: Keynesians and monetarists alike held firmly to the belief that fixed rates were nothing more than an absurd legacy of the long past days of the gold standard. They belonged, it was claimed, to the relics of an economically unenlightened past.

Flexible exchange rates offered a greater latitude for expansionary fiscal policy (according to the Keynesians); and permitted a more accurate control by their national authorities of their monetary aggregates (according to the monetarists). Stimulation of the economy by either fiscal or monetary means did not need to run into the problems of balance of payments which had dogged the pre-1972 world (and, in particular, British politics). Under the old system of fixed exchange rates, as internal and international prices changed at different rates, as imports became cheaper relative to exports, and as the trade balance deteriorated, crises arose. The constant threat of yet another sterling crisis produced more or less permanent political embarrassment. Under flexible exchange rates, all this could be avoided since the ratio of domestic and international prices might remain constant because of changes in exchange rates.

In the meantime, this argument against fixed rates has itself come to look dated. The practical result of the policy of fixed exchange rates was continual depreciation of the external value of the currency. The accusation against the post-Bretton Woods system of flexible rates is that it proved merely to be a perfect mechanism for inflicting on the world ever higher rates of inflation.

In most countries inflation doubled or tripled in the 1970s from the level of the 1960s (which had already suffered from `creeping inflation' thanks to expansive US monetary policy in a world centred on the dollar). Retail prices rose in the 1970s by an average annual rate of 13.7 per cent in Britain, 7.8 per cent in the USA and even in Germany by 5.1 per cent. Flexible exchange rates made domestic monetary growth the easy option for governments: for the penalties were neither immediate or obvious (though they were real). There were no longer `crises' as exchange rates were adjusted, only continual slides.

In the light of this development, the historical record was

reexamined, and the fixed exchange rate regimes looked more attractive -- and rightly so.

There have been three eras in which a relatively rigid international system increased confidence and facilitated the growth of trade, of capital flows, and of a genuinely beneficial international division of labour, to the benefit of the world as a whole.

The longest and most successful of these epochs of stability was between the 1870s and the First World War, when world trade grew far quicker than industrial production. The second epoch lasted through the 1920s and into the 1930s. After the Second World War, the Bretton Woods system amounted to a relaunching of the gold standard without such a heavy requirement of gold as before. The fixing of exchange rates allowed first a dramatic expansion of trade in the 1950s, and then a return toward full convertibility of currencies (i.e. an end to many exchange controls) by 1958.

The fixing of exchange rates after the First World War, it must be admitted, was much less of a triumph. The disastrous world depression of the early 1930s helped to convince many academic economists that fixed rates were a fatal barrier to economic growth managed in a national context. It is indeed correct that in the quest for a rapid `return to normalcy', and gripped by the idea that gold might restore the confidence and solidity of the last pre-war years, many countries restored the gold standard at highly inappropriate exchange rates.

Critics of fixed exchange rate systems like to point to the breaking up of all these systems as evidence that they were artificial constraints, which in the end led to more problems -- more national resentments, and more barriers to trade.

But in fact the pre-1914 system collapsed simply because of

the outbreak of war, and not for any fundamental or structural reason. The Bretton Woods regime lasted until the dollar weakness of the early 1970s. The US position was undermined by a combination of the large increase in domestic spending to create a welfare system (President Johnson's `Great Society') and overseas military spending to fight in Vietnam. Once more it was a war that led to the breakdown.

The interwar collapse is the most difficult to explain. It did not coincide with a major war. Many contemporaries blamed the economic depression on the restoration of the gold standard. A better explanation attributes that depression to the collapse in the prices of raw material and agricultural produce, which was in turn a delayed response to the large increase in production during the wartime period 1914-1918. Thus again it was the consequences of large scale armed international conflict -- though with a time-lag -- that prompted the disintegration of the international monetary system.

This brief examination suggests that fixed exchange rate systems are much less vulnerable than is usually supposed; provided that no great errors are made in the initial fixing of exchange rates. They break down in the aftermath of large-scale and devastating wars, and this can hardly be a surprise. The experience after 1972 also suggests another lesson: that floating rates represent an ideal instrument for the international transmission of inflationary processes.

Furthermore, attempts to squeeze out inflation by means of high interest rates in the context of floating exchange rates -- as implemented since the early 1980s -- have had traumatic effects for the world economy as a whole. There was a deep recession in 1981-2; and the effect of the floating exchange rate system on the international distribution of economic growth has been unfortunate. High interest rates have made the developing countries' debt crisis much more severe. Whereas Western

industrialised countries have recovered relatively well from the slump at the beginning of the 1980s, growth elsewhere has been slowed down. In consequence, in many African and Latin American countries, per capita incomes have fallen appreciably. On a world view, currency policy over the last two decades, in the era of flexible rates, cannot be held up by anyone as a model for success.

It does not follow, of course, that there would be no objections to international stabilisation through regional units such as EMS. And having answered the question as to whether fixed exchange regimes are appropriate for the world, we should still ask: are they good for Britain?

3. A Commitment to high inflation?

The utopian argument against joining EMS as part of an effort to stabilise Britain's currency is that the EMS is associated with an excessively high rate of inflation. Such a case barely looked plausible before the acceleration of British inflation in 1988-89. Now it is even more difficult to take seriously.

The assumption underlying it is destructive of the notion of any stabilisation policy at all. Other countries are naturally `inflationary', the arguments runs. But if it is true that countries have a `natural rate' of inflation, determined by specific political and social constellations (such as the attitude and power of the central bank, habits of consumer borrowing, or patterns of wage negotiation), and the German rate moves between 2 and 3 per cent, then the same logic would suggest that Britain's lies between 8 and 10 per cent. If this `natural rate' were an accurate account of reality, all attempts at reducing inflation below that level would be destructive. Fortunately, the assumption is false (and Germany in fact had more or less complete price stability in 1986-8).

A `softer' version of this hypothesis claims that the Germans could but do not have the will to eradicate inflation. This is simply not true. It is difficult to think of any country where the major political parties share such a long-standing commitment to price stability as West Germany.

The Current Debate

Critics of any system of monetary management are undoubtedly right if they suggest that price stability should be a major target of policy, but that it has too frequently not been. Stability is desirable both from the point of view of justice -- since it is morally wrong to carry out a covert expropriation of the kind represented by inflationary processes -- and from the point of view of expediency. Stable prices provide a general framework in which rational long term views can be formulated and acted upon.

The central argument about British membership of EMS should therefore revolve around ways of reducing inflationary pressures in Britain.

It needs to be stressed once again that EMS is not a preparation for EMU. The two are actually contradictory in intention. It is not surprising that quite different political interests argue for each. The goal of EMU, as highlighted by the Delors report, is to avoid some of the restrictions imposed by EMS -- in particular the anti-inflationary constraints.

EMS's major achievement has been the surprising reduction of inflation in Latin countries -- especially in France and Italy. It runs counter to many political aspirations, which see in fiscal stimuli a political bonus. All the most controversial aspects of the Delors Report try to reduce the automaticity of the European Monetary System: the Report proposes instead a system whereby the excessively restrictive policy of the Bundesbank would be prevented from asserting itself too vigorously. The political independence of the Bundesbank would be watered down by the introduction of central banks more directly amenable to control by politicians.

The third stage of the Delors Report makes this outcome even clearer. It advocates the establishment of central institutions with the task of coordinating fiscal policy: essentially what is meant is a stimulatory policy for the sake of promoting rapid advance in less well developed regions of Europe, and dismantling what is alleged to be `structural' unemployment. The rationale on which this suggestion is founded is faulty on its own terms: it is incorrect to claim that an extensive measure of fiscal coordination is needed for the successful operation of a single monetary system. Even within a monetary union, member states could be free to make their own fiscal policies, and have their own access to credit markets, as the experience of the United States demonstrates. But under the proposals in the third stage of the Delors Report, individual European national states would have considerably less room for manoeuvre in fiscal policy than for instance do the Governors of New York or New Jersey in the American federal system.

On the other hand, the peculiarities of EMS -- and its peculiar advantages -- lie in a relative rigidity in exchange rate policy, an impressive anti-inflationary record, and the absence of anything more far-reaching. The specific advantages for Britain are:-

(i) Exchange rate stability

Membership would remove a substantial part of the exchange rate risk which at present weighs on British exporters and importers. At present, the pound has a much more volatile history, with quite abrupt short and long term movements, than either the German mark or the French franc. The possibility of such movements makes long term calculations difficult. While it is certainly possible to offset exchange rate risk in the short term with futures contracts, in the

longer term (one year or over) the market for such contracts becomes much thinner. In addition, forward exchange rates are a notoriously poor predictor of actual future rates, with the result that margins need to be high. Since these forward rates are simply the result of calculations on the basis of the relative structure of interest rates and the current exchange rate, they are just as, and often more, volatile than spot rates. They can give no long term guidance. Smaller firms in particular suffer from the uncertainties of the foreign market, and find it difficult to live in an export world in which their own and their competitors' prices swing quite wildly.

Complaints are widespread from firms which suffered in the 1980s first from a rise in sterling, and consequently shrank their production, but were then unwilling or unable to risk expanding when the exchange rate fell back.

It might be added that low inflation rates alone do not guarantee the exchange rate stability desirable for developing overseas commerce. Amazingly, one of the most internationally volatile currencies over the past ten years has been the Swiss franc, despite consistently low rates of inflation in Switzerland. Such an illustration offers a demonstration of the advantages of stabilisation within a framework of international agreement.

(ii) The problem of high British interest rates

One of the most striking features of the British economy at present is the very high rate of interest. It is high even in comparison to a world economy in which rates have soared. Whereas the commercial banks' prime lending rate is 15 per cent in Britain,

it is 8.5 per cent in West Germany and 9.6 per cent in France. These differences are higher than the differences in rates of inflation or wholesale prices (in France, wholesale rates may even be slightly above those in Britain at present). In the meantime, high British interest rates have become domestically a major target of popular resentment.

If Britain's trade balance continues to deteriorate, it is possible to envisage circumstances in which high or yet higher rates of interest would be again required to defend the pound. If we believe that such rates are required to keep the foreign exchange value steady, British membership of EMS might immediately remove some part of the perception of exchange rate risk, and thus partly remove the need for high interest rates. Of course, there would still be national, and even regional variations -- in the same way as there are substantial variations even within the USA. But the differences would not be as pronounced.

(iii) Breaking British inflationary expectations

Since 1988, however, the main goal of high interest rates in Britain has been not so much to stabilise the exchange rate of sterling as to reduce the rate of inflation. A given policy instrument -- in this case the management of interest rates -- obviously may serve different goals; and at present there is no doubt that the primary target of British monetary policy is the reduction of inflation.

Increasing interest rates have undoubtedly slowed down the growth of some kinds of consumer spending. They have made it more costly to buy houses as well as reducing the prices houses and expenditure

associated with moving (on furniture etc). On the other hand, they do not seem greatly to have affected other aspects of consumer spending -- for instance on automobiles. Nevertheless in general they impose considerable costs on the economy as a whole. Investment becomes less attractive as interest rates rise. All the major forecasts are now predicting a major setback. It would be a terrible irony if investment suffered from the credit squeeze more than consumer spending.

Looking back at a longer historical period, the volatility of interest rates in the 1970s and 1980s has reduced the ability to formulate and implement long range plans. In the 1970s, on the whole, rates were very low in real terms (high levels of price increases compensating for high nominal rates of interest); in the 1980s, on the whole they have been high both in nominal and in real terms. But even within the framework of these generalisations, they have oscillated wildly. Any standard accounting model as developed, say, in business schools will assess rewards to investment by discounting future returns; and in order to calculate present discounted values it is necessary to predict rates of interest in the future. But the ups and downs of recent history mean that it is impossible to do anything more than make a very rough guess at the interest rates that will prevail in the future. Such uncertainty means that when businessmen think ahead, their time horizons necessarily contract. The result is, to use a currently voguish term `now-nowism': an inability to think in the longer term. We need more `now-futurism'.

Changing interest rates in dramatic steps is a profoundly disorienting way of managing economic policy, desirable only if no other alternatives existed. The impact of interest rate alterations should be to affect expectations about the future development of prices, in the broadest sense (including wages). Unfortunately, in reality it affects some prices much more than others. Even the high interest rates of 1989 have not had a major impact on expectations as revealed in wage-determination. Consumers' markets have in part reacted by now to the Chancellor's policy; but there is currently (as of September 1989) no sign of a lessening of wage settlements. These reflect both the levels that employers feel that they will be able to pay, and that employees (and their unions) feel that they will need in order to offset future price rises and still obtain a real rise in income. How much a 9 per cent deal is worth will clearly depend on expectations about the future rate of inflation.

Expectations of this sort which are widely disseminated throughout the economy can be modified only by a substantial shock. The introduction of the Medium Term Financial Strategy after 1980 is an example of this kind of shock. It demonstrated the Government's resolve to drive down inflation rates without leaving any possible room for doubt about the priority of this policy. Markets responded to this drama, and altered prevailing expectations (both about pay settlements and about the demand for credit). The rate of inflation fell.

It is possible hypothetically to imagine other kinds of shock that might stun the market. The Chancellor of the Exchequer might announce his

intention to go on a starvation diet if inflation remained above four per cent. The Prime Minister might promise to wear a tricolore and make all her speeches in French if prices went on rising. These would certainly be ways of making clear a commitment to fight inflation. They would convince the markets, however, only if <u>everyone</u> were to take them seriously.

In looking around for the most appropriate kind of shock, it is best to find the one which has the most limited side-effects, just as when a physician casts around for a desirable drug. Attacking inflation or monetary growth by means of dear credit hurts much too much of the economy too indiscriminately to be regarded as anything other than a desperate (and then even only partly effective) last resort.

Joining EMS would administer a `shock effect' without many of the undesirable consequences of raising interest rates: it would be a demonstration of an intent to restrain price rises, to which economic agents would quickly respond. This was exactly the reason why Spain, with a historically high and a currently rising rate of inflation, joined EMS in June 1989, one year before she was committed to membership.

The record of EMS members on inflation is impressive. While in Italy, in the early 1980s, consumer prices rose at rates over 20 per cent, and French prices were rising at 15% per cent, both countries now have retail price increases below those in Britain, in the case of France (which operates in the narrower EMS band) substantially below. Rises in consumer prices over the last year have been 8.3 per cent in Britain,

but 7.0 per cent in Italy and 3.6 per cent in France (which is rapidly coming down to the West German 3.0 per cent). How does EMS alter inflationary expectations?

The mechanism for policy adjustment resembles that of any fixed exchange rate regime. If a country's domestic monetary policy is too lax, or its fiscal policy too expansive, the prices of its products would rise without the likelihood of an exchange rate adjustment. This would mean that imported goods became cheaper relative to those produced domestically, and correspondingly that its exports became dearer and less competitive. The emerging adverse balance of trade would then require restrictive action and a revision of policy. In other words, EMS does not mean that a magic wand makes balance of trade problems disappear. But because of the knowability of the constraint, and because of the declared unavailability of adjustment in exchange rates, governments are likely to adjust their policies in advance of the appearance of such problems. This certainty about government action is what provides the magic wand.

Its magic lies in the fact that everyone knows about the constraints. The room for manoeuvre is thus limited. Returning to the wage-setting example, if expectations about the future level of prices change, a 5 per cent settlement may appear to employees to be more generous than a rate of 9 per cent in the former conditions. And equally, on the other side of the negotiating table, the employers will believe that it will be more difficult to achieve sufficient profits to pay the 5 per cent.

Joining EMS involves a commitment to maintaining a price stability roughly in line with that of other members, and a monetary policy based on a concern for price stability. By contrast, declarations about the desirability of EMU paint a more inflationary, and more Latin, vision; and would not have such a striking effect on views of the future and their influence over present actions.

In the short term, EMS is thus an instrument of policy that may be used to create new and less inflationary expectations without the costs involved in the high interest strategy: costs which are primarily economic, but may also, in view of the large number of quite highly leveraged mortgage borrowers, turn out to be political as well. We do not need to resort to retrospective calculations, such as that recently attempted by the National Institute, which purport to show that Britain would have been better off joining EMS in 1979 (for 1988, this calculation showed interest rates at 5.8 per cent and retail price inflation at 2.3 per cent) (Financial Times, 8 August 1989, p.8). Such acts of historical fantasy do not help much in formulating present policy. A forecast presented by the London Business School, however, suggests that EMS membership from now, with the £sterling pegged at DM 3.10 to 3.20, would lead to lower increases in British retail prices by 1990 than would an unchanged strategy. By 1991 British output, too, would be higher than if sterling continued to float (See David Currie and Geoffrey Dicks, `Economic Viewpoint: The MTFS or the EMS: Which Way for credible Monetary Policy', Economic Outlook June 1989). The key mechanism is in the first place the reduction in inflationary expectations, and in the second a

consequent lowering of the interest level needed to maintain price stability.

The long term offers an even more encouraging prospect. Economically, the framework of more stable expectations about interest rates and prices would allow the more rational calculation of investment costs and returns. We could adopt a longer perspective. Politically, EMS membership offers a framework for a British participation in a market-oriented rather than dirigiste Europe.

Conclusion

This argument has emphasised the anti-inflationary and consequences of British membership in EMS. The benefits from EMS membership have been greatest for those countries attempting to emerge from a vicious cycle of inflationary expectations; and EMS has done more to reduce inflation in France and Italy than in Germany. (This is a consequence, incidentally, for which Italian Governments, with a history of reliance on inflation as a way of buying off political demands, have not always been grateful.)

The immediate and short term benefits of joining EMS for a country with lower inflation are slighter, and the pronounced anti-inflationary shock will clearly not be present. On the other hand, the long term framework of stability will still emerge.

This means that the case often argued, that Britain should first end inflation, and overcome the effects of the credit expansion of 1987-8, and then join EMS is incorrect. Britain's greatest immediate gain is in using EMS as an anti-inflationary strategy more localised in its effects than a dear money regime. And it should be pursued as soon as possible. But both for the sake of intellectual honesty, and for the political practicability of such a measure, it must be emphasised that EMS membership is nothing more than one possible instrument of British policy. It can be used to attain concrete goals -- the simultaneous reduction of inflation and of interest rates; and the creation of a stable longer term climate for investment and exports. It should not be seen as a stalking horse for anything else. EMS's attractions lie not in political dreams about a `European' future, but in offering a practical way of addressing two endemic British problems: high levels of inflation and high interest rates.

PART II

AGAINST

by Christopher Culp

Introduction

Since 1979, the formal policy of the British Government toward the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) has been that Britain will join 'when the time is right.' It is well-known, though, that Mrs Thatcher is adamantly opposed and considers that the time will never be right. At the recent European summit, however, she indicated a willingness eventually to join the ERM, but only after its members abolished exchange and other controls, and only after the British inflation rate falls.

The Committee for the Study of Economic and Monetary Union in the European Economic Community (EEC), headed by Jacques Delors, outlined steps last April to transform the EMS mechanism into a full-fledged monetary union, some characteristics of which are those in which Mrs Thatcher is interested. In addition, however, to complete liberalisation of capital and financial markets such a union would include irreversible currency convertibility and 'the elimination of margins of fluctuation and the irrevocable locking of exchange rate parities.' This union would evolve into a single-currency system with a European central bank at the monetary policy helm.

The success of existing currency unions such as the United States suggests that a single currency in Europe might be desirable. What is too often unchallenged, though, is the assertion that the EMS is a necessary precursor to such a union. EMS supporters are fond of claiming that it has led to increased exchange rate stability and a downward convergence in inflation rates among member nations. While these things did occur, claims that the EMS was responsible are dubious. Moreover, the EMS

mechanism has not promoted trade growth in the EEC, a paramount objective of the 1992 project.

The empirical success of the EMS is at best questionable, but its political drawbacks are clear: membership in the exchange rate mechanism of the EMS removes the capacity of nations to pursue independent monetary policies. Even if the EEC perseveres in its pursuit of monetary union, it is not at all clear that the EMS is the optimal way to attain such a policy objective. Considering its many drawbacks, the EMS seems to be neither an effective means of achieving monetary union, nor an effective alternative to it.

The EMS Arrangement

The EEC's 'fixation' on stabilising nominal exchange rates is not a recent development. In March of 1972, the EEC instituted a 'snake' exchange rate regime. This established narrow margins of permissible fluctuation for any member's EEC currency vis-a-vis other EEC currencies, though it allowed wider fluctuations against the U S dollar. However, the momentum toward monetary integration was lost in the early 1970s as each nation pursued divergent economic objectives in the face of world economic shocks of the period. In 1979, however, momentum was recaptured with the introduction of the EMS and its Exchange Rate Mechanism (ERM)[1].

The EMS mechanism set up a 'target zone' regime. Each member nation must declare a bilateral par value with every other member of the system. The currencies must then be maintained two and a half percent above or below par (six percent for the Italian lira and Spanish peseta). Whenever the upper or lower boundary of variability is reached, the central banks of both nations must intervene to bring the vagrant nation within its prescribed band by buying or selling currency and altering interest rates.

Separate from this 'parity grid' arrangement, the EMS also set up a 'finger pointing' system to determine which member nation's economic policy is diverging from the policy of other members. Such divergence is measured through the use of the ECU, or European Currency Unit. Each nation maintains a fixed amount of their currency in the ECU, which is a weighted average of all EEC members' currencies. The relative weights for each nation are determined by the relative strength of its economy and its intra-EEC trade volume.

Using the ECU as a benchmark, 'thresholds of divergence' are

calculated for each currency, except sterling and the drachma. Immediately after a threshold is crossed, the country should realign its economic policy with other EMS nations. Since Germany consistently outperforms other member nations in terms of international trade, economic growth and price stability, EMS currencies are <u>de facto</u> linked to the DMark, a currency much stronger than their own. Hence, many European currencies are artificially held at levels above their fundamental equilibrium values. Part of the reason why these currencies remain undervalued is the persistent reluctance of governments to devalue them. Much of this resistance may be a result of the political appeal of a relatively strong currency; hence, government's machismo becomes responsible for refusing to devalue[2]. Such overvaluations can last for a long time.

The ECU sets up a type of 'big brother' for monetary policy, where the benefits of Germany's price stability are distributed amongst EMS would-be inflationists. Chart 1 shows how ERM inflation rats would appear without Germany. However, this implied convergence toward Germany's inflation rate has not been without cost. Chart 1 also shows that the average ERM inflation rate has been generally higher than that of Germany. Because of the lags in realignments, this has resulted in a persistent undervaluation of the DMark and has contributed to Germany;s current account surplus through much of its membership in the ERM. Steve Hanke, an economist at Johns Hopkins University, refers to this phenomenon as the 'EMS Drag' on the DMark[3].

Considering the political aspects of this arrangement, it is no surprise that Mrs Thatcher has come under tremendous criticism for opposing the incorporation of sterling into the ERM. Entrance of such a currently weak currency would make it more overvalued than many other EMS currencies, thus making presently misbehaving EMS nations seem stronger.

In addition, Germany hopes that Britain will join the ERM to

counter French cries for 'symmetry' and France hopes that Britain would unite with them to mitigate the Bundesbank's hard-line monetary policy. Ironically, if these French hopes are realised, then one of the only reasons for Britain joining the mechanism -- namely the tight discipline of the Bundesbank -- is eliminated.

Because of its built-in divergence indicators, the EMS is not devoid of attempts at discipline. If a nation's currency diverges too much from average EEC economic performance, the country is not only supposed to intervene and keep its currency in line, it is also supposed to change the policies which caused such divergence in the first place. In theory, all nations would thus be moved toward the example set by Germany of low inflation and high growth. In practice, the road of adjustment to this idealised state has been far more painful than proponents of this system like to claim.

Price Stability in Europe

Requisite to the orderly conduct of virtually all business between EEC nations is the need for a stable measure of exchange - money. The only means of achieving stability in prices is through the proper conduct by governments of their domestic monetary and fiscal policies. Hence, the Delors Committee explains that a primary advantage of fixed exchange rates is that they prompt member nations to gear 'their policies, notably monetary policy, to the objective of price stability, thereby laying the foundations for both a downward convergence in inflation rates and the attainment of a high degree of exchange rate stability'.

However, the evidence suggesting that the ERM has led to a decline in inflation rates for member nations is ambiguous. Chart 1 shows the change in the Consumer Price Indexes for nations in Europe, as well as those for Japan, Canada and the United States. It is apparent that during the period 1979-1987 inflation rates in the non-ERM counties fell by almost as much as rates within ERM countries.

The real, as distinct from monetary, performance of ERM countries is revealed by Chart 2, based on Michele Fratianni's thorough analysis completed in 1988[4]. The chart shows that unemployment has risen in the ERM since its inception -- though somewhat more in European non-ERM nations. It shows also that, comparing the pre-EMS period of 1974-1978 with that of 1979-1986, the average rate of real GNP growth within ERM nations fell by 0.72 percentage points. In Canada, Japan, and the United States, the growth rate also fell, but only by 0.27 percentage points, whereas in the European non-ERM nations it rose by 0.71 percentage points.

Short-term interest rates in the ERM have been relatively volatile. Chart 2 shows that the variability of short real interest rates (proxied by their standard deviation) has increased more in ERM nations than in non-ERM nations. Such interest rate volatility within a fixed exchange rate regime comes as no surprise.

Volatility of interest rates within a fixed exchange rate regime comes as no surprise. Since ERM nations are forced to defend the par values of their currencies, they must not only buy and sell currency, but also, as need arises, alter their interest rates. For example, when Spain entered the EMS mechanism on 19 June of this year, the peseta appreciated dramatically. Spanish monetary authorities were forced to intervene by buying $419 million -- almost one quarter of Spain's foreign reserve intake for April -- to prevent an excessive appreciation[5]. Even so, it was still necessary to cut interest rates by almost three percentage points to quell the peseta's appreciation in its first few days of ERM fixity. Furthermore, the high mobility of capital at present evident in Britain, and envisaged for all Europe by 1992, would be likely to increase interest rate volatility even more, as capital inflows constantly apply pressure on exchange rates.

The EMS also disables members from pursuing independent monetary policies designed to give independent price stability. All policy is surrendered to the exchange rate peg. Britain's recent experience tells that sorry tale. On the departure of Sir Alan Walters as personal economic adviser to Mrs Thatcher in 1983, British monetary policy was changed. Sir Alan had targeted the monetary base as the best way to achieve stability in prices. By contrast, Nigel Lawson followed other monetary indicators, shadowing the Dmark from early 1987 to March 1988, which *de facto* placed sterling in the ERM. But the success of Mrs Thatcher's policies had boosted the rate of return on capital in Britain. Portfolio managers, anticipating that the Dmark peg would hold,

took advantage of the high British interest rates, causing funds to flood into the country and putting upward pressure on sterling. Eventually, after massive intervention, the Chancellor was forced to reduce interest rates to contain this rise of the pound. The growth rate of high powered money expanded and produced the inevitable inflationary pressures.

By fixing the sterling-mark exchange rate, ERM membership would exacerbate Britain's problems; membership would mean a re-run of 1987-88. As Sir Alan has said, the oscillations in interest rates and capital flows caused by exchange rate fixity in the ERM place money 'on a roller-coaster'[6].

Mrs Thatcher's decision to consider membership in the EMS mechanism was, politically, perhaps a good move. Since she wants some say in the emerging monetary union, her continued refusal to cooperate with the Commission on such matters could have resulted in the EEC simply proceeding toward its goal without Britain. However desirable at the time, though, the damage which could result to Britain's economy from ERM membership might potentially hurt her more than her persistent refusal to join the mechanism. Even if Britain's inflation rate is low when it enters the mechanism, there is nothing to ensure that it will remain low in the future. The ERM creates an omnipresent rigidity which prevents currencies from rising or falling fully to reflect changes in price levels. As long as the possibility for inflation exists, gyrations in capital movements and interest rates of the sort described above will continue.

Price stability has been improved among ERM nations since 1979. However, whether this was caused by the EMS mechanism is questionable. By contrast, the wild fluctuations in interest rates and capital flows produced by the ERM are undeniable.

Promoting EEC Trade

The Delors Committee asserts that 'the high degree of exchange rate stability' created by the EMS has led to 'reduced uncertainty' and has 'protected intra-European trade from excessive exchange rate volatility'. Indeed, trade stabilisation is perhaps the most frequently cited benefit of fixed exchange rates.

However, as mentioned previously, the ERM undervalues the DMark and overvalues most other currencies. As Sir Alan explains, this is perhaps best evident in the overvaluation of the French franc which has been evident throughout France's membership in the ERM. This overvaluation has resulted in a deterioration of France's exports and accordingly a structural deficit in her current account. So, while the ERM creates a cosmetic sense of stability and does promote some policy convergence toward Germany's economic performance, it prevents currencies from being traded at values consistent with fundamental economic conditions. Partially as a result of these exchange rate misvaluations, Fratianni shows that the growth of intra-EEC trade has declined in the EMS period relative to the pre-EMS years.

Furthermore, the assumption underlying trade development under fixed exchange rates is that fixed nominal exchange rates would provide certainly and therefore make long-term trade more stable and attractive. But the assumption that nominal exchange rates will be perfectly stable, even in the proposed regime of 'irrevocably' fixed rates, is essentially groundless.

Roland Vaubel's analysis of the ERM reveals that nominal exchange rates have been less than stable: decreases in variations of the nominal effective exchange rates of ERM currencies have been less than that of European non-ERM currencies, and changes in exchange rates have increased more in

ERM currencies than in non-ERM currencies.[7] While the ERM has succeeded in decreasing volatility among ERM currencies, it has done so at the expense of increased volatility against non-ERM currencies, most notably the yen, dollar, and sterling. Quite a high price to pay, indeed.

Moreover, it is the real, not the nominal, rate of exchange which is important to trade. The real exchange rate adjusts the nominal exchange rate for differences in price levels. So, unless the inflation rates of member nations are equal, the real exchange rate will continue to vary in the presence of a fixed nominal exchange rate. J. Orlin Grabbe asserts that the system of ERM fixity, coupled with divergent inflation rates in the early years of the EMS, led to unnecessary changes in real exchange rates and further distortions in international trade during this period.[8]

The ERM has been 'realigned' eleven times since its inception. When these realignments are anticipated by the market, speculation can wreak havoc on interest rates as investors flee from currencies facing imminent devaluation. The ever-present threat of realignment compounds uncertainty in this system of fixed rates. Furthermore, it is difficult to believe that a Europe with an even greater degree of capital mobility than that which presently exist could maintain par exchange rate values indefinitely.

Furthermore, the experience of Canada and the United States illustrates the fallacy that floating exchange rates inhibit trade. Although the exchange rate between the Canadian and the US dollar has not been fixed since 1970, bilateral trade in goods and services between Canada and the United States is larger than that between any other two countries in the world (greater than $166 billion in 1987.[9]

Canada has had two experiences with floating exchange rate

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Canada has had two experiences with floating exchange rate

regimes: 1950 to 1962 and 1970 to the present. During the first period of a floating Canadian dollar from 1950-1962, large scale trade disruption did not occur. Indeed, exports and imports rose in volume and value[10]. Floating the Canadian dollar also allowed Canada to pursue a monetary policy independent from that of the United States.

During the 1962-1970 period of exchange rate fixity, trade also increased on average, as compared to the previous period of exchange rate flexibility (see figure 1). However, this was not necessarily the result of a stable nominal exchange rate but was more likely the result of a relatively stable real exchange rate. The real exchange rate remained stable during this time period because the inflation rates in both Canada and the United States remained nearly convergent and fairly low. This would probably have occurred under a floating regime, as well, since the convergence in inflation rates would have would have still engendered real exchange rate stability.

After eight years of a fixed exchange rate, Canada again decided to float its dollar, prompted predominantly by a balance of payments crisis. Figure 1 shows the average annual increase in exports and imports as a percentage of GDP which Canada has experienced under a floating dollar since 1970. While this increase might not have been a result of exchange rate flexibility, it illustrates the fact that trade has not been hurt by exchange rate flexibility.

Conclusion

The objectives outlined by the Single European Act and the plan set forth by the Delors Committee have similar objectives in principle, but whether the proposal of the Delors Committee would enhance or impede the prospects for European monetary union is uncertain. If the EMS provides any reliable indication of how well Europe functions under exchange rate fixity, the argument of the Committee for monetary union loses much of its potency.

By maintaining exchange rate flexibility, the nations of Europe could continue to exhibit the economic sovereignty to which each is entitled, and such monetary flexibility would not be inimical to or threatened by most of the Single Act's objectives. In fact, if flexible exchange rates in Europe behave as the theory and empirical evidence suggest they would, the economy of Europe might possibly perform better than if exchange rates were fixed.

Hence, Europe should abandon the ERM. By simply replacing it with a system of floating exchange rates the preferences of currency holders in Europe, rather than bureaucrats in Brussels, would become the force that drove monetary integration. Such a system of floating exchange rates would complement the forthcoming liberalisation of capital markets by enhancing the freedom of consumers to choose between currencies. This freedom of choice would create freedom of competition between currencies at the national level, imposing market discipline on EC members. Nations would be free to pursue independent monetary and fiscal policies, but the consequences of these policies would be manifest in the demand for their respective currencies.

Moreover, such a system of floating exchange rates would not preclude the emergence of a single currency. Rather, it would leave such a determination to market forces. As Vaubel notes,

'currency competition is not only the optimum currency competition process, if currency unification is desirable, but also the optimal procedure for finding out whether currency union is desirable'.[11]

When the dubious benefits of the ERM are compared with its obvious political and economic shortcomings, a floating exchange rate system emphasising consumer preferences and market discipline seems greatly preferable. To that end, Mrs Thatcher should persevere, and remain outside the ERM. She will do her nation, and paradoxically all Europe, far more harm if she yields to current political pressures.

Britain's refusal to join might force the European Commission to reconsider its erroneous policy recommendations. Given the 'capital chaos' caused by the ERM, it seems as though the Commission is concerned that without the ERM member nations might not pursue of their own accord policies conducive to integration of European markets on their own. If that is indeed the case, Europe should be asking more fundamental questions than 'whither the EMS?'-- questions like 'whither Europe 1992?'

Sir Alan Walters, who has been a key opponent of the EMS since its inception -- a role for which he has been much criticised -- has accurately analysed the multiple flaws of the EMS mechanism. It is unfortunate that the Delors Committee and the nations of the EEC have neglected to heed his words:-

> the half-baked European Monetary System is a long step away from a monetary integration of a United States of Europe. The EMS is a major source of uncertainty, of massive flight of footloose capital, of great oscillations in interest rates and of repressive policies. If Britain, with its open capital markets, joined the EMS mechanism, such evil effects would be exacerbated. And the cause of monetary union would be damaged, perhaps irreparably.[12]

References

1 The EMS is comprised of all members of the European Economic Community except Portugal. Members of the ERM include all of the above members of the EMS except the United Kingdom and Greece. Spain has recently added the peseta to the ERM.

2 As Keynes eloquently noted in 1923, the Government of Britain was guilty of this machismo, motivated by a dsire to 'look the dollar in the face'. Its reluctance to devalue resulted in the overvaluation of sterling until 1931, at which time a massive financial crisis forced Britain to float its currency.
See John Maynard Keynes, A Tract on Monetary Reform (London: St Martin's Press, 1971).

3 Steve H. Hanke, 'The EMS Drag' Friedberg's Commodity and Currency Comments, 20 November, 1988.

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8 J. Orlin Grabbe, International Financial Markets, New York, Elsevier, 1986, p.42.

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10 Since GDP was rising at a slightly greater rate than imports and exports, trade as a percentage of GDP actually fell slightly during part of this period (See Figure 1). However, as Robert Dunn has noted, 'the rapid growth of Canadian trade hardly suggests that a flexible exchange rate was a great barrier to international transactions.'
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11 Roland Vaubel, 'Currency Unification, Currency Competition, and the Private ECU: Second Thoughts before the Workshop on the International Monetary System, the European Monetary System, the ECU and Plans for World Monetary Reform, European University Institute (Florence), 2-3 April, 1987.

10 Walters, op. cit.

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