P.O-CH/NL/0362

PART A

Part. A.

**SECRET**

(Circulate under cover and notify REGISTRY of movement)

Begins: 3/9/85.
Ends: 29/10/87.

PO -CH /NL/0362
PART A

PO -CH /NL/0362
PART A

Chancellor's (Lawson) Papers:

PROPOSALS TO JOIN THE EXCHANGE RATE MECHANISM

DD's: 25 Years

24/11/95.

Ch
Terry would be a good private secretary!

Re 3/9

Many thanks

SECRET

FROM: T BURNS

DATE: 3 September 1985

CHANCELLOR

cc: Sir P Middleton
Sir G Littler

**EMS**

You asked yesterday whether I could recall Eddie George's arguments against EMS. I have looked back through my notes and have pieced together the following.

2. "EMS might help to stabilise exchange rates on a day to day basis but was unlikely to help with the big problems. Main concern that in really difficult situations EMS could aggravate speculative flows.

3. The general framework of policy would have to remain essentially the same and the exchange rate would not be fundamentally different. The main difference was in the intervention arrangements. In some circumstances they would help but in some they would not. They would tend to help when the pressures were small. But when they were serious EMS would aggravate the position. This was because EMS involved using reserves to defend the exchange rate level and taking market pressures head on. This kind of intervention was less effective than the sort of intervention we engaged in outside EMS.

4. It meant exchanging greater exchange rate certainty for corresponding uncertainty about monetary policy. This was high risk and meant raising the stakes. It would do nothing to help the bill mountain.

5. Existing policy had its difficulties but it had succeeded in delivering a much lower inflation rate and a good steady expansion of activity."

TB

T BURNS

SECRET

From: SIR PETER MIDDLETON
Date: 9 October 1985

CHANCELLOR

cc Sir T Burns
Mr Cassell
Mr Lavelle

**THE ERM**

I have received the proposed list of questions from No 10 and discussed them with those to whom I have copied this minute. It will clearly be difficult to drop questions - but I have tried to put them in a logical order so that they could be accompanied by an annotated agenda. This seems to me to be our best tactic to get an orderly discussion - and to set the issues out for a new group of Ministers. It would be far better than writing another large paper from scratch.

2. There are a number of questions which, following the previous discussion, we need to be clearer about. These particularly concern the way in which we conduct our open market operations in different sets of contingencies - in domestic and external markets - and the sort of effect we could expect on the reserves and interest rates. I have set up a small Treasury/Bank working group under Mr Cassell to sort these out and report in good time before the resumed seminar. Some of the results can be fed into the answers to the questions.

3. It will be a bore to go through this exercise yet again, but if you are content with what I suggest I will feed these thoughts into No 10 before the weekend. You will no doubt be advising the Prime Minister on the Ministerial composition of the next seminar!

P E MIDDLETON

## ERM QUESTIONS

### Issues of Principle

1. What are the benefits from joining the ERM. — this is 9th links with 10 & 13

2. What are the risks - and what is the worst outcome.

3. Would there need to be a change in our policy stance to stay with Germany in the ERM.

4. What would be the role of monetary targets - in theory and in practice.

5. How much flexibility in the operation of policy should we lose - and is this an advantage or a disadvantage.

6. What would be the effect on expectations.

7. Would setting a published or unpublished band for the exchange rate be an alternative to the ERM-advantages and disadvantages.

### Techniques

8. How should we deal with:

   (a) upward pressure;

   (b) downward pressure.

9. What would be the effect on:

   (a) the reserves - are they adequate;

   (b) interest rates - including volatility;

   (c) revaluations. ?

## Presentation

10. How would the decision to join the ERM be presented.

11. Could joining the ERM be presented as an extension of present policy.

12. Would it be easier to sell a tightening in policy - or a loosening - in the ERM. eh?

13. What are the problems of presentation from sticking to present policies.

## Timing

14. Are the objections to joining of a fundamental nature or are they questions of timing.

15. What are the reasons for wanting to take a decision now - one way or the other.

10 DOWNING STREET

*From the Private Secretary*

7 October 1985

Dear Peter,

ERM QUESTIONS

I understand that Nigel Wicks agreed to send you informally a list of questions about the ERM which we are putting together here. I now attach a first attempt at them. I intend to put them to the Prime Minister this weekend and would be grateful for any comments before then.

If she agrees, I would aim to circulate them thereafter, asking for written replies by the end of the month.

? A more comprehensive piece of work will also no doubt be needed as the basis for the meeting now scheduled for 13 November to put in the picture, among other things, those Ministers who have not been involved before.

Yours sincerely,

David Norgrove

David Norgrove

Sir Peter Middleton KCB
HM Treasury

## ERM QUESTIONS

1. Would joining the ERM amount solely to an evolution of the policy framework or would it also imply a change in the policy stance?

2. Are present monetary and fiscal policies tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy? For how long?

3. To what extent would the present level of reserves provide a cushion against temporary downward pressure on the exchange rate, on the basis of past experience here and in other countries?

4. Is it envisaged that interest rates would change more often than they do now?

5. In periods of upward pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?

6. How would the role of the monetary targets change if sterling were to join the ERM?

7. How much weight would in practice be given to them?

8. In what ways would joining the ERM have a helpful effect on expectations?

9. Would a tightening of policy (if that proved necessary) be more easily accepted within Government and by the Government's supporters if sterling were in the ERM rather than outside it? Why?

10. What policy flexibility would be lost by sterling joining the ERM?

11. ~~Would~~ What are the downside risks?

12. How would the decision to join the ERM be presented both to the markets and more widely?

13. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?

14. How might macro-economic policy change if sterling does not join the ERM?

upset

15. How would its presentation change?

What are the problems for policy & presentation if we don't join?

+ for ... questions

MJ2BFD

6

**SECRET**

V. interesting. Many thanks. N

From: Sir G.Littler
Date: 14 February 1986

**CHANCELLOR**

c.c. Sir P.Middleton
Mr Fitchew

## EXCHANGE RATE MECHANISM

You should know of one very interesting point which I learned yesterday from Tietmeyer.

2. The Irish Pound has been under very heavy pressure, because of its link with Sterling. There is a debate going on in Dublin which could easily result in a decision to seek realignment - and indeed a realignment would make a great deal of sense. But of course the French, and the Germans on their behalf, are terrified that a move by the Irish could rock the boat. They would prefer to avoid it until the French elections are out of the way; but in case this proves impossible, they are looking to contain it.

3. Tietmeyer has therefore reached a private agreement with our Irish opposite number, endorsed by the French and Dutch (and I gave my agreement yesterday), to the following effect. If the Irish decide they want to realign, Tietmeyer will seek agreement by telephone from others, on the basis that no meeting of either Ministers or even officials will be held: there would then simply be an announcement of an agreed change, with the new rates, and a clear message that no other changes were under discussion or to be expected.

4. In a brief discussion between Tietmeyer, Lebegue, Russo of the Commission and myself, I asked whether they could be confident of cooperation from all others, especially the Belgians who have also been under a good deal of pressure. The feeling was that the Belgians would acquiesce, because they are anxious broadly to stay with the French franc. But Tietmeyer and Lebegue recognised this as the potential weak link in the plot, and I guess they will try to do some arm-twisting when the time arrives, if not before.

(Geoffrey Littler)

SECRET

CHANCELLOR

FROM F CASSELL
DATE 20 FEBRUARY 1986

cc Eonomic Secretary
Sir P Middleton
Sir T Burns
Mr Peretz
Mr Kelley
Mr Walsh
Mr Davies

Ch/ If the situation developed to the point when the Bank were wanting to use 2:30 lending, you might want a meeting. But not quite yet, you could discuss with Peter tomorrow. RL 20/2

Thanks. A week is a long time in the financial markets. For the time being I am content with the "foot-dragging" mode. But before there is any question of 2.30 lending I wd want to have a meeting. Other things being equal, I agree that an interest rate cut in response to the Budget is better than any move before the Budget. But other things may prove not to be equal. N

MARKETS

I am sure that you, and other recipients, will not be misled by the report in The Times Today that "the Bank of England is ... wheeling its rate-cutting machinery into position." This is not a piece of machinery I have much experience of, but when I discussed the markets with Eddie George last evening his mind was on more familiar instruments.

The Times, of course, is right in saying that the money markets - which are nothing if not volatile - are now scenting a fall in rates. The expectation is especially strong in the discount market. The Bank would like to discourage it - and hold on to the present level of rates until the Budget. The clear conclusion of Sir Peter Middleton's monetary meeting last week was that we should not allow rates to fall before the Budget. The market tone has changed since that meeting, but given all the uncertainties, the advice still seems right.

At the moment the Bank are simply in "foot dragging" mode - i.e. generally under-assisting the market and forcing the discount houses to borrow from it (at 2.45) on unappetizing terms. But 2.30 lending is seldom far from their mind and Eddie was hinting that they might want to suggest it if their more modest signals did not have the desired effect - but not at the moment.

Managing the money markets in the run-up to the Budget may not be easy, and quick reassessment may need to be made. It would be helpful to know that you agree that the aim should be to resist market pressures for lower rates ahead of the Budget. (? irrespective of what happens to the exchange rate – effective now 76.9)

F CASSELL

SECRET

NORGROVE
→ LOMAX
18/10

# 10 DOWNING STREET

*From the Private Secretary*

18 October 1985

**ERM**

Could you please send a copy of the reply to the questionnaire and the paper for the 13 November meeting to Sir Alan Walters (personal and confidential) c/o Julian Exeter at the British Embassy, Washington? They ought to catch the confidential bag on either Monday 4 or Tuesday 5 November if he is to have an opportunity to consider them and to comment.

Tom Par

pp (David Norgrove)

| CH/EXCHEQUER | |
|---|---|
| REC. | 21 OCT 1985 |
| ACTION | |
| COPIES TO | SIR P. MIDDLETON 21/10 |
| | MR CASSELL |
| | |
| | |

Mrs. Rachel Lomax,
H.M. Treasury.

SECRET

Foreign and Commonwealth Office

London SW1A 2AH

OK

14 April 1986

Dear Rachel,

ERM

Lynda Chalker

Sir Geoffrey Howe will be making a speech on 16 April to the Conservative Group for Europe. He has it in mind to include the following paragraph, but before taking a final decision he would welcome any comments the Chancellor may have:

> "Many would say that that vital link between domestic and European policy is clearly seen in the Exchange Rate Mechanism of the EMS. I will not rehearse the arguments in favour of UK membership, not least because UK policy has for a long time been a matter of when, not whether, to join. Political factors cannot be ignored. But nor can a decision be postponed indefinitely. In deciding when to join most attention should properly be paid to those with day to day responsibility for the conduct of currency/ monetary policy".

Yours Sincerely,

Colin Budd

(C R Budd)
Private Secretary

Mrs Rachel Lomax
PS/Chancellor of the Exchequer

3059/029

From: H P EVANS

Date: 15 August 1986

SIR GEOFFREY LITTLER

cc Sir T Burns
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Matthews
Mr Courtney
Mr Osborne

A NEW FIXED EXCHANGE-RATE IDEA

You asked us to look into a scheme mooted by the Chancellor for fixed exchange rates. Under this scheme, a small group of major countries (e.g. G5) pursuing sound financial policies and low rates of inflation would, as well as consulting closely on policy, maintain fixed rates by market intervention. A major feature of the scheme would be the willingness on the part of authorities with strong currencies to intervene as far as necessary. Discipline on policies is proposed to stem from a rule that any member of the group whose inflation rate rose above a certain number would be excluded.

2. The scheme itself is outlined in Annex A of Mark Courtney's attached paper, which after looking (paragraphs 3-8) at the general characteristics of fixed exchange rates then discusses (paragraphs 9-19) the proposed scheme, and concludes (paragraphs 20-22) with an overall assessment.

3. I have only a few comments to make:

(i) The G3, much more than the G5 or G7, will be crucial to any scheme for fixed exchange rates (see paragraph 10).

(ii) Countries with strong currencies are most unlikely to agree to intervene without limit. And it would be most undesirable for them to do so, because of the inflationary bias entailed.

Not so, given use [illegible]

(iii) The idea that any country with domestic inflation above a certain number should be excluded from the group raises very difficult problems, not least because inflation in the group (whether 3, 5, 7) is strongly affected by developments elsewhere in the world, notably in commodity markets: inflation is not only a function of exchange rates and domestic policies.

4. Increased international co-operation and enhanced surveillance are currently features of most schemes for a more stable economic environment, including more stable exchange rates. These features are common to the proposed scheme and to the current consensus. But there is a pretty fundamental distinction between a scheme, such as the one considered here, for subordinating policies to fixed exchange rates and something like the present arrangements which are being designed with the much more modest target (in exchange rate terms) of avoiding the worst of misalignments, while keeping other objectives in view.

5. If you and others agree with the arguments in this paper, we can work it up before sending it to the Chancellor. You should note that Mark Courtney is about to move into FIM; his post in IF2 is being filled by Mike Osborne.

HPE

H P EVANS

£1 = $1.50 = DM 3 = ¥225 (less elegant: more accurate)

**COMMENT ON: A NEW FIXED EXCHANGE-RATE IDEA**

oops! AA

**Introduction**

and the arithmetical elegance of $1 = £1.50 = DM2 = ¥150!

The current situation, where all the major countries have quite similar and low inflation rates and where there are no glaring exchange-rate misalignments between them, represents the first occasion since the early 1970's when some sort of fixed exchange rate system might be feasible. At the same time, some things have changed since then. There is much greater international capital mobility (as well as a higher ratio of international trade to GDP) and among governments a greater appreciation of the many channels by which economic disturbances are transmitted internationally and of the limitations of their own macroeconomic policies both in pursuing internal objectives and in influencing their external balance. Thus, although more stable exchange rates are generally desired, a return to the sort of fixed exchange rate systems of the past would not necessarily be feasible. Different and possibly less formal arrangements might be more desirable as well as more practicable, and any new scheme deserves examination.

2. This note starts by looking at the historical working of fixed exchange rates. From this, the general characteristics of any feasible fixed exchange-rate system are derived. The sketch of a new fixed exchange-rate idea is then analysed against these characteristics. Finally, an assessment is made of the form in which more stable exchange rates might be achieved.

**Historical Experience with Fixed Exchange Rates**

3. There were two periods when fixed exchange rates functioned smoothly - the period of th gold standard before the First World War, and from the end of the Second World War to the end of the 1960's. In both cases there was a dominant, central currency which acted as the focus of the system - the pound sterling (convertible into gold) before WWI and the US dollar (convertible into gold in a more limited way) after WWII.

4. The presence of a dominant, central currency was important because it was one way of solving the problem of arriving at a set of mutually agreed exchange rates. This has been called the (n-1) problem, because with n different currencies, there are only (n-1) independent exchange rates between them. One of the easiest ways of determining a consistent set of fixed exchange rates is to have one currency acting passively as numeraire, with

the others choosing their exchange rate with the numeraire currency. The remaining $\frac{1}{2}(n-1)(n-2)$ cross exchange rates between all other currency pairs are then determined by the ratio of the exchange rates to the numeraire currency.

5. Solving the problem of determining the set of agreed exchange rates in this particular way is also useful because it provides relatively simple rules for maintaining the fixed exchange rate system. The central currency has to remain passive and not take a view on its exchange rate, while maintaining the domestic monetary conditions which make it a suitable choice as central currency. The remaining (n-1) countries have in normal times simply to direct their macroeconomic policy, particularly their monetary policy, to maintaining the fixed exchange rate with the numeraire currency. Additionally, and importantly, the presence of a passive central currency makes it relatively easy for adjustment to take place in abnormal times by a devaluation or revaluation against the numeraire currency. This could be done unilaterally, although there might sometimes be consultation to avoid competitive devaluations.

6. Finally, the convertibility of the central currency into gold was important because it was one way of providing a nominal anchor for the whole system - ensuring that the central currency followed a reasonably non-inflationary course, and avoiding the possibility that all countries could inflate simultaneously while maintaining fixed rates. In the period after WWII the stability of the system depended in practice on the non-inflationary conduct of US monetary policy. The suspension of gold convertibility in 1968 was significant mainly as a signal that the Europeans had lost confidence in US monetary policy.

7. The periods when fixed exchange rates broke down are also instructive. Between the wars there was no dominant, central currency and insufficient international cooperation to act as a substitute. In the early 1970's the US was probably still sufficiently large to have continued as the central currency, but its inflationary conduct had lost it the confidence of the Europeans and it was itself no longer prepared to act passively towards its own exchange rate.

**Characteristics of a Fixed Exchange Rate System**

8. As an historical description, the preceding section leaves out much

of importance, but it does enable one to list the essential characteristics that any workable fixed exchange rate system must have. These characteristics need not be embodied in the type of system that prevailed in the past, but one way or another they must be present. They are:

(i) A solution to the problem of agreeing on a consistent set of exchange rates.

(ii) Robust rules of behaviour to maintain the system in normal times, and to allow changes in exchange rates when fundamental economic conditions change.

(iii) A nominal anchor for the whole system, to limit inflation or deflation.

**A New Fixed Exchange Rate Idea**

9. The scheme for a new fixed exchange rate idea is set out in Annex A. Its main features are considered in this section under the three aspects identified above.

**(i) agreement on exchange rates**

10. In the absence of a single dominant central currency, the sketch asumes a core of the G5 or G7 countries, who would co-ordinate their monetary and other policies and agree on a set of exchange rates among themselves. Other countries could then individually choose to peg or not to peg to this central core, much as did the countries other than the US under Bretton Woods. The system therefore depends for its operation on the close co-operation of the countries in the central core. Here, the sketch may be unrealistic in emphasising the G5 or G7 countries. In the context of an agreement on exchange rates, only the G3 are important. Given the close relationship to the dollar of many American and Gulf currencies and the central role of the German mark in the wider EMS (including the Swiss franc and Austrian schilling which in practice shadow the mark), if the dollar-DM and dollar-yen rates were fixed, the world would essentially be on a fixed-rate system. These three blocks together would, for example, account for 89% of the weight given to currencies in the sterling effective index (Annex B looks at various measures of the importance of the major currencies in international transactions). On the other hand, it can be argued that in a wider political context agreement in the G5 or G7 might be easier than in the G3, if only because the other

Europeans would be reluctant to see Germany committing them not just to exchange-rate targets but to any measures designed to maintain those rates - it was just such an exclusion from the Plaza agreement that impelled Italy to press for expansion of the G5. In any case, we are at the moment still rather far from Japanese-US agreement on a fixed dollar-yen exchange rate, or from agreement on the other major cross rates for that matter. The problems in determining and agreeing on a set of fixed exchange rates were studied at some length in the debate over the proposal for target zones (considered at the April 1986 Interim Committee). Given the poor record in forecasting exchange rates, and the problems and uncertainties in trying to calculate equilibrium exchange rates, arriving at a proposal for a sustainable exchange rate would be an imprecise exercise, and agreement on exchange rates among a number of countries would be unlikely. Even those in favour of target zones, such as John Williamson or D Lebegue, envisage wide zones with soft edges, at least at first. At the moment there is a general agreement on the need for greater international co-operation and surveillance over a wide range of economic policies, and such broad, fuzzy target zones might fit in at same stage with such an approach. But an agreement on a fixed rate system would represent a decisive departure from such a philosophy.

pressures on other policies [illegible] ∴ XR [illegible]

11. In such a case, there would be a single dominant target for international co-operation, with co-operation and pressure concerning other economic policies subordinated to maintaining the fixed exchange rates. If such a philosophy were accepted, agreement on exchange rates might actually be easier, even though more would be at stake. This is because with only one target there could more easily be a certain amount of trial and error initially in revising the exchange rate; and because with other macroeconomic policies directed to maintaining a fixed rate, exchange rates which might not have been eqiuilibrium rates to start with would be validated by the appropriate monetary policy, just as monetary policy in the UK was adapted to a return to the pre-war parity after World War I, or the excessively low sterling parity set in 1949 was validated by subsequent inflation. However, with the possible exception of the French, it does not look as if the major countries are sufficiently convinced of the virtue of a single, exchange-rate target to make such an approach likely.

**(ii) <u>rules of operation</u>**

12. The sketch introduces the idea that the fixed exchange rate system would be maintained by the country with the <u>stronger</u> currency intervening

& destroy all credibility system

to sell its currency without limit. Thus, problems of the inadequacy of reserves to counter private speculation would be overcome. But the way in which intervention supports exchange rates needs to be considered. Apart from any signalling effect - which can be important in special situations - intervention whose monetary effects are sterilized has a relatively small impact. It operates through changing the supplies of bonds of different currencies, and if these are still imperfect substitutes even for the same expected return, there may be some portfolio effects which influence the exchange rate. But powerful effects come only when intervention is not sterilized, since then interest rates will change and alter the attractiveness of holding assets in the different currencies. Thus a scheme which provides unlimited reserves for intervention can make management of a fixed rate easier, but it cannot alter the fact that defending a fixed rate against private speculation involves enlisting monetary policy to that end and altering interest rates perhaps quite sharply - either directly, or indirectly via the effects on the money supply of sufficiently large, unsterilized intervention.

13. The drawbacks to such a scheme for intervention are acknowledged in the sketch but need to be drawn out explicitly. First, there is its inflationary bias. Given the scale of, probably unsterilized, intervention that might be necessary, there would be a tendency for the money supply in the stronger currency to expand and for the inflation rate of the core to gravitate towards that of its most inflationary member. Although particularly obvious, this sort of bias is not unique to the system proposed in the sketch. It has been argued that in the EMS, where in practice most intervention has been done by the weaker currency, there has been a deflationary bias: in part this has been a deliberate choice, with convergence on the low inflation rate of Germany being aimed for. Whether this will remain appropriate in the future is another matter. It has also been argued that the Bretton Woods system of fixed exchange rates had an inflationary bias. The main influence was the inflation rate in the central country, the US, but other countries on the whole tended to devalue rather than revalue against the dollar, partly because it was easier to live with an undervalued currency and a build-up of reserves than with an overvalued currency and the need to borrow, partly because of the greater political weight in many countries of producers and exporters who favoured an undervalued currency than of consumers and importers who favoured an overvalued one.

14. This brings us to another aspect, the improbability that countries with stronger currencies would be prepared to sell their currencies without

limit. Such action would have awkward monetary consequences for them, and in the absence of any pressures such as the outflow of reserves which afflicts weak currencies, they would not do so. In the past, Germany when the strongest currency in the EMS did little to intervene by selling DM, and the French as the strongest currency are doing very little selling of francs now. If one goes back to the early 1930's, the French, with the strong currency vis-a-vis the pound, did little selling of francs then.

15. The sketch does propose that the inflationary bias be limited by requiring that any country with domestic inflation above a certain number (however that would be measured) should drop out. This raises more problems than it solves. If one of the core countries dropped out permanently, that would effectively end the scheme. Or dropping out might mean remaining in the scheme after a devaluation. In either case this would encourage massive private speculation, as the inflationary signs would be seen well in advance. With the type of intervention proposed, it might indeed be impossible for private speculation to enforce the exchange-rate change before time. But this would only be prevented if intervention and changes in monetary policy were large enough to alter monetary conditions significantly and to change relative interest rates between the two countries sufficiently to offset the expected devaluation, when due allowance is made for the uncertainty of its timing.

16. A variant of the scheme proposed in the sketch would be to base the drop-out provision not on an absolute measure of inflation but on an inflation performance higher by a certain amount than that of the next most inflationary member. (To relate it to the average inflation of the group would have the paradoxical result that a very deflationary performance by one member could cause other members to drop out even if they had low absolute rates of inflation). This variant would impart a little more flexibility, as it would allow for the common impact of an external inflationary shock such as an oil price increase, and it might make predicting a drop-out a little more difficult, as speculators would have to predict the difference between two countries' inflation rates rather than the inflation rate of just one of them. However, it would weaken whatever effect the drop-out provision had for restraining inflation in the core countries as a group.

17. Any fixed-rate system has to incorporate a mechanism for allowing changes in parities if fundamental conditions change - for example a large natural resource discovery. If setting exchange rates depends on common agreement among a core group of countries, altering them is likely to prove more

difficult than if there is a peg to a single central currency. However, the experience of the EMS shows that realignments are possible in such circumstances.

vague

**(iii) a nominal anchor**

it has interesting assertions

18. The inadequacy of the drop-out provision in restraining inflation has already been noted. But the sketch also says that members of the core "would dedicate themselves to the pursuit of sound financial policies and very low rates of inflation." Presumably they would do so by co-ordinating monetary policy among themselves, and by trying to make it consistent with the set of fixed exchange rates. This brings us to the most critical aspect of the proposed fixed exchange-rate scheme, namely how the core group of countries might agree on macro-economic policies which would provide the stable nominal anchor necessary as the centrepiece of a fixed exchange-rate system. The sketch does not elaborate on how this might be done. One scheme has been outlined in various forms by R I McKinnon, which would produce similar effects to the way the specie-flow mechanism was supposed to operate under the gold standard. This scheme would involve the core countries (in McKinnon's case the G3) agreeing on rates of domestic credit expansion and agreeing not to sterilize any exchange-rate intervention which they carried out to maintain the exchange rates between their currencies. In this way currency substitution by the private sector between the three currencies would be accommodated, while the aggregate G3 money supply would grow at the predetermined rate. Of course, in this set-up there is no guarantee that intervention would be sufficient to maintain the fixed exchange rates. The impression is that for McKinnon the important thing is a stable core rate of monetary growth, while agreement not to sterilize intervention is only a means of maintaining this - an agreement not to intervene at all would work just as well, but might involve excessive exchange rate fluctuations. But in this case, too, unsterilized intervention sufficient to maintain fixed rates would have important monetary consequences, and rather than wait for relative money supplies to contract and expand, the countries might prefer to alter their interest rates immediately, as under the gold standard, though in this case there would have to be consultation to ensure that this was done in such a way as to maintain aggregate G3 monetary growth.

19. In view of the difficulties with monetary targeting, a variant of the McKinnon approach might be to have agreement on nominal demand growth. Here, however, there would be a more tenuous link between intervention involving

a pair of currencies and the extent to which such intervention should be allowed to affect the growth of nominal demand in the two countries so as to maintain aggregate core nominal demand growth. Thus the problem of reconciling the fixed exchange rates and the nominal demand growth targets would be greater than with targets for monetary growth.

## Assessment

20. The first question is whether international co-operation and surveillance should be directed to a range of economic variables, of which mutually consistent exchange rates would be one, or whether there should be a system of fixed exchange rates which would be at the centre of economic co-operation, with co-operation on other issues subordinated to that. At the moment, the international consensus seems very much along the former lines, with concern not only about exchange rates but also that nominal demand be maintained, and with the related issues of fiscal imbalances and the current high levels of real interest rates. But there are arguments that can be deployed in favour of concentrating on exchange-rate targets. If one believes that exchange rate volatility and misalignments are caused not so much by unstable or incompatible macroeconomic policies as by speculative bubbles and unstable expectations, then an explicit exchange-rate target might be necessary. But although there have been occasions when bandwagon effects seem to have operated in the exchange markets (for example raising the value of the dollar in early 1985), the extent of policy differences between countries makes it difficult to believe that speculative bubbles have been the chief cause of exchange-rate misalignments. It can also be argued that even if the form of co-operation induced by exchange-rate targets is concentrated in one particular area, it is a good visible system for putting pressure on countries to modify policies with undesirable spill over effects. And in practice for relatively open economies without exchange controls, the exchange rate might be the best single indicator of monetary conditions.

What the practical issue?

more often than they do

21. It is not clear which approach the sketch takes. Despite its emphasis on fixed rates, it does mention regular surveillance and a common anti-inflationary goal. If exchange-rate objectives are embedded in a general system of surveillance, what is likely to emerge is agreement from time to time to take action to correct particularly glaring misalignments which exist or are developing. In general, this approach would emphasise that by co-ordinating macroeconomic policies in a number of areas, exchange-rate misalignments would be less likely to emerge and in practice exchange rates

would be much less volatile than they have been in the recent past. Once this level of surveillance had been in place and had established its creditibility it could be compatible with the softest version of target zones, where central rates are announced with fairly wide bands and soft edges so that if the exchange rates reached them there would be a presumption of some action, though not necesarily to defend the zone. On one interpretation, the McKinnon proposals to co-ordinate the core rate of growth of money could be part of such an approach, though one would have to have a large measure of faith in monetary targets to think that that would be a sufficient degree of international co-operation on its own.

all wrong

22. Harder target zones or the sort of fixed rate system developed later in the sketch have a different philosophy. The maintenance of the fixed rates among the core countries would be the focus of co-operation to which other policies would be subordinated. There could perhaps be agreement on common rates of domestic credit expansion to provide a nominal anchor, although given the difficulties which financial liberalisation have posed for the interpretation of monetary aggregates, some other nominal anchor might have to be found. And there could certainly be a more symmetrical pattern of intervention by strong and weak currencies than in the past. But in the end the participants would have to be prepared to see the market test the zones and to direct interest-rate policy (coupled with, and to some extent determined by, unsterilized intervention) to defending them. There would also need to be sufficient co-operation among the core countries for them to be able to agree together on the conditions when a realignment would be necessary, although the present situation of convergent low inflation rates has perhaps rendered less important the advantages that floating rates have in coping more easily with divergent trend rates of inflation. My own view is that the world would need to get used to more international co-ordination, low inflation and relatively stable exchange rates for some time before it would be ready for a more formalised fixed exchange-rate system.

yes

**M M COURTNEY**

**FEU**

## ANNEX A: A NEW FIXED EXCHANGE RATE IDEA

### The basic concept

The core system would be confined - at least initially and probably permanently - to a limited number of potential members. Typically and perhaps optimally they would be the group of leading industrial countries constituting the G5 or G7.

Regular and close mutual surveillance would subsist within the group, whose members would dedicate themselves to the pursuit of sound financial policies and very low rates of inflation and to the maintenance of fixed (or at least relatively fixed) exchange rates within the group.

Any divergent tendency of exchange rates might be corrected by domestic policy action in one or other country (the idea of close and regular surveillance implies that there would often be some consultation about such policy action). If the divergence reflected the impact or expected impact of inadequate financial policies in one country, there would be group pressure for action to improve policies.

Otherwise, exchange rates would be maintained by market intevention by the authorities. In order to make this fully credible in the markets, it would be a general rule that all such necessary intervention would be undertaken in their own currencies by the authorities of the currencies which were at the time showing excessive strength. Those authorities would have no reserve problems - they would be selling their own currencies of which the market would know that they possessed literally unlimited amounts. Private speculation against such a system would become pointless.

To guard against the risk that a member might choose to adopt weak financial policies in the knowledge that fellow-members of the group were obliged to support its exchange rate, there would be a firm rule that any member of the group whose domestic inflation rate rose above a certain number would automatically cease to be a member of the group. The inflation rate number would be agreed within the group at the outset and, although not immutable, it would not normally ever be changed.

**Some operational problems**

The scheme would be built on, and would heavily depend on, trust between the participants. If that trust existed, and were recognised by the markets, there could well develop a market tendency to keep the exchange rates of the group in line, and the willingness of the authorities to intervene might never be seriously tested.

But it is surely necessary to consider what would happen if in practice a severe test did arise:

- the strong currency (or currencies) would be issued on world markets in exchange for weak ones of the group: would this be in principle sterilised or not? Would it not on the potential scale of a severe test be bound to be unsterilised?

- the implication is that there would be important monetary effects in one or more members of the group: where the financial stance of the weaker currencies was tightened, this might be welcome; similarly if the strength of one currency were due to excessively tight monetary policy, the weakening effect of massive intervention could be welcome: would this be intended? or acceptable?

- if at the end of the day an exchange rate change became necessary, the stronger currency authorities which had intervened would be left with a substantial loss of value from their intervention, as well as perhaps some awkward domestic monetary side-effects.

Separate problems might arise in practice over measuring the inflation rate:

- could agreement be readily reached on the correct data and definitions to be used?

- what about timeliness of data?

real problem

**Some political problems**

As already stated, a successful scheme would have to rest on trust. Is that likely?

Much depends on the real importance to each member of his membership of the group (and of course on how others perceive the value he places on membership). This is because, in the last resort, the sanction against weak financial behaviour is being expelled from the group. How important would this be, for example, to the United States?

On the face of it, those countries which have the best track record on inflation, and not entirely accidentally also have strong currencies, would seem likely to be deeply suspicious of a scheme which would seem to place obvious, unavoidable and potentially troublesome and costly obligations on them, in return for a club membership sanction whose weight they would see as being unguaranteed. On the other hand, Germany and Japan do at the present time appear to have some interest in arrangements which could prevent a further decline in the value of the dollar - to some extent they have shown willingness to intervene - and they might welcome a system which seemed to add to existing pressures on the US. How do we rate the chances of their being interested and could we develop any persuasive arguments?

Would the UK government be interested and willing to take on all the potential obligations?

**A Last Thought**

Even if the scheme sounds implausible when viewed cold, is there a chance that it could provide a framework for any future agreement on maintained target zones? Can we see scope for any supplements or variations?

## ANNEX B: RELATIVE IMPORTANCE OF NATIONAL CURRENCIES IN INTERNATIONAL TRANSACTIONS

There are various possible measures of a currency's importance in international transactions, for not all of which accurate figures are available. This annex assembles four measures: the share of world exports invoiced in a particular currency (only rather dated survey figures are available); the share of a currency in external bank lending; its share in external bond lending; and its share in official reserves. On all except the first measure the pound ranks below the dollar, Deutschemark and yen, although comfortably above all other currencies (except for Swiss franc strength in external bond offerings and some measures of bank lending).

**Table 1: Currency Share of World Exports**

| | (1979 weights) % of world exports priced in |
|---|---|
| US dollars | 54.8 |
| German marks | 14.4 |
| Sterling | 7.5 |
| French francs | 6.1 |
| Yen | 2.3 |
| Others | 14.9 |
| Total* | 100 |

* includes trade of centrally planned economies

Source: S Page "The choice of invoicing currency in merchandise trade", NIESR, November 1981. The figures relate to surveys in different years, mainly in the late 1970's, weighted together using 1979 trade weights.

**Table 2a: Currency shares of total external lending by BIS area banks[a]**

Percentages: estimated exchange rate effects are excluded

| Increases in year to end-September | US$ | DM | Sw. Fcs | Yen | £ | Other[b] |
|---|---|---|---|---|---|---|
| 1981 | 67.3 | 9.6 | 7.9 | 3.9 | 3.8 | 7.5 |
| 1982 | 78.6 | 3.7 | 3.3 | 2.7 | 2.0 | 9.7 |
| 1983 | 47.2 | 15.0 | 2.4 | 7.6 | 4.8 | 23.0 |
| 1984 | 38.5 | 10.1 | 7.5 | 12.4 | 9.7 | 21.8 |
| 1985 | 36.7 | 12.0 | 4.7 | 17.9 | 6.4 | 22.3 |
| Stock outstanding at end-Sept 1985 | 66.2 | 10.7 | 5.6 | 5.0 | 3.1 | 9.3 |

(a) Excluding the lending of the 'offshore' banking centres for which currency detail is not available: the dollar share may therefore be understated.

(b) Including ECU and unallocated items.

Source: Bank of England Quarterly Bulletin, March 1986.

**Table 2b: Currency shares of external medium term bank loans[1]**

per cent

| | 1983 | 1984 | 1985 | 1986(*) |
|---|---|---|---|---|
| US dollar | 79.6 | 71.7 | 61.7 | 63.2 |
| Yen | 7.4 | 12.2 | 14.1 | 11.7 |
| Sterling | 4.1 | 4.8 | 10.2 | 15.3 |
| ECU | 0.9 | 2.9 | 6.2 | 1.1 |
| Swiss franc | 0.6 | 1.6 | 2.6 | 1.6 |
| Deutschemark | 1.5 | 2.2 | 2.0 | 3.8 |
| Hong Kong dollar | 1.3 | 0.8 | 0.7 | 1.1 |
| Canadian dollar | 2.2 | 0.9 | 0.1 | 0.2 |
| Australian dollar | 1.6 | 0.8 | - | - |
| Others | 0.8 | 2.1 | 2.4 | 2.0 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| Total in US$ billion equivalent | 66.6 | 57.5 | 42.7 | 14.6 |

1. Foreign and international medium-term bank loans, excluding loan renegotiations. Currencies od denomination converted at constant (end-1983) dollar exchange rates.

(*) January-May.

Source: OECD Financial Market Trends, June 1986.

**Currency of distribution of external bond offering**(1)

| | 1983 | 1984 | 1985 | 1986(*) |
|---|---|---|---|---|
| | | | | Per cent |
| US dollar | 58.0 | 62.8 | 59.3 | 54.4 |
| Swiss franc | 17.1 | 12.3 | 9.5 | 9.9 |
| Yen | 5.5 | 5.5 | 7.4 | 8.5 |
| Deutschemark | 8.1 | 6.2 | 6.8 | 7.3 |
| ECU | 2.7 | 2.8 | 4.6 | 3.7 |
| Sterling | 3.8 | 5.4 | 4.3 | 6.3 |
| Australian dollar | 0.3 | 0.3 | 2.2 | 3.5 |
| Canadian dollar | 1.4 | 2.1 | 1.8 | 2.5 |
| Dutch guilder | 2.0 | 1.7 | 1.1 | 0.9 |
| French franc | 0.2 | - | 0.9 | 1.2 |
| Other | 0.9 | 0.9 | 2.1 | 1.8 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 |
| Memorandum item: Total issues in US$ billion equivalent | 75.8 | 113.9 | 172.9 | 211.9 (2) |

(*) January-May

1. All currencies converted into US dollar at constant (end-1983) exchange rates.

2. At annual rate.

Source: OECD Financial Market Trends, June 1986.

**Table 4: Share of National Currencies in Identified Official Holdings of Foreign Exchange, end of year, %**

| | 1977 | 1984 |
|---|---|---|
| US dollar | 78.0 | 65.1 |
| Pound Sterling | 1.8 | 2.9 |
| German mark | 9.1 | 12.0 |
| French franc | 1.2 | 1.1 |
| Swiss franc | 2.2 | 2.0 |
| Netherlands guilder | 0.8 | 0.8 |
| Japanese yen | 2.4 | 5.2 |
| Unspecified currencies | 4.4 | 11.0 |

From 1979, the value of ECU's issued against dollars are allocated to the dollar, ECU's issued against gold are excluded from this table.

Source: IMF Annual Report, 1985.

Ch
The movement in exchange rates since Tokyo does seem to have produced a set of cross-rates generally viewed as closer to "equilibrium" that at any time in the recent past (though any such judgement is fraught with danger). So one major obstacle is greatly eased. But, as always, the issue remains whether all participants would be ready to make the necessary commitments. Would you like a meeting to discuss this?
AA 27/8.

From: Sir G.Littler
Date: 27 August 1986

**CHANCELLOR**

c.c. Sir P.Middleton
Sir T.Burns
Mr Huw Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Matthews
Mr Courtney
Mr Osborne

**A POSSIBLE FIXED EXCHANGE-RATE SCHEME**

It was during our journey to Tokyo that you were thinking aloud with me about a possible fixed exchange rate group of major currency countries, with unlimited intervention obligations on strong currencies and expulsion of members failing to keep within a prescribed low maximum rate of inflation.

2. More recently I asked Mr Evans to arrange for some analysis of the idea. I attach the initial result. My own feeling is that this is not a realistic runner, in terms of negotiability with the other potential members of the group - the reasons are identified in these papers. Nor do I at present see scope for variants on the essential themes which would make it more attractive.

3. For the present, therefore, I am not inclined to ask for any further polishing of the papers.

(Geoffrey Littler)

I am grateful to Mr Courtney's very clear paper, which makes a number of fair points. But its fundamental inadequacy – its failure to grasp the nature of the modern foreign exchange market or the psychology of the players in it, or the practical politics of international monetary co-operation (or the lack of it) – only serves to underline my belief that the scheme I proposed makes sense. I shall ... how best to take the matter forward. N.

VR70

SECRET AND PERSONAL

pwp

Keep safely

COPY No: of

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

24 September 1985

David Norgrove Esq
10 Downing Street
London SW1

Dear David,

**ERM**

I attach a nearly final draft of the joint Treasury/Bank paper on ERM for discussion at the Prime Minister's seminar next week. I will be sending you (and the FCO) a final version, complete with charts, by the end of the week.

As agreed, I have sent copies via the FCO bag, to Alan Walters and Brian Griffiths in the United States.

I am also copying to John Bartlett (Bank of England).

Yours ever
Rachel

RACHEL LOMAX

1257/2

**FROM:** H J DAVIES

**DATE:** 3 FEBRUARY 1986

**CHANCELLOR**

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler

A straight-forward argument for monetary & fiscal laxity from Redwood: given his past form, no less of [illegible].

**EMS**

At last Friday's Centre for Policy Studies conference on employment, the substance of which I am reporting separately, there was some animated discussion about our membership of the exchange rate mechanism. The advocates of membership included Sam Brittan, Sir Michael Edwardes and the Hon Rocco Forte.

2. Their comments provoked a very sharp and hostile response from John Redwood. His line was that the Government was constantly being told that the right rate for membership had been achieved. They were told so a few months ago, and look what has happened since. Proponents did not understand the implications of the commitment to defend a particular rate. Would they be prepared to pay the price if it meant huge rises in interest rates or, for example, £1 billion of tax increases? Redwood's interventions in debate are, in my experience, always robust and somewhat charmless, but on this occasion he was more animated and aggressive than usual.

ugh.

HJD

H J DAVIES

RA7.49

pwp

FROM: A C S ALLAN
DATE: 17 November 1986

CHANCELLOR

cc Mr Culpin (personal)

Thanks

**EMS**

David Norgrove tells me the Prime Minister gave a long interview to Malcolm Rutherford and Peter Riddell today. There was a long discussion about EMS, at which the Prime Minister gave a much more balanced presentation than usual. For example, when she was asked about timing, she said she would not rule out joining before the election, though she thought it was much more likely the time would be right after the election.

2. The interview was on the record, and may start to appear in stories on Wednesday and thereafter.

AA

A C S ALLAN

3883/028

CONFIDENTIAL

1 Alex
2 MKE folder

Ch
Geoff spoke to Lelegue, who indicated in a guarded way that he wasn't expecting a realignment this weekend (but he would have to do that anyway!)
AA

PSA explain nature of obligation on Germany - & confirm that the [illegible] that the Germans have bought on their own account & have then - collectively - added francs to their [illegible] [illegible]

FROM: C W KELLY

DATE: 6 January 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Ms Goodman o/r

**THE ERM**

The French had another very difficult day in the Exchange Rate Mechanism. They sold $1.7 billion of deutschemark bringing their total over the last three days to $2.4 billion on top of the more than $3 billion they laid out in December. Even so they, failed to hold the rate they were trying to defend against the DM and consequently took the rather unusual step of announcing that they were ceasing to do so. Not surprisingly, they immediately sunk to the bottom of the fluctuation band.

2. The Germans were under the rules obliged to intervene themselves at this point. But they confined themselves to buying a token $8 million of French francs'. They did also sell $164 million of DM for lira. But that was on behalf of the Italians, who were on holiday today.

3. While all this was going on, the French made further statements to the effect that any realignment would have to take the form of a revaluation of the DM rather than a devaluation of the franc. The Germans let is be known that they took the opposite view.

4. In the circumstances, it is not surprising that there is a lot of speculation about whether or not the French can hold on until after the German elections on 25 January. Clearly there is a risk that they might not be able to do so, and a realignment conference could (very awkwardly for us) be called as early as

this weekend. But the odds may still be against. The French have a powerful incentive to try to tough it out if they can, since their chances of securing a German revaluation in advance of the election must be very small. A lot will depend on the industrial situation in France. The news today on that front looked a little better.

5. The behaviour of Eurofranc rates suggests that the markets still think a post 25 January realignment to be more likely. One month Eurofranc rates moved up to 12 1/8 per cent, implying a demand for funds to be repaid after the end of the month. One week rates stand at 9 per cent. There is still a differential over domestic franc rates, implying that the remaining French exchange controls still have some force (or that the markets have not yet fully caught up with the changes).

6. One helpful feature of all this is that in the turmoil sterling has been able to stay on the sidelines.

C W KELLY

SECRET AND PERSONAL

From: SIR PETER MIDDLETON

Date: 12 June 1987

CHANCELLOR

PUP

THE ERM

... I attach four short notes. One summarises the arguments - you need not spend much time on this. The second deals with the rate and the third with timetable questions. Finally, there is a note on the legal point we discussed before the Election. There is now an overwhelming case for joining quickly at something very close to the present DM rate if we are going to join at all. I hope therefore that it will be at the very top of your agenda for the new Parliament and that we can discuss tactics at the earliest opportunity.

P E MIDDLETON

pmp

OUTGOING FAX

FROM: GOVERNOR'S OFFICE, BANK OF ENGLAND
FAX No 601-4953
OPERATOR No 601-4421

TO: Chancellors Office

DATE: 9/9 TIME: 10.15

ACKNOWLEDGEMENT REQUIRED: ~~YES~~/NO

MESSAGE

Copy of report on the Strengthening of the EMS

(13 pages follow)

Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

Basle, 8th September 1987

Please find attached the final text of the report by the Committee of EEC Central Bank Governors on the strengthening of the EMS. As it was agreed at the meeting of the Committee, the Governors are invited to pass a copy of this document on to their own Minister of Finance.

The Chairman of the Committee will formally hand a copy of the report to the Chairman of the informal meeting of the ECOFIN Council in Nyborg. The French and German translations will be sent shortly and will also be available in clean copies in Nyborg.

Kind regards.

G. Morelli

Attachment

Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

8th September 1987

# REPORT BY THE COMMITTEE OF GOVERNORS
# ON THE STRENGTHENING OF THE EMS

1. In the Communiqué issued on the occasion of the realignment of 12th January 1987 the Ministers of Finance of the EEC countries asked the Committee of Governors and the Monetary Committee to examine measures to strengthen the operating mechanisms of the European Monetary System (EMS). Pursuant to that request, preparatory work for the Committee of Governors was conducted by the Committee's expert groups and the Alternates. Two oral interim reports on this work have been presented by the Chairman of the Committee of Governors to the Council of Ministers of Finance, respectively on 4th April and 15th June 1987. The Governors' final report, which focuses primarily on the matters within their competence, is presented below.

2. The Report is divided into two parts. Part I reviews the experience with the EMS and analyses the major changes in the economic environment that are likely to influence the working of the system. Part II summarises the main conclusions of the analysis and discusses ways and means to strengthen the EMS mechanisms and improve their functioning.

## I. THE ECONOMIC ENVIRONMENT AND THE FUNCTIONING OF THE EMS MECHANISMS

### A. Changes in the economic environment

3. Over the years, the EMS has performed satisfactorily, despite pronounced instability in the world economy. The Governors are convinced that the system has contributed to the achievement of a considerable degree of exchange rate stability based on greater economic convergence by fostering discipline in monetary and fiscal policies and preventing undue delays in policy adjustments. It is nonetheless their belief that the performance of the EMS benefited from a number of factors and circumstances whose influence on the system may now be changing.

4. Since the inception of the system the EMS countries have given priority to reducing inflation. In many cases exchange rate changes have

not fully accommodated inflation differentials, and higher inflation countries have maintained appropriate interest rate differentials. This has had a stabilising effect on exchange rate expectations and helped to reduce speculation against weak currencies. A remarkable reduction of inflation rates has indeed been achieved, but inflation differentials have not been eliminated and there has been less convergence in budgetary and other policies that have a bearing on exchange rate cohesion. As long as convergence remains incomplete, central rate realignments will continue to be necessary from time to time and there is a danger that interest rate policy will be excessively constrained by external considerations especially if realignment decisions are unduly delayed.

5. The EMS exchange rate arrangement has been affected by the large movements in the dollar exchange rate, both because the Deutsche Mark is a preferred substitute for the US currency in international portfolios and because dollar swings influence the competitiveness of EMS countries differently. Downward pressure on the US currency has generally been associated with upward pressure on the Deutsche Mark within the EMS. As long as large payments imbalances between the major countries persist and the policies being pursued do not appear fully consistent with their correction, the international environment will continue to be a potential source of destabilising pressure within the EMS; this pressure will be reinforced by remaining differences in the performance and policies of the EMS countries.

6. Increasing integration of financial markets, sophistication of market operators and mobility of international capital are likely to accentuate EMS tensions stemming from the internal and external factors indicated above. The Community countries that had maintained capital restrictions have been gradually removing them, in line with the objective of completing the internal market by 1992. In practice, the dismantling of capital controls can have conflicting effects on exchange rate stability. On the one hand, it not only fosters more efficient resource allocation and macro-economic policy convergence but also reinforces external discipline, with a potentially stabilising influence on exchange rate expectations; on the other, it increases the risk of markets amplifying the exchange rate repercussions of external disturbances or perceived policy divergences of a temporary nature.

7. With fixed but adjustable exchange rates and increased capital mobility resulting from progressive integration of financial markets and

the abolition of remaining restrictions, national monetary policies will be exposed to strains so long as individual countries' economic and financial policies and performances leave room for departures from internal and external balance whose effects spill over to other countries. This implies that all partners should pursue in a closely co-ordinated manner policies that foster stability of domestic prices and costs and external balance as a basis for lasting exchange rate stability: in particular, countries should agree that central banks would be committed to giving priority to the objective of price stability in the conduct of monetary policy.

8. It is recalled that, as recorded in the conclusions of the Presidency of the European Council in December 1978, the purpose of the EMS is to establish a greater measure of monetary stability in the Community and the EMS should be seen as a fundamental component of a comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonisation of living standards and the lessening of regional disparities in the Community. Moreover, the Single European Act specifically aims at reducing such disparities, with a view to strengthening the economic and social cohesion of the Community. In the absence of a strengthening of the economic and social cohesion of the Community, the completion of the internal market and the full liberalisation of capital movements may exacerbate these disparities. Therefore, consistent monetary policies, exchange rate stability and, indeed, overall progress towards monetary and financial integration must not be seen as ends in themselves, but rather as part of a process that, allied to direct Community action, will facilitate the reduction in regional disparities in the Community.

## B. The functioning of the EMS mechanisms

### Exchange rate management

9. When strains have developed within the system, they have initially been met by intramarginal interventions, sometimes very large, by the central bank whose currency was under downward pressure. Intramarginal interventions have been effective in avoiding destabilising expectations and more generally in providing relief and gaining time to decide on more comprehensive responses when pressures persisted. Experience has nonetheless shown that if a given intramarginal exchange rate is defended for too long and the market becomes aware of the scale of intervention, speculation may be reinforced. Moreover, on occasion market perception of an

inclination by the authorities to rely primarily on interventions may have fuelled speculative pressure.

10. Interest rate policies have also proved helpful in reducing exchange rate tensions when the changes in rates were made quickly and on an appropriate scale. Experience shows that it was the central bank of the weak currency that generally had to raise its interest rates and widen differentials. However, central banks' ability to adjust interest rates to meet incipient market pressures has sometimes been constrained by domestic policy considerations. In certain instances market pressures have been heightened by delays in the implementation of supporting domestic policy measures. Although the initial reaction to strains in the system has normally come from the central bank of the weak currency, when the pressure has proved too strong and the weak currency has been allowed to fall to its lower limit, the strong currency central bank has had to intervene and accept the effect on its money market conditions of the inflow of foreign exchange.

<u>Realignments</u>

11. Realignments have generally been carried out smoothly. In some cases they were nonetheless decided on under heavy pressure after being widely anticipated by the markets; the possibility of deciding upon a new set of central rates has sometimes tended to be linked to member states' domestic political calendars. Moreover, changes in central rates sometimes resulted in significant adjustments in market rates, thereby encouraging the belief that speculative activity prior to a realignment would be profitable.

<u>Interventions</u>

12. Under current EMS rules, interventions at the margins are compulsory, and can be financed without limits by drawing on the very short-term financing facility (VSTF). Intramarginal interventions are basically unregulated except that: (i) those in EMS currencies require prior agreement by the issuing central bank; (ii) those in dollars are to be avoided when bound to accentuate dollar trends or conflict with the aims of simultaneous dollar interventions by other EMS central banks. These rules have been applied flexibly and the concertation procedures have in general made it possible to overcome emerging conflicts.

13. Most of the interventions within the system have been intramarginal, and chiefly in dollars and Deutsche Mark. In some instances, when use of the main currencies appeared inappropriate, resort was made to intervention in the private ECU market.

14. In certain circumstances co-ordinated intramarginal interventions may be effective in forestalling market pressures. However, such interventions can, in some cases, result in an accumulation of EEC currencies in official reserves. Such holdings would need to be fully liquid and usable for intervention in conformity with the existing rules. However, some countries are reluctant to allow the accumulation of their currency as a reserve asset.

Credit mechanisms

15. The Governors agree that the present VSTF arrangements have neither been abused nor caused major difficulties for debtor countries. Nonetheless, the period for repayment under the rules has expired on occasion before capital flows were reversed and debtor positions could be unwound through reflows in the currencies of the creditor countries. Repayment obligations were met in these circumstances by market borrowing, which has so far been easily available. This problem, however, is likely to become more serious as larger capital movements can now be expected. Moreover, since financial market conditions may change, it is important that the financing facilities provide adequate resources for the management of the system in periods of tension.

16. The VSTF was conceived at a time when most interventions were expected to be at the margins. Since then, intramarginal interventions have become standard practice and now far exceed compulsory interventions. Some Governors therefore consider that the fact that recourse to the VSTF for intramarginal interventions is dependent on the consent of the two central banks involved may have deprived the system of a powerful deterrent against speculative attacks. Indeed the few instances of use of the VSTF for such interventions occurred only in 1979. Easier access to VSTF for intramarginal intervention would also represent an encouragement for countries not participating in the exchange rate mechanism to join it. Other Governors, by contrast, consider that speculation could actually be encouraged by a perception that the system's financing constraints had been eased. It was pointed out moreover that the central banks with stronger currencies liberally and flexibly accepted the use of their currencies for

intervention in the past. These central banks might have reason to reconsider their attitude if the financing of intramarginal interventions were to compromise the stance of their monetary policy.

17. Short-term monetary support has not been used since 1974. This has not been due to shortcomings in the mechanism, but rather to the reluctance of EEC countries to finance balance-of-payments disequilibria with official credit when market financing was easily available. Moreover, when recourse to official credit mechanisms was made, countries showed a preference for medium-term instruments, such as the Community loan mechanism, in view of the nature of balance-of-payments imbalances and the time needed to correct them.

The role of the ECU

18. On the whole little use has been made of official ECUs in settlements and no large net ECU positions have built up since debtor countries have tended to repurchase their ECUs promptly. This tendency has undoubtedly been strengthened by the switch from official discount rates to market rates for the remuneration of ECU positions. The usability of the official ECU has been improved by the mobilisation mechanism introduced in July 1985. This allows central banks to obtain dollars or Community currencies against ECUs, for a limited time, subject only to the requirement of a need for intervention currencies.

19. The development of the private ECU market has been followed closely by the Committee of Governors on the basis of periodic reviews by their experts. The Governors welcome the fact that with the recent abolition of specific restrictions on the use of the private ECU in Germany and Spain the ECU is now essentially on the same footing as any other foreign currency in all EEC countries. The remaining restrictions on use of the ECU are side effects of the foreign exchange controls still in force in some countries.

Non- or incomplete participation in the exchange rate mechanism

20. The EMS was intended to encompass all the EEC countries; at present only eight of them participate in the exchange rate mechanism. In general, non-participation has not caused major difficulties, though the movements of sterling have from time to time put pressure on the Irish pound, owing to Ireland's close trade links with the United Kingdom.

However the inclusion of the pound sterling and the Greek drachma in the ECU basket means that changes in their exchange rates affect the market value and yield of the ECU. Such changes, and movements of the lira outside the narrow band of the exchange rate mechanism, can to an extent distort the divergence indicator and alter the value of claims and liabilities in the VSTF; they can also affect the private ECU market. The basic problem with non-participation, however, is that it casts doubt on the future of European monetary integration.

21. Italy's retention of wider fluctuation margins has not caused significant problems for other EMS countries or for the system as a whole, in part because less than full use has been made of its broader band, which has served principally to provide operational flexibility and to avoid large changes in market rates on the occasion of realignments. However the reduction in inflation differentials has weakened the reasons for maintaining wider margins, but it is understood that Italy is giving priority to the dismantling of its long-standing foreign exchange controls.

22. For many years, the BLEU has maintained a two-tier exchange market as a way to stabilise official exchange rates for commercial transactions while achieving and maintaining full freedom for capital transactions. This arrangement has allowed the authorities to avoid the introduction of restrictions at times of crisis. Moreover, the spread between the rates in the two markets has generally been less than 1 per cent. Nevertheless, the participation of the BLEU in a fully derestricted Community-wide capital market would logically entail the adoption of a unified exchange rate system.

## II. POLICIES TO STRENGTHEN THE EMS

### Main conclusions of the analysis

23. Persistence of international payments disequilibria coupled with the remaining disparities in economic fundamentals and increased capital mobility between EMS countries could result in destabilising capital flows. In such circumstances it would prove more difficult to preserve exchange rate stability within the EMS, especially if monetary policies are not adapted more promptly and co-ordinated more closely when temporary pressures develop in foreign exchange markets. Some member countries with highly open economies fear the adverse impact on economic growth of raising

domestic interest rates to stem capital outflows. Conversely, the countries that have defeated inflation and whose currencies are tending to appreciate fear lest the huge capital inflows that could occur in periods of tension should cause them to lose control of their monetary aggregates. There is, therefore, the risk that temporary pressures will lead to realignments that economic fundamentals do not justify and that would otherwise have been avoidable. This would impair the credibility of the EMS and compromise its positive role in promoting the downward convergence of inflation rates.

24. The Governors agree that the risk of exchange rate stability being adversely affected by increased mobility of capital and the elimination of exchange controls should be avoided. To this end the anti-inflationary stance of economic policies and the present flexibility of the system should be preserved. Moreover, to help achieve these goals, they consider that various policy steps are in order. Some of these steps require action by national governments, while the central banks are competent to act on others related more specifically to the management and operating mechanisms of the EMS.

A. Issues requiring action by national governments

25. The stability of the EMS and the possibility of further progress in the construction of an integrated monetary area in Europe depend primarily on the convergence of economic fundamentals. Indeed, since monetary policy on its own cannot ensure the convergence required to achieve stable exchange rates, the full support of fiscal and other policies is required. Further convergence would help to stabilise exchange markets and strengthen private operators' perception that exchange rates will remain stable.

26. It is also desirable for all the EEC countries to accept the discipline of the exchange rate mechanism on an equal footing (see paragraphs 20-22). The Governors stress that progress towards this objective should be made sooner rather than later, as an important step towards full monetary integration in Europe.

27. Realignment policy can also enhance EMS stability by minimising the potential gains from position-taking in expectation of a realignment. In the first place, markets should be led not to expect large exchange rate movements in the wake of a realignment. Secondly, any impression that the authorities are prepared to yield to market pressures through realignments should be avoided. Accordingly, realignments should be infrequent and changes in central rates should be kept small so as, whenever possible, to

avoid changes in market rates. This implies, however, that further progress should be made in the convergence of economic fundamentals. There is also a need to make realignments less predictable, notably by early recognition of fundamental disequilibria and, when these develop, by a prompt decision to realign before the markets see this as inevitable. Finally, everything possible should be done to dispel the impression that realignments are somehow linked to domestic political events.

B. Action by Central Banks

The role of monetary policies

28. In a medium-term perspective, monetary policies should be geared to narrowing the remaining inflation differentials and making national inflation rates converge on price stability. In the short run, this approach should continue to be implemented in a flexible way. Departures from the desired path of monetary growth should, however, be temporary so as not to allow serious or extended divergence from a policy course that is consistent with domestic price stability and convergence; otherwise, expectations would be generated in the market that the emergence of fundamental causes of tensions will be tolerated. Accordingly, short-term policy adjustments should be made in full consideration of the causes of exchange market strains and the final objectives of price stability and convergence within the system.

29. Increased financial innovation and liberalisation of capital movements in those countries which have not already taken this action will not only have implications for interest and exchange rate policies, but also for monetary policy instruments and intermediate targets. The foreseeable increase in residents' holdings of foreign liquid assets will make it more difficult to analyse monetary and credit aggregates. The scope for circumventing controls will be greatly increased, thereby strengthening the case for the use of indirect monetary tools based on interest rates. The abolition of exchange restrictions will improve the allocation of resources and reduce the cost of financial intermediation, but careful consideration must also be given to the differences in the supervisory, regulatory and fiscal arrangements governing financial markets with a view to eliminating distortions that might have a bearing on financial stability.

Exchange rate management - a strengthened monitoring procedure

30. The Governors agree that in the new environment there is scope for a more active and flexible use of all the instruments available to central banks for meeting short-term exchange rate pressures and for better co-ordination of such action among the central banks participating in the EMS. Full and concerted use of all the instruments for defending EMS stability will be all the more necessary to cope with any financial shocks that originate outside the system and affect the participating currencies differently. While recognising that intramarginal interventions will continue to play an important role, the Governors are considering allowing fuller use of the exchange rate fluctuation band with the aim of enhancing the perception of exchange risk among market participants. They also believe that interest rates should be adjusted more promptly when incipient pressures arise, thereby helping to check speculation by raising the cost of open foreign exchange positions. Moreover the Governors intend to seek ways of strengthening central bank co-operation on interventions and related policies, regarding not only EMS currencies but, when appropriate, third currencies and ECUs.

31. To promote more effective use of the instruments available for maintaining exchange rate cohesion within the EMS, the Governors have agreed to strengthen, within the Committee of Governors, the procedure for joint monitoring of economic developments and policies with the aim of arriving at common assessments of prevailing circumstances and appropriate policy responses. This new procedure will build on existing arrangements for mutual exchange of information and monitoring, but it will entail two significant innovations. First, to ensure that potential strains are identified as early as possible, monitoring will focus more specifically and systematically on simultaneous consideration of intervention, exchange rate, and interest rate policies. Secondly, the Governors will use the findings of the monitoring exercise to discuss appropriate policy responses, including the use of interventions and their co-ordination.

EMS mechanisms

32. The Governors emphasise that it is essential to avoid any easing of discipline or change in the balance between adjustment and financing of balance-of-payments disequilibria. In the light of their operational experience with the EMS mechanisms and the changes in the environment, the

Governors have agreed that a number of modifications would be useful and desirable.

(a) Very short-term financing

33. The duration of such financing (which is unlimited in amount) will be extended by one month, taking the maximum duration from two and a half to three and a half months. Initial financing operations will still be automatically renewable for three months at the request of the debtor country, but the ceiling on automatic renewal, at present equivalent to the country's debtor quota in the short-term monetary support mechanism, will be raised to 200 per cent. of this quota.

34. The Governors have agreed that automatic VSTF financing of intramarginal interventions should not be introduced. They point out that such financing of intramarginal interventions through the EMCF is already possible if the central banks directly involved concur. They accept a presumption that intramarginal intervention agreed to by the central bank issuing the intervention currency will qualify for financing via the EMCF on the following conditions:

- the cumulative amount of such financing does not exceed the double of the debtor quota of the debtor central bank in the short-term monetary support mechanism;
- the debtor central bank is also prepared to use its existing holdings of the currency to be sold for intervention in amounts to be agreed;
- repayments shall be made in accordance with the rules specified in Article 16.1 of the EMS Agreement. The creditor central bank reserves the right to request payment in its own currency if this appears necessary in the light of its own monetary conditions, taking into account the reserve position of the debtor central bank.

35. Larger cross-holdings of EMS currencies in participating central banks' reserves can be expected to develop as a natural consequence of increased integration and monetary convergence in the EMS. Although substantial accumulations of assets in EMS currencies do not appear desirable, holdings of larger working balances in these currencies, subject to prior agreement by the issuing central banks, could in certain circumstances help to improve the working of the system. The Governors believe that current

arrangements in this regard do not constitute an obstacle to such enhanced holdings of partners' currencies.

(b) Short-term monetary support

36. The Governors consider that the short-term monetary support mechanism does not need to be modified.

(c) Matters relating to the ECU

37. On the basis of the positive experience with official ECU mechanisms, the Governors have agreed to accept settlement in ECUs of outstanding claims in the VSTF in excess of their central bank's obligation and up to 100 per cent. as long as this does not result in an unbalanced composition of reserves and no excessive debtor and credit positions in ECUs emerge since these would in time endanger the ECU's credibility. After two years of experience, the formal rules relating to the official ECU will be subject to review.

38. As regards the further development of the ECU, the Governors reaffirm their belief that the private ECU market should continue to develop in response to market forces. The Governors welcome the lifting of restrictions on the use of the private ECU in Germany and Spain and are confident that the remaining restrictions on the use of the private ECU will be removed as part of the liberalisation of capital movements under way in the Community.

39. The Governors have examined other ways to broaden the usability of the ECU. In particular, they have considered various proposals to introduce a link between the private and official ECU circuits. They have reached the conclusion that these proposals would be feasible and that they would neither raise major technical or legal problems nor have major monetary or exchange rate implications under present circumstances. Although their practical consequences in the short term would appear to be limited, their implementation would nonetheless raise issues relating to the long-term evolution of the ECU and the involvement of the monetary authorities in the functioning of the private ECU market, issues which the Committee of Governors will keep under review.

CONFIDENTIAL

From : D L C Peretz
Date : 10 September 1987

PPS

cc Sir G Littler
Mr C W Kelly
Miss J Barber

**INFORMAL ECOFIN : STRENGTHENING THE EMS**

I attach a copy of the final version of the report by the Chairman of the Monetary Committee, which has just arrived.

D L C PERETZ

NREX

LAWSON FAVOURS EMS ENTRY, SAYS ISSUE UNDER REVIEW

NYBORG, DENMARK, SEPT 13 - CHANCELLOR OF THE EXCHEQUER NIGEL LAWSON SAID BRITAIN SHOULD BECOME A FULL MEMBER OF THE EUROPEAN MONETARY SYSTEM (EMS) BUT SAID THE ISSUE WAS STILL UNDER REVIEW.

"I THINK THAT AT THE END OF THE DAY WE SHOULD GO TO FULL MEMBERSHIP," LAWSON TOLD JOURNALISTS WHEN ASKED IF HE THOUGHT INFORMAL INTERVENTION UNDER LAST FEBRUARY'S LOUVRE AGREEMENT TO STEADY CURRENCIES WAS AN EQUAL ALTERNATIVE TO JOINING.

HE DECLINED TO COMMENT ON THE TIMING OF ANY SUCH MOVE, SAYING THE TREASURY KEPT THE ISSUE UNDER VERY CLOSE REVIEW. EMS IMPROVEMENTS DECIDED BY EC FINANCE MINISTERS HERE ON SATURDAY WERE WELCOME BUT NOT DECISIVE IN THE DEBATE ON JOINING, HE SAID.

13-SEP-0907 MON935 MONJ REUTER

P QUOTE/MON-AAQA/AAAA0831

NREY

LAWSON SEES PROBLEMS FOR DEBT PLAN

NYBORG, DENMARK, SEPT 13 - TOUGH LINES ON DEBT REPAYMENTS BY BRAZIL AND ARGENTINA ARE MAKING IT HARDER TO WIN SUPPORT FOR A DEBT RELIEF PLAN FOR THE POOREST COUNTRIES IN SUB-SAHARAN AFRICA, BRITISH CHANCELLOR OF THE EXCHEQUER NIGEL LAWSON SAID.

LAWSON TOLD JOURNALISTS SOME COUNTRIES WERE CONCERNED THAT THE MOMENT WAS NOT RIGHT FOR SUBSCRIBING TO SUCH A PLAN BECAUSE THEY FEARED IT WOULD COMPROMISE THEIR RELATIONS WITH BRAZIL.

LAWSON HAS PROPOSED A SUB-SAHARAN DEBT INITIATIVE UNDER WHICH OLD AID LOANS TO THE POOREST COUNTRIES WOULD BE WRITTEN OFF AND DEBT OWED TO WESTERN GOVERNMENTS RESCHEDULED OVER 20 YEARS WITH 10 YEARS' GRACE AT LOW INTEREST.

13-SEP-0922 MON940 MONJ CONTINUED ON - NREZ

P QUOTE/MON-AAQA/AAAA0831

LAWSON SEES =2 NYBORG NREZ
THE PLAN WAS DISCUSSED BY EUROPEAN COMMUNITY FINANCE MINISTERS HERE ON SATURDAY. LAWSON SAID FRANCE HAD YET TO ACCEPT THE PROPOSAL FOR LOW INTEREST BUT APPEARED TO MOVING TOWARDS IT.
WEST GERMAN SUPPORT WAS WEAKER STILL, WHILE ITALY AND EC COMMISSION PRESIDENT JACQUES DELORS SUPPORTED IT, HE SAID.
LAWSON SAID HE FELT HIS PROPOSALS SHOULD BE DISCUSSED IN PARALLEL WITH A PLAN BY INTERNATIONAL MONETARY FUND MANAGING DIRECTOR MICHEL CAMDESSUS FOR TACKLING DEBT OWED BY THE POOREST COUNTRIES TO INTERNATIONAL BODIES LIKE THE IMF.
CAMDESSUS HAS PROPOSED TRIPLING THE RESOURCES OF THE IMF STRUCTURAL ADJUSTMENT FACILITY TO HELP THE COUNTRIES CONCERNED.
13-SEP-0928 MON945 MONJ
CONTINUED FROM - NREY REUTER
P
QUOTE/MON-AAQA/AAAA0831

EC TO STRENGTHEN CONTROL OVER EXCHANGE RATES NRFD
BY TONY CARRITT
NYBORG, DENMARK, SEPT 13 - EUROPEAN COMMUNITY (EC) MEMBER STATES ARE TO STEP UP COORDINATION OF THEIR ECONOMIC AND MONETARY POLICIES TO STRENGTHEN CONTROL OVER EXCHANGE RATES AND FIGHT CURRENCY SPECULATORS.
A PACKAGE OF SIGNIFICANT MEASURES TO BOLSTER THE 12-NATION BLOC'S JOINT CURRENCY FLOAT, THE EUROPEAN MONETARY SYSTEM (EMS), WAS ANNOUNCED ON SATURDAY AFTER A MEETING OF EC FINANCE MINISTERS AND CENTRAL BANKERS IN THIS DANISH SEASIDE RESORT.
"WE AGREED TO DISCOURAGE SPECULATION FROM THE BEGINNING," FRENCH FINANCE MINISTER EDOUARD BALLADUR TOLD JOURNALISTS.
13-SEP-1113 MON975 MONJ
CONTINUED ON - NRFE
P
QUOTE/MON-AAQA/AAAA0831

NRFE

TO STRENGTHEN =2 NYBORG

THE PACKAGE FOCUSES ON INCREASING LENDING BETWEEN CENTRAL BANKS TO FINANCE INTERVENTION BEFORE PARITIES REACH PERMITTED LIMITS AND ON NARROWING DISPARITIES BETWEEN MEMBER STATES' ECONOMIC PERFORMANCES TO STOP EXCHANGE RATE TENSION BUILDING UP.

DANISH FINANCE MINISTER PALLE SIMONSEN, HOST OF THE INFORMAL TALKS, SAID MINISTERS CONSIDERED THE AGREEMENT "A MILESTONE FOR COOPERATION IN THE MONETARY FIELD WITHIN THE COMMUNITY."

EC COMMISSION PRESIDENT JACQUES DELORS SAID IT TOOK THE EMS INTO A PHASE IN WHICH NOT ONLY WEAK-CURRENCY COUNTRIES BUT ALSO THOSE WITH STRONG UNITS, LIKE WEST GERMANY, MAY HAVE TO SHOULDER SOME OF THE BURDEN OF ADJUSTING POLICIES TO STABILISE RATES.

13-SEP-1116 MON976 MONJ

CONTINUED ON - NRFF
CONTINUED FROM - NRFD

P

QUOTE/MON-AAQA/AAAA0831

NRFF

EC TO STRENGTHEN =3 NYBORG

NOTHING IN THE PACT IS BINDING AND BUNDESBANK PRESIDENT KARL OTTO POEHL SAID ITS PRACTICAL IMPACT WAS LIKELY TO BE LIMITED.

ALTHOUGH BALLADUR WELCOMED THE AGREEMENT, IT IS LESS CONCRETE THAN RADICAL EMS REFORMS HE PROPOSED EARLIER THIS YEAR.

DANISH NATIONAL BANK DIRECTOR ERIK HOFFMEYER SAID STRONG-CURRENCY COUNTRIES IN THE SYSTEM HAD AGREED TO PROVIDE THEIR OWN MONEY FOR EXCHANGE MARKET INTERVENTION WITHIN THE PERMITTED MARGINS BY CENTRAL BANKS OF COUNTRIES WITH WEAK CURRENCIES.

HE SAID THIS SHOULD CUT THE COST OF INTERVENTION BY DOING IT OUT BEFORE MARKETS FORCE IT ON CENTRAL BANKS, WHO CAN ONLY HOLD SMALL AMOUNTS OF EACH OTHERS' CURRENCIES, HAMPERING ACTION.

13-SEP-1123 MON980 MONJ

CONTINUED ON - NRFG
CONTINUED FROM - NRFE

P

QUOTE/MON-AAQA/AAAA0831

EC TO STRENGTHEN =4 NYBORG NRFG

THE LOANS WILL BE MADE ON A DISCRETIONARY BASIS AND ONLY UNDER CERTAIN CONDITIONS, GIVING STRONG-CURRENCY CENTRAL BANKS SUCH AS THE BUNDESBANK A CONTINUED VETO OVER SUCH INTERVENTION.

THE BUNDESBANK IS CONCERNED THAT HIGH MARK LENDING WOULD WEAKEN ITS CONTROL OF DOMESTIC MONETARY POLICY AND OF INFLATION.

EC CENTRAL BANKERS AND TOP OFFICIALS GROUPED IN THE EC'S MONETARY COMMITTEE WILL ALSO TRACK MEMBER STATES' ECONOMIC AND FINANCIAL PERFORMANCE CLOSER BY MONITORING ECONOMIC INDICATORS.

"ALL OF US ACKNOWLEDGED THAT IMPROVED ECONOMIC CONVERGENCE .... IS THE SINGLE MOST IMPORTANT FACTOR FOR ACHIEVING A HIGH DEGREE OF EXCHANGE RATE STABILITY," SIMONSEN SAID.

13-SEP-1126 MON981 MONJ

CONTINUED FROM - NRFF CONTINUED ON - NRFH

P

QUOTE/MON-AAQA/AAAA0831

EC TO STRENGTHEN =5 NYBORG NRFH

BUT GOVERNMENTS WILL BE UNDER NO AUTOMATIC OBLIGATION TO ADJUST POLICIES IF THEIR ECONOMIES PERFORM BELOW EXPECTATIONS.

DELORS STRESSED THE NEED TO BOLSTER THE EMS SO THAT IT WILL BE ABLE TO WITHSTAND THE IMPACT OF GREATER CROSS-BORDER FLOWS OF CAPITAL AS THE EC ABOLISHES EXCHANGE CONTROLS BY 1992.

13-SEP-1127 MON982 MONJ

CONTINUED FROM - NRFG

P

QUOTE/MON-AAQA/AAAA0831

From : D L C Peretz
Date : 14 September 1987

NOTE FOR THE RECORD

cc PPS
PS/EST
PS/Sir P Middleton
Sir T Burns
Sir G littler
Mr Cassell
Mr Culpin
Mr Grice
Mr C W Kelly
Mr S Pickford

**PROFESSOR JACQUES MELITZ ON "WHY BRITAIN SHOULD JOIN THE EMS NOW"**

This lunchtime talk (summary attached) will no doubt be reported in the press tomorrow.

2. The talk itself was not particularly interesting. To the extent that the arguments were not familiar, on the whole they struck me as fairly doubtful. For example, Melitz seemed to be saying that one of the reasons for the success of the ERM, and one of its most attractive features, is that realignments nowadays are made frequently, and quickly. And his "petrocurrency" argument appeared to amount to saying that we are wrong to allow oil price changes to be reflected in the exchange rate.

3. What was more interesting was the tenor of the subsequent discussion. On the whole the questions were mildly hostile to membership. They also showed a better appreciation both of the problems, and benefits, of membership than I recall from past occasions of this sort. Has the ERM not worked up to now only because of the existence of exchange controls in most countries, and would life not be different as between sterling and the deutschemark? How do you avoid foreign exchange operators making large speculative gains at realignments (Walter Eltis). What do we lose from continuing to shadow the deutschemark, without formal membership? (Richard O'Brien, Amex Bank). Is it not true that the system is essentially run by the Bundesbank; and would it really be different with the Bank of England in? (Andrew Britton). Would we not do better to target the ERI, rather than the DM/£? (Malcolm Crawford).

4. One other interesting feature of the occasion. Not a single mention of the Louvre Accord either in the talk, or the subsequent discussion!

DLP

**D L C PERETZ**

Centre for Economic Policy Research

For Release on Monday 14 September at 1.30 pm

Please describe this meeting as "a lunchtime meeting organized by the Centre for Economic Policy Research"

For further information contact Stephen Yeo (01 930 7154)

**WHY BRITAIN SHOULD JOIN THE EMS NOW**

Britain should join the EMS now, according to French economist **Jacques Melitz.** He presented evidence which suggested that EMS membership would help stabilize the real effective exchange rate of the pound and the UK terms of trades. The arguments against UK entry had little merit, Melitz argued. There would be no real loss of monetary policy independence: the authorities had largely abandoned monetary control in favour of exchange rate targets in any event, and Britain would retain a voice in the adjustment of parities within the EMS. Melitz also dismissed the argument that the importance of North Sea oil made membership inadvisable. The petrocurrency status of the pound was one of the strongest reasons for British entry, since EMS realignments tend to reflect economic fundamentals, whereas sterling had a history of persistent misalignment in the 1980s. The role of the pound in international portfolios could give rise to more serious problems with EMS membership, Melitz conceded, but he believed that these could be managed. As to the timing of entry, now was as good a time as any: foreign exchange markets were now quiet and the pound had remained steady against the Deutschmark for some time.

Jacques Melitz is a member of the Research Unit at the Institut National de la Statistique et des Etudes Economiques (INSEE) in Paris and a Research Fellow in the Centre's International Macroeconomics programme. He is the author of several CEPR Discussion Papers, including No. 178, "Monetary Discipline, Germany and the European Monetary System". He has also written extensively on exchange rate and monetary policy with particular reference to the EMS, on which he has advised both the EEC and the House of Commons Treasury and Civil Service Committee. The meeting at which Melitz spoke was one of a series sponsored by the German Marshall Fund of the United States, focusing on the international economy. The views he expressed were his own, however, and not attributable to the German Marshall Fund or to the Centre, which takes no institutional policy positions.

Melitz considered four arguments against British entry: (1) the importance of preserving an independent UK monetary policy; (2) the desirability of targeting the effective exchange rate of the pound instead of the pound-ECU rate; (3) the special petrocurrency status of the pound; and (4) the attractiveness of the pound as an international currency in a world of capital mobility. Only the last argument against membership should be taken seriously, according to Melitz: the others had little merit.

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EMS membership does limit the range of monetary policy choices, Melitz conceded. In the UK case, however, monetary growth rates are considered highly unpredictable and uncontrollable: for this reason Britain has apparently abandoned monetary in favour of exchange rate targets. In one sense then, the United Kingdom has no monetary policy independence to lose: only its freedom to choose an exchange rate target. Since realignments do occur within the EMS, however, some independence in exchange rate policy would remain.

EMS membership would tend to stabilize the pound-ECU rate. Is this the correct exchange rate to control? Objections to UK membership have focused on the importance of the dollar to British trade. Melitz noted, however, that the EMS currencies were just as important for the UK as for the German and French economies: the EMS member nations represented 58% of the weights in the effective exchange rate of the pound, compared to 63% for the Deutschmark and 62% for the franc.

Melitz also discussed evidence [see Table below] suggesting that entry into the EMS might stabilize the real effective exchange rate of the pound. He noted that both before and after the establishment of the EMS, the pound and the EMS currencies have displayed similar variability relative to non-EMS currencies. Since the creation of the EMS, however, the pound has varied much more relative to the EMS currencies than have the EMS currencies relative to one another. As a result, given the importance of trade with EMS members, the real effective exchange rate of the pound has fluctuated much more against all other currencies than have the EMS currencies. If entry into the EMS would stabilize the real effective exchange rate of the pound relative to the EMS currencies without destabilizing it relative to the other currencies, then entry would assure Britain an overall gain in stability. This gain would be very difficult to match outside the System, Melitz argued.

Another argument against British membership in the EMS involves the petrocurrency status of the pound. This was actually one of the strongest reasons in favour of British entry, according to Melitz. If the British government stays out of the EMS in order to determine its own response to a possible oil shock, this tells the market that the government will let sterling adjust in response to an unforeseen change in the price of oil. In this case, however, the persistent sterling misalignments of the 1980s might be repeated. With Britain in the EMS, on the other hand, it is likely that the other members of the System would only consent to realignments based on economic fundamentals; that is, the current and prospective movements in British competitivity and trade. Melitz argued that the EMS has a good record: in particular, it has managed to avoid the tendency of fixed exchange rate systems to "underadjust". When problems have arisen the EMS has allowed fairly early corrections, some of them small. Some of these successive corrections in exchange rates have resulted in large adjustments over several years. Thus, for example, both the lira and the French franc were allowed to drop over 25% relative to the Deutschmark over an 18-month period. Melitz concluded that the EMS was capable of managing the strains the pound would put on the System, without any overshooting or misalignment. Hence the petrocurrency status of the currency,

But we want to adjust when there is a shock

But if you always realign quickly, what is the discipline and its vulnerability to oil-price shocks, was an excellent reason for Britain to join the EMS, not to stay out.

British entry could give rise to difficulties as a result of the importance of the pound in international portfolios, however. EMS membership could mean larger swings between pounds and Deutschmarks if these two currencies became closer substitutes as a result of UK entry. In that event, however, smaller adjustments in interest rate differentials between London and Frankfurt would suffice to dampen such capital movements, although the spread between British and German interest rates would need to be reduced as well. UK policy-makers would have less room for manoeuvre, but this would not necessary pose a problem, according to Melitz: at present UK macroeconomic policies appeared to be close to those of Germany. Britain might even potentially benefit from the extra monetary discipline it would gain from tying the pound to the well managed Deutschmarks. But the most important benefit of British entry, according to Melitz, would be the extra stability of the UK terms of trade.

?

Melitz concluded by dismissing the argument that the time is not ripe for UK entry. In the successive reports of the House of Lords and the House of Commons in 1983 and 1985, it was argued that the pound was still overvalued. Since then the index of the effective exchange rate of sterling has fallen from 78 to around 72-73. The pound has also fallen from around 3.50 DM to around 2.8-2.9 DM. There was no better time to enter than during a period of quiescence, Melitz argued. If timing of entry was still really the problem, the time will never come.

for £ dominant factor was oil / counter inflation policy; for $ its rise & the fall

EXCHANGE RATE VARIABILITY

| | Against EMS Currencies | | Against Non-EMS Currencies | | Against All Currencies | |
|---|---|---|---|---|---|---|
| | 1974-78 | 1979-85 | 1974-78 | 1979-85 | 1974-78 | 1979-85 |
| Average for EMS currencies | 13.1 | 7.2 | 17.8 | 22.7 | 14.8 | 12.9 |
| UK | 14.1 | 22.8 | 18.9 | 24.4 | 16.1 | 23.5 |
| US | 16.5 | 27.7 | 16.0 | 20.5 | 16.1 | 21.9 |

Coefficient of variation (times 1000) of the real effective exchange rate (adjusted for CPI inflation). Based on monthly data.

Source: IMF Occasional Paper No. 48, "The European Monetary System: Recent Developments," December 1986. Last pair of columns inferred by approximation.

[JMPS/PP3]

cc PS/Chancellor 2
Mr Peretz
Mr Kelly
Ms Goodman

# Centre for Economic Policy Research

I attended this meeting for information.
G. Westmead APS/EST 14/9

For Release on Monday 14 September at 1.30 pm

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For further information contact Stephen Yeo (01 930 7154)

## WHY BRITAIN SHOULD JOIN THE EMS NOW

Britain should join the EMS now, according to French economist **Jacques Melitz**. He presented evidence which suggested that EMS membership would help stabilize the real effective exchange rate of the pound and the UK terms of trades. The arguments against UK entry had little merit, Melitz argued. There would be no real loss of monetary policy independence: the authorities had largely abandoned monetary control in favour of exchange rate targets in any event, and Britain would retain a voice in the adjustment of parities within the EMS. Melitz also dismissed the argument that the importance of North Sea oil made membership inadvisable. The petrocurrency status of the pound was one of the strongest reasons for British entry, since EMS realignments tend to reflect economic fundamentals, whereas sterling had a history of persistent misalignment in the 1980s. The role of the pound in international portfolios could give rise to more serious problems with EMS membership, Melitz conceded, but he believed that these could be managed. As to the timing of entry, now was as good a time as any: foreign exchange markets were now quiet and the pound had remained steady against the Deutschmark for some time.

Jacques Melitz is a member of the Research Unit at the Institut National de la Statistique et des Etudes Economiques (INSEE) in Paris and a Research Fellow in the Centre's International Macroeconomics programme. He is the author of several CEPR Discussion Papers, including No. 178, "Monetary Discipline, Germany and the European Monetary System". He has also written extensively on exchange rate and monetary policy with particular reference to the EMS, on which he has advised both the EEC and the House of Commons Treasury and Civil Service Committee. The meeting at which Melitz spoke was one of a series sponsored by the German Marshall Fund of the United States, focusing on the international economy. The views he expressed were his own, however, and not attributable to the German Marshall Fund or to the Centre, which takes no institutional policy positions.

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EMS membership does limit the range of monetary policy choices, Melitz conceded. In the UK case, however, monetary growth rates are considered highly unpredictable and uncontrollable: for this reason Britain has apparently abandoned monetary in favour of exchange rate targets. In one sense then, the United Kingdom has no monetary policy independence to lose: only its freedom to choose an exchange rate target. Since realignments do occur within the EMS, however, some independence in exchange rate policy would remain.

EMS membership would tend to stabilize the pound-ECU rate. Is this the correct exchange rate to control? Objections to UK membership have focused on the importance of the dollar to British trade. Melitz noted, however, that the EMS currencies were just as important for the UK as for the German and French economies: the EMS member nations represented 58% of the weights in the effective exchange rate of the pound, compared to 63% for the Deutschmark and 62% for the franc.

Melitz also discussed evidence [see Table below] suggesting that entry into the EMS might stabilize the real effective exchange rate of the pound. He noted that both before and after the establishment of the EMS, the pound and the EMS currencies have displayed similar variability relative to non-EMS currencies. Since the creation of the EMS, however, the pound has varied much more relative to the EMS currencies than have the EMS currencies relative to one another. As a result, given the importance of trade with EMS members, the real effective exchange rate of the pound has fluctuated much more against all other currencies than have the EMS currencies. If entry into the EMS would stabilize the real effective exchange rate of the pound relative to the EMS currencies without destabilizing it relative to the other currencies, then entry would assure Britain an overall gain in stability. This gain would be very difficult to match outside the System, Melitz argued.

Another argument against British membership in the EMS involves the petrocurrency status of the pound. This was actually one of the strongest reasons in favour of British entry, according to Melitz. If the British government stays out of the EMS in order to determine its own response to a possible oil shock, this tells the market that the government will let sterling adjust in response to an unforeseen change in the price of oil. In this case, however, the persistent sterling misalignments of the 1980s might be repeated. With Britain in the EMS, on the other hand, it is likely that the other members of the System would only consent to realignments based on economic fundamentals; that is, the current and prospective movements in British competitivity and trade. Melitz argued that the EMS has a good record: in particular, it has managed to avoid the tendency of fixed exchange rate systems to "underadjust". When problems have arisen the EMS has allowed fairly early corrections, some of them small. Some of these successive corrections in exchange rates have resulted in large adjustments over several years. Thus, for example, both the lira and the French franc were allowed to drop over 25% relative to the Deutschmark over an 18-month period. Melitz concluded that the EMS was capable of managing the strains the pound would put on the System, without any overshooting or misalignment. Hence the petrocurrency status of the currency, and its vulnerability to oil-price shocks, was an excellent reason for Britain to join the EMS, not to stay out.

British entry could give rise to difficulties as a result of the importance of the pound in international portfolios, however. EMS membership could mean larger swings between pounds and Deutschmarks if these two currencies became closer substitutes as a result of UK entry. In that event, however, smaller adjustments in interest rate differentials between London and Frankfurt would suffice to dampen such capital movements, although the spread between British and German interest rates would need to be reduced as well. UK policy-makers would have less room for manoeuvre, but this would not necessary pose a problem, according to Melitz: at present UK macroeconomic policies appeared to be close to those of Germany. Britain might even potentially benefit from the extra monetary discipline it would gain from tying the pound to the well managed Deutschmarks. But the most important benefit of British entry, according to Melitz, would be the extra stability of the UK terms of trade.

Melitz concluded by dismissing the argument that the time is not ripe for UK entry. In the successive reports of the House of Lords and the House of Commons in 1983 and 1985, it was argued that the pound was still overvalued. Since then the index of the effective exchange rate of sterling has fallen from 78 to around 72-73. The pound has also fallen from around 3.50 DM to around 2.8-2.9 DM. There was no better time to enter than during a period of quiescence, Melitz argued. If timing of entry was still really the problem, the time will never come.

EXCHANGE RATE VARIABILITY

| | Against EMS Currencies | | Against Non-EMS Currencies | | Against All Currencies | |
|---|---|---|---|---|---|---|
| | 1974-78 | 1979-85 | 1974-78 | 1979-85 | 1974-78 | 1979-85 |
| Average for EMS currencies | 13.1 | 7.2 | 17.8 | 22.7 | 14.8 | 12.9 |
| UK | 14.1 | 22.8 | 18.9 | 24.4 | 16.1 | 23.5 |
| US | 16.5 | 27.7 | 16.0 | 20.5 | 16.1 | 21.9 |

Coefficient of variation (times 1000) of the real effective exchange rate (adjusted for CPI inflation). Based on monthly data.

Source: IMF Occasional Paper No. 48, "The European Monetary System: Recent Developments," December 1986. Last pair of columns inferred by approximation.

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# EMS: Advance or Face Retreat

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- Crucial changes to the EMS are under discussion, to move some of the policy-making power away from Germany and share it more evenly among other members.

- Future realignments are less likely if the system is changed, but will become more likely and more messy if the changes are blocked.

- The current discussions give a new dimension to the U.K. debate about EMS entry. They mean the U.K. can have a firm sterling-DM link without becoming a German satellite.

- With the changes, EMS entry looks attractive to the U.K. It would enhance the credibility of the U.K. government's commitment to reducing inflation. Without the changes, the benefits of entry are less clear.

- The U.K.'s current policy of living in sin with the EMS looks set to continue for some while but will get increasingly difficult politically. In the long-term marriage or separation are the only alternatives.

- The EEC finance ministers' meeting on 12th/13th September, will be important for the internal EMS debate. Progress could smooth the path to eventual U.K. entry although there appears to be little U.K. interest in the discussions at present.

# Contents

# SECTION 1

## Summary

### Keep the Credibility, Share the Power

Major changes to the European Monetary System (EMS) are under discussion among Europe's finance ministers. There is still a heated debate about how far the changes should go, but the direction of change is to apply the Bundesbank's credibility as a monetary authority to rather broader targets than at present, implying less need for realignments in future. Agreement on some changes would smooth the path to full U.K. membership.

The rule changes would allow the U.K. and France a greater say in European monetary policy than under the present system in which Germany is disproportionately powerful, and might tip the balance in favour of the U.K. joining.

In this summary (as in the main paper), we first review the debate over full EMS membership that has taken place in the U.K. over the last few years. Then we turn to the evolution of the EMS including possible rule changes. Finally, we discuss some of the evidence on the operation of the system since 1979.

### The U.K. Debate over the EMS

A great attraction of the EMS is that it offers a discipline to replace the U.K. government's existing monetary targets, which now have many drawbacks. Those targets were first set out by the present government in the 1980 Medium Term Financial Strategy (MTFS). That offered a coherent framework for macroeconomic policy based on a single monetary target, M3, backed up by projections for the public sector borrowing requirement (PSBR). Targets showed a gradual decline in M3 over several years, and this provided a statement of the government's determination to reduce inflation. The M3 targets were in the form of bands, allowing some discretion, but there was a commitment to tighten (or relax) policy as necessary if the bands were breached. The M3 target provided a simple rule that was attractive to financial markets.

Attempts to hit the M3 target resulted in high interest rates, reflected in the strong exchange rate, which helped to reduce inflation quickly. However, M3 was soon subject to great distortion from financial innovation, undermining its credibility and ultimately forcing its abandonment as a formal target. There is still a PSBR projection and the government still promises some degree of automatic response to its M0 target, but the system has become increasingly judgmental.

This degree of discretion leaves the financial markets uncertain about government policy and people have become sceptical about the government's ambition of eliminating inflation.

not significant

The move to informal exchange rate targets since the Paris Accord in February does not appear to have substantially reduced expectations of inflation. The current policy of "shadowing" or "living in sin" with the EMS looks unlikely to be maintained indefinitely, because it will strengthen other European countries' demands that the U.K. should join formally so as to strengthen the European Community (EC) politically. It seems that marriage or separation are the only politically-viable options in the long run.

Formal full membership of the EMS would offer many of the advantages that motivated the original MTFS. It would offer a coherent framework for policy based on a dominant variable (this time the exchange rate), and a clear statement of the government's aim of reducing inflation to German rates. It would reduce exchange rate volatility. Moreover, experience suggests that it would reduce interest rate volatility, contrary to the consensus view.

Against these advantages, full membership of the EMS involves a surrender of some national discretion in policy making. While that loss of discretion is in part necessary because it makes the anti-inflation commitment more credible, it is politically unattractive and is probably a major reason for the Prime Minister's reluctance to join. The changes in rules now under discussion offer the possibility that this objection could be weakened by allowing the U.K. a greater say in European policy making. The advantages of commitment and credibility need not be lost, however, because cooperation would be based on a set of policy indicators. The idea is not to dilute the credibility of the Bundesbank's resistance to inflation but to transfer this credibility to a broader set of objectives in whose determination there is an element of collective decision-making.

## Changes in the EMS

The EMS is not a rigid or immutable rule book. The French finance minister, Edouard Balladur, has submitted proposals for changes in the EMS rules which do not require legislation. These will be discussed by EC ministers on 12th and 13th September. The changes are intended to reduce the current overwhelming power of Germany in the EMS. That power has turned out greater than intended by the architects of the EMS, as explained below. Until recently, that situation was acceptable to the other EMS countries, because their main priority was to reduce inflation. They tackled inflation by linking their own policies to the highly credible German policy, and by allowing their exchange rates to become overvalued against the Deutsche mark.

Policy objectives outside Germany are now changing. Unemployment is a greater concern. This increases the likelihood of a conflict between Germany and the other countries, even though inflation rates are much closer than they were. Such conflict is particularly likely when countries have different attitudes to dealing with external events like a fall in the dollar. So the former extent of German dominance is now questioned by France and other EMS countries, and Balladur is calling for change. Another reason for change is the dismantling of exchange controls in France and now Italy, which means that the former style of reactive realignments is no longer possible.

The singular power of Germany, and hence the need now for change, is increased because the operation of the EMS has evolved from the original plan. It was originally envisaged that exchange-market intervention would be greatest at the margin: when exchange rates moved to their maximum permitted limits (the parity limits). Such marginal intervention was expected to be more important than intervention within these limits (intramarginal intervention). In the early years, intervention was important but it has now become insignificant except for brief periods.

Central banks have found intramarginal intervention far more effective in influencing the market. Once a currency is at its limit speculative pressure requires much more massive and expensive intervention. Yet there is a problem. The EMS rules provide for obligatory, symmetrical, unlimited support of weak currencies by both central banks when a pair of currencies reaches the parity limit. By contrast, the EMS rules (even as amended in 1985), provide almost no formal facilities to assist intramarginal intervention. Indeed, the EMS rules can actually obstruct intramarginal intervention, by restricting central banks' holdings of other member countries' currencies.

Despite this feature of the rules, the European central banks have generally worked together informally to make intramarginal intervention work. But in the absence of formal arrangements the central bank with the strongest currency, usually the Bundesbank alone, tends to have autonomy in monetary policy and hence to have greatest influence on overall EMS monetary policy.

The French proposals for rule changes would allow central banks to hold an indefinite amount of other EMS countries' currencies without needing special agreement as at present. This would, in practice, mean a build-up of Deutsche mark holdings outside Germany and hence a lessening of the Bundesbank's control over the immediate supply of Deutsche marks at any time. Improved credit facilities, for intramarginal intervention, and a greater role for the ECU, are also proposed and would have a similar effect.

These proposals alone do not go far enough to establish symmetry. For example, if those proposals were implemented, sales of Deutsche marks by the Banque de France could in principle be offset by purchases of those Deutsche marks by the Bundesbank. However, the French also envisage a more explicit co-ordination of economic policy-making in EMS countries, with joint monitoring of economic indicators and joint agreement on target zones against the dollar and yen. ??

The German attitude to such coordination is very reserved. The Bundesbank has recently expressed public opposition to the French proposals for improved credit facilities for intramarginal intervention. However, the Bundesbank appears less hostile to the use of the Deutsche mark by other EMS central banks and so it is possible that this part of the proposals might be agreed. Discussions on developing joint policy indicators have taken place with little visible progress to date. ?

## Empirical Evidence

In the first annex to this paper we explain the technical working of the EMS. In the second annex we review the economic data and show how the EMS has worked in practice over the eight and a half years since it became operative in early 1979. Our results are summarised here.

## Financial Stability

The EMS has been associated with a reduction of exchange-rate volatility and some reduction in the cumulative movement of exchange rates against the Deutsche mark. There is also some evidence that it has made exchange rates more predictable.

The data provide no support for the proposition that exchange rate stability has been achieved only at the expense of interest rate instability. Only in France is there evidence of greater interest rate volatility after adoption of a pegged exchange rate, and with exchange controls that was confined to Euro-franc interest rates. French exchange controls have now been largely removed, so domestic and Euro-market rates will move closely together in future. The increased interest rate volatility that we observe was confined to a period of expansionary fiscal policy when the exchange rate was also relatively unstable.

The evidence thus supports the view that fixed exchange rates raise interest rate volatility only if fiscal policies move divergently among countries. It is also worth noting that the Bretton Woods adjustable peg exchange rate system also saw relatively low interest rate volatility.

On the other hand, there is not any support for the proposition that reduced volatility of exchange rates within the EMS enables interest rates to be lower on average than in countries outside.

**Policies, Output and Prices**

Unemployment has risen steeply in all EMS countries since the system was initiated in 1979, and output now appears to be well below the potentially achievable level. Much of this increase is attributable to the tight fiscal policies adopted by Germany since 1980 and by France since 1982, and to the tight monetary policy followed in those countries and in Italy. The inflexibilities in labour markets and in other aspects of the European economies have also been a factor.

It is clear that the adoption of tight policies outside Germany was linked to the existence of the EMS. Having committed themselves to the system in 1979, governments have to some extent kept to the spirit of the agreement by following the lead of Germany and imposing tight monetary and/or fiscal policies so as to reduce the need for realignments against the DM. The clearest example of a failure to do this was the expansionary fiscal policy followed by Mitterand in France up to 1981 and the reversal of that policy from 1982. This is an obvious example of policy being brought into line with that in Germany. Tight policies in a few countries were probably facilitated by EMS membership but, as the experience of other countries shows, membership was not indispensable for such policies.

The EMS commitment to quasi-fixed exchange rates has had some direct effect on unemployment and output outside Germany. This direct effect comes via the tendency for countries outside Germany to have over valued exchange rates against the Deutsche mark. This has acted to reduce inflation in those countries, at the cost of some reduction in output and employment. In effect, those countries have accepted that overvaluation so as to obtain the benefit of lower inflation. The employment costs of this are lower to the extent that the governments can, via EMS, acquire some of the credibility of the Bundesbank's monetary policy.

The great divergence among inflation rates that existed when the EMS became operational in 1979 has narrowed substantially but has not disappeared. We estimate that an underlying inflation rate of below 2 percent in Germany compares with an underlying rate just above 4 percent in Italy, with the French rate somewhere in between these figures.

## The Issues

The future of the EMS depends on two related debates. The first is the debate within the U.K. over how British macroeconomic policy might benefit from, or be hampered by, full membership of the EMS. The second is the debate on the commitment of Europe about the evolution of the Exchange Rate Mechanism (ERM) of the EMS, and possible rule changes. These changes have scarcely been discussed in the U.K., yet they are important to the question of U.K. membership. Here, we start by reviewing the issues that have been raised in the U.K. and then turn to the debate over changes in the ERM.

## What Benefits Does ERM Convey?

Those in Britain who favour participation in the ERM do not all do so for the same reason. In that, British discussion has echoed an ambivalence which existed among EMS's creators at the time of its inception in March 1979. Views of the ERM fell, and fall, into two groups. They are not mutually exclusive.

The first view sees the EMS as a means of reducing volatility in exchange markets, which might otherwise inhibit trade. This view, popular outside the ranks of professional economists, believes unfettered or unguided exchange markets, while reflecting fundamentals, also display 'excess volatility'. The EMS provides an anchor for expectations and eliminates excess volatility and exchange rate swings having nothing to do with fundamentals. When the fundamentals indicate that exchange rates should change, EMS parities can be realigned.

This view is congenial to people who believe that, in any case, an exchange rate target is a reasonable way to calibrate monetary policy. This is true if most shocks to the economic system, as a practical matter, are shocks to the demand for money or other financial assets. Exchange-rate targeting is stabilising in such circumstances, compared to the practice of targeting monetary aggregates.

Critics of this view question whether there is excess volatility in exchange markets (although this line of criticism is becoming much less popular that it was). Even if there is excess volatility, they question whether the financial authorities can distinguish the 'unjustified' movements of exchange rates from those due to fundamentals. And while accepting that some incipient exchange rate movements are due to changes in asset demands, they point out that many are not. Attempting to hold the exchange rate fixed in the face of another sort of shock (such as a change of fiscal policy) merely transfers the instability elsewhere in the system.

The second view sees the ERM quite differently. People with this view are happy to accept that exchange markets are well behaved but think they are disturbed by erratic and inconsistent government policies or, at least, by uncertainty as to what governments will do. The purpose of the ERM then is to constrain the policies of governments. If they are obliged to maintain a fixed exchange rate, that will not only prevent monetary excesses, limiting inflation, but, given the links between fiscal and monetary policy, it will limit fiscal excesses too.

It is constitutionally independent, whereas other major European Central banks are not

Why should governments have any interest in tying their own hands? The answer lies in the beneficial effect this could have on private sector expectations, which could in turn make policy more effective. As long as the commitment to the fixed exchange rate is credible, the market can predict the response of government to any eventuality, knowing its overriding exchange rate target. Of course, this only works if there is something solid to which the exchange rate can be pegged. In the case of Europe and the EMS, this problem is held to be solved by the existence of the Deutsche Bundesbank which has a reputation for adamantine resistance to inflation. The Deutsche mark therefore plays the role of reserve asset, like gold before 1914.

Professor Goodhart has quite neatly summarised these two views by saying that the former view wishes to use EMS to prevent large movements in *real* exchange rates, while the latter view wishes to use EMS to prevent large movements in *nominal* exchange rates.

The use of the ERM as a 'nominal peg', facilitating counter-inflationary policy, is itself a game that could be played the hard way – resolutely never realigning against the DM irrespective of inflation – or the easier way – occasionally realigning, though perhaps by less than the accumulated inflation differential. Of existing EMS members, the Netherlands has followed the first approach and Italy the second. The appropriate strategy for the United Kingdom is discussed in Section III below.

**Must the EMS Change – And How?**

Those are more or less familiar issues. The ERM is not set in stone. Its operation has evolved already. Now there are factors which seem certain to force further, more radical, changes.

One powerful force for change is the financial development of the European economies, particularly the liberalisation of exchange controls and domestic credit controls that are under way in several. Countries in the ERM have made great, if periodic, use of exchange controls to inhibit capital flows, especially in the periods leading up to realignments. The abolition of such controls and closer integration of capital markets must affect the future operation of the system.

Other issues stem from the change in the world economic situation. The EMS was founded at a time of very high inflation in Europe and elsewhere. The birth of the exchange rate system co-incided with the second oil shock. Most countries were agreed in giving top priority to control of inflation. Harmonising monetary policy on a line dictated by the Bundesbank, therefore, seemed reasonable. Inflation has subsided to rates that now seem tolerable to many politicians and members of the public, while unemployment has more than doubled since 1979 in all European countries.

At any rate, protectionism has become stronger and more widespread and countries are more likely to fear overvaluation than undervaluation of their exchange rates, in marked contrast to the beginning of the decade.

As inflation has declined, inflation differentials have narrowed, making desired realignments more evidently a matter of changing real exchange rates in the interests of promoting competitiveness. How might the EMS function in a world without capital or exchange controls and one in which persistent unemployment intensifies competition for foreign markets?

Will that make it harder for the Bundesbank to maintain hegemony? If so, must the system become less stable or could it evolve to a more multi-polar system with explicitly co-ordinated monetary policy? That is now clearly a French objective, but it is unclear whether the Bundesbank, or the German government, could abide a system which imposed changes on their policy. These issues are addressed in Section IV.

One motivation for considering U.K. entry to the ERM is political. The ERM is the most concrete part of the EMS, which, in turn, is an important expression of the movement towards West European political unity. In this section we leave those matters on one side, for the moment, and look at the economic arguments.

## The Original MTFS Framework

To understand why U.K. policy-makers and commentators are interested in the ERM we will look at how policy has been managed and calibrated and describe some of drawbacks of the current approach.

Since 1980, the U.K. government's macroeconomic policy has followed the broad outline set out in the Medium Term Financial Strategy (MTFS). This was first published at the time of the 1980 Budget and described the government's plans for using monetary and fiscal policy to reduce inflation. The original publication set out a series of declining target ranges for M3 growth for each financial year until 1983-84, supported by illustrative figures for the public sector borrowing requirement (PSBR). This was designed to give a clear indication of the direction of policy over the medium term.

The use of a target band for M3 (7-11 percent in 1980-81), rather than a precise objective, left the authorities with an element of discretion within this range. But under the plan set out in the original MTFS, once M3 growth moved outside this range, the authorities were committed to taking action to bring it back.

The forward-looking nature of this commitment was an important characteristic of the MTFS, distinguishing it from the regime of single-year monetary targets adopted by the previous Labour government. These declining monetary ranges were designed to have the maximum favourable effect on inflationary expectations. In making this forward commitment so explicit, the government was, in effect, seeking a bargain with the private sector which would, in principle, constrain its own future freedom of action. Provided that people thought that the government would keep its side of the bargain, then this would influence expectations favourably, bringing inflation down more quickly than a tightening of policy alone and reducing the adverse effect on unemployment.

The role which the advance publication of the M3 target ranges played in the original MTFS can best be seen from the perspective of the theory of optimal economic policy. This has developed rapidly during the 1980s as economists have begun to grapple with the problems with which expectations confront the policy-maker, and in particular the role of inflationary expectations. Exhibit 1 reviews some of the relevant economic theory.

## Exhibit 1.

**Rules versus Discretion:**
**The Theory of Optimal Economic Policy under Rational Expectations**

Everyone in the financial markets knows that the announcement effects of changes in economic policy are very important, often causing sharp changes in sentiment and prices. Economic policy-makers are also very well aware of this and will usually frame and time the announcement of their decisions in order to achieve the maximum favourable effect. Indeed, as part of the more determined stance against inflation in recent years, policy-makers have gone further than this, making announcements about their *future* inflation ambitions either directly or indirectly in the form of monetary or exchange rate targets. The advance monetary targets announced in the U.K. as part of the original MTFS give a good example of this.

Unfortunately, there is an inherent difficulty with any attempt to influence expectations by making announcements about *future* policy. Quite simply, there is a strong temptation for policy-makers to say they will do one thing in order to achieve a favourable expectational response – and then when the time comes, do another. This phenomenon is known as 'time inconsistency'[1]. Because the markets are aware of this problem they in turn find it difficult to take such statements of intent very seriously, preferring to believe that policy-makers will simply do what suits them at the time.

This conclusion is fairly obvious, although its formal proof involves some complex mathematics, based on game theory[2]. These mathematical techniques have proved very useful as a way of showing how policy-makers can in principle achieve favourable expectational effects, by building up a reputation for consistency, or in other words, credibility. In order to build confidence in this way, policy-makers must limit their own freedom of action by announcing plans and achieving them.

Academic economists have shown that in certain circumstances in which expectations are important, policy-makers find it best to stick to simple rules rather than following discretionary policies. (A discretionary policy is one in which the authorities keep their options open to deal with future events as they find them.) In this situation[3] the policy-maker is usually tempted to depart from the simple rule (such as a fixed exchange rate or monetary target range) in order to achieve a short-term gain (such as an output gain from a devaluation). But he does not do this because he forfeits his credibility and this causes trouble in future years. The reputation which the Bundesbank acquired during the 1970s gives a practical example of the benefits which credibility can bring.

So to conclude, theory and experience suggest that there are two ways for policy-makers to behave when expectations are important. The first is simply to ignore them, following a discretionary policy which keeps all options open. The second is to formulate a coherent policy strategy and stick to it, in order to maximise the long-term effect on expectations. Game theory seems to suggest that this is an all or nothing choice, with few realistic alternatives between these extremes. This apparently leaves the policy-maker with a stark choice, which will depend upon the likely scale and variety of unforeseen future events (favouring discretion) and the importance of expectations relative to other influences on inflation (favouring rules).

1. The problem of Time Inconsistency was first formalised by Kydland and Prescott: "Rules rather than Discretion: The Inconsistency of Optimal Plans", Journal of Political Economy, 1977.
2. The Optimal Time Consistent Policy has been formalised in an unpublished paper by Cohen and Michel: "Towards a Theory of Optimal Precommitment: An Analysis of Time-consistent Equilibria", CEPR, 1984. Currie and Levene ("Time Inconsistency and Optimal Policies in Deterministic and Stochastic Worlds", CEPR, 1984), show that this solution is identical to that of a "time-consistent closed loop Nash game". This means that the private sector's reactions function and the way it forms its expectations are independent of government policy announcements.
3. Backus and Driffill "Inflation and Reputation", American Economic Review (1985) provides an excellent example of this type of model, which is known to economists as the analysis of 'reputation'.

## The Evolution of the MTFS

In these terms, the original MTFS can be seen as the first step in a confidence-building exercise. If people came to believe inflation would fall, that would be quickly reflected in wages and prices. When the government did tighten policy, more of the effect would be felt directly in prices and less would need to fall on output and employment. For such a favourable response on expectations, it was important for the government to be seen to be sticking to its chosen path, no matter what the circumstances were, building up confidence that it would continue to do so in the future.

This helps explain why the original MTFS was phrased in terms of a single target variable, M3 (or sterling M3 as it was then) available on a regular and timely basis, enabling both the authorities and the markets to monitor progress. It also helps explain why the PSBR was retained as the basic indicator for monitoring fiscal policy after the target for M3 (to which it is closely related) was dropped: it is available on a much more regular and timely basis than other indicators such as the financial deficit.

In the event, the U.K. money supply measures, particularly the M3 indicator, were badly distorted, both by the ending of controls which had pushed lending outside the banking system, and by the introduction of new types of bank account. In many cases, these new accounts pay an interest rate close to a short-term market rate, making it unnecessary to economise on working balances, so inflating the demand for money.

Those developments swelled the wide monetary aggregates and, in particular, the M3 aggregate upon which the MTFS was originally based. These aggregates have all been growing much faster than nominal incomes, implying a large fall in monetary velocity and making the interpretation of monetary conditions very difficult. This made it unrealistic to operate the MTFS as an automatic system in which there had to be a policy response whenever the target variable strayed off course.

Faced with the distortions to the wide monetary aggregates, the monetary authorities inevitably came to take account of the narrower monetary aggregates (which were less affected by these developments) as well as other indicators of monetary conditions such as the stock market and house price inflation. Targets for M3 were finally discarded in this year's Budget, leaving M0 as the sole target variable.

## The Present Framework of Monetary Control

The MTFS still contains a policy rule in the form of a target range for M0, the monetary base. The Chancellor specifically cited fast M0 growth as a reason for the decision to raise base rates last autumn and a change in interest rates would presumably be triggered automatically if M0 growth were to move outside the target range (2-6 percent for the current financial year).

The M0 measure largely consists of holdings of notes and coins and as such tends to respond to changes in money incomes and the general level of interest rates. It is a timely and useful statistic, but is unlikely to give an advance warning of money GDP growth and inflation in the same way as M3 was once thought to do. That is why the authorities have continued to rely upon other indicators such as the exchange rate, which have acted as leading indicators of inflation in the past. It also helps explain why the PSBR figures set out in successive versions of the MTFS, have increasingly come to be regarded by the market as a formal commitment, though they were initially regarded as being just an illustrative guide.

Despite this commitment to the M0 target, the evolution of the MTFS has left us with a rather judgmental monetary control system which depends upon the Chancellor's assessment of monetary conditions and his willingness to raise interest rates when he thinks that monetary conditions are too easy. These policies have delivered a striking fall in money GDP growth and inflation, even though credit and the wider monetary aggregates have been growing rapidly. The evidence, reviewed in Annex 2, also suggests that there has been a reduction in the volatility of interest rates since 1979, as many monetarists had claimed there would be.

Despite this track record, investors are now uncertain about the government's commitment to 'stable prices' and the time scale over which it hopes to achieve them. The declining M0 ranges set out in the most recent versions of the MTFS give some indication but are not much emphasised by the government and do not appear to be taken very seriously by the markets. And although consumer price inflation fell in 1986 this was largely in response to lower oil prices and interest rates. The underlying rate of earnings growth has remained in the range of 7 to 8 percent since 1983 and there has been no reduction in the rate of money GDP growth since then.

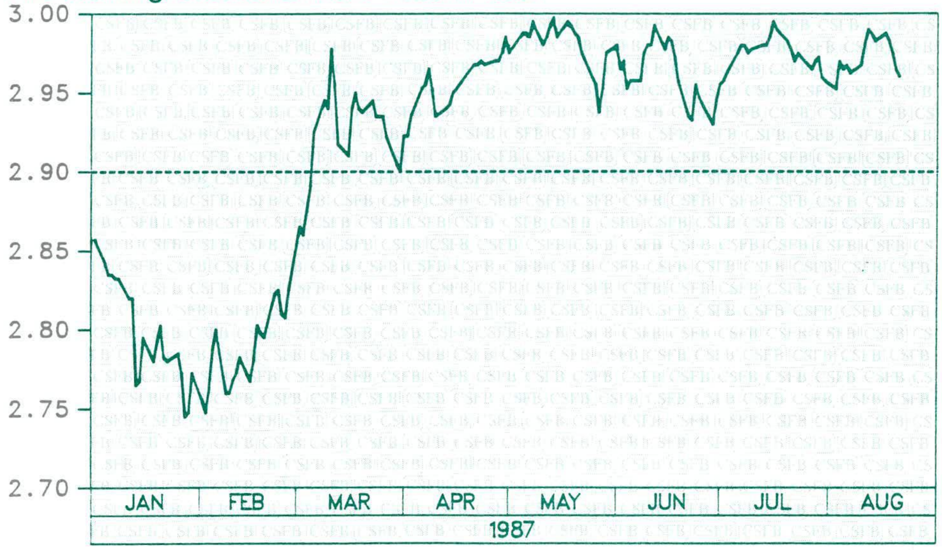
The markets dislike the present system because it leaves uncertain the criteria for changes in interest and exchange rates. The authorities have made it clear that they would be unwilling to let the exchange rate fall in response to wage inflation, but the 1986 experience suggests that they would permit an adjustment in response to a major change in oil prices. It is not clear what would happen if the exchange rate came under pressure for other reasons, or how the need for parity changes would be judged. Investors would almost certainly prefer a simple system of target and response based on the exchange rate.

## The Role of the Exchange Rate

The Chancellor seems to have recognised the market's concern and has made several statements to clarify exchange rate policy over the last year. Last December, when sterling had fallen to 2.80 Deutsche marks, he said that he was not willing to see a further significant fall in sterling. Then at a meeting of NEDO in March, following the G7 meeting in Paris, he said that he would like sterling to remain close to exchange rate levels then prevailing. (These were DM 2.90 and $1.66.)

These statements have been accompanied by a marked change in the Bank of England's exchange market intervention policy. Until last summer this was confined to small-scale operations designed to smooth the exchange rate. Then the Bank intervened heavily to support sterling in September and October, and to sell sterling as the currency came under strong upward pressure between February and May of this year. The Bank made apparent its determination to cap the exchange rate at three Deutsche marks and succeeded in doing so. The exchange reserves rose by nearly $10 billion in four months.

The Sterling/Deutsche mark Rate in 1987




Since the G7 meeting in Paris in February of this year, sterling has traded closely in line with the Deutsche mark, as demonstrated by the above chart. Variations in the £/$ and DM/$ rates have been significantly greater than in the £/DM cross rate, though less than observed in earlier periods. It seems that the authorities have an unpublished target range for the sterling-Deutsche mark rate, and that they are experimenting with a shadow-EMS policy, with a view to formal entry.

### The Inflation Risk Factor

Reflecting concerns about inflation, and perhaps about the monetary policy framework, yields on sterling assets have incorporated a significant premium for the risk of accelerating inflation in recent years. This does not seem to have narrowed in recent months despite the moves towards a more specific exchange rate policy. The risk factor is discussed in Exhibit 2.

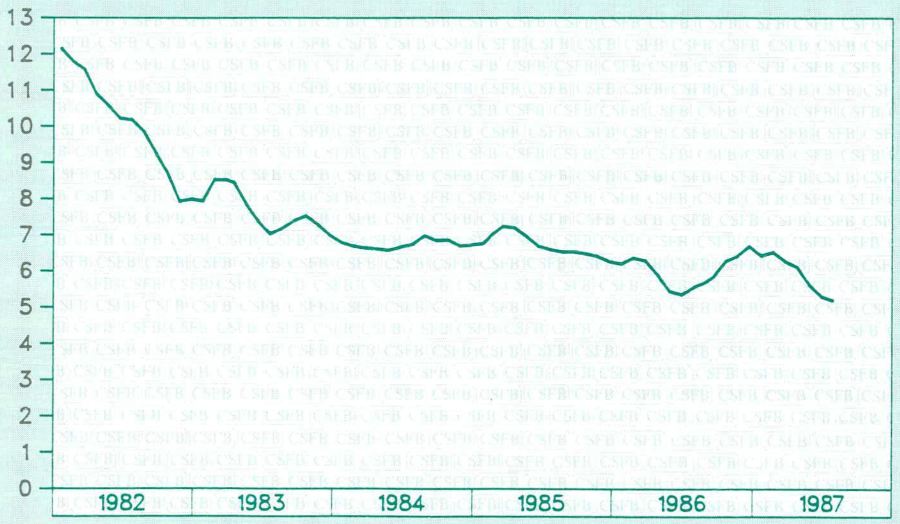
This risk factor offers a useful barometer of changes in market sentiment about inflation. But it may be more significant, reflecting medium term inflationary expectations in the economy more generally. Although opinions are diverse, the general view seems to be that inflation is likely to remain low this year, but then drift up. For example, the Treasury's regular survey of outside forecasts suggests that forecasters now accept the Chancellor's view that inflation will fall to below 4 percent by the end of this year. But on average they then expect a slight acceleration next year, to nearly 4½ percent. We now consider how those expectations could be affected by full EMS entry.

## Exhibit 2

### The Inflation Risk Factor

Since the issue of index-linked stocks in 1981, it has been possible to derive a useful indicator of inflation risk, as perceived by the financial markets. The yield on these stocks measures the real rate of return, and subtracting this from the yield on a conventional stock of similar maturity gives a measure of the market's expected rate of inflation, as shown in Chart A below.

**Chart A**
Inflation Expectations in the Gilt Edged Market
Treasury 11¾-2% IL 2006




If we subtract the underlying rate of inflation from this forward-looking measure, this gives a measure of the market's allowance for future changes in inflation, as shown in the chart below. In the interests of conciseness, we call this allowance for a change in the rate of inflation the "inflation risk factor" (IRF).

**Chart B**
The Inflation Risk Factor
Treasury 11¾-2% IL 2006 (PPI)

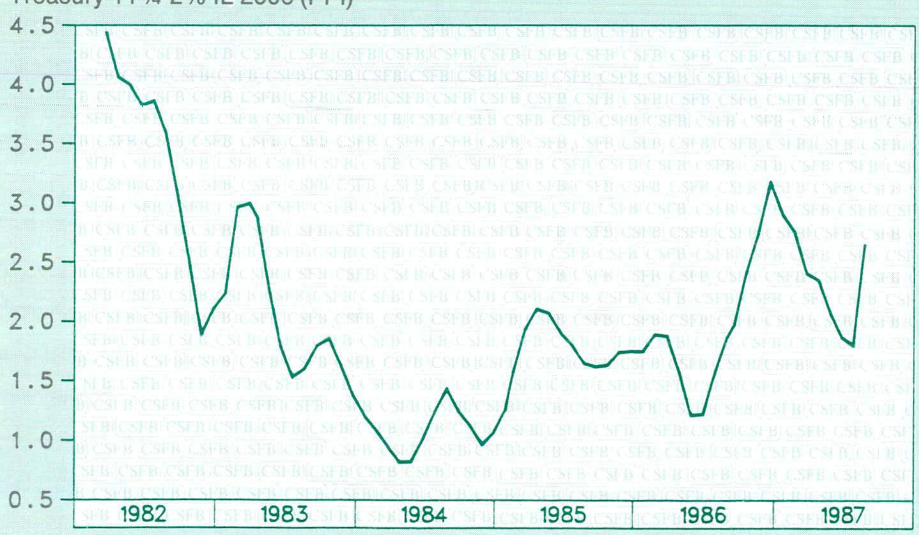



Chart B shows a sharp fall in the IRF in the spring of 1986, as oil prices fell, leading the market to expect a fall in the rate of inflation. Sterling held up quite well initially, but then depreciated over the summer and autumn as the oil price fell further, and worries about consumer spending and the balance of payments mounted. The conventional gilt market fell sharply in September and again in October, pushing the IRF up, and signalling a 3 point rise in the rate of inflation (shown in chart B), from the current rate of 4 percent a year to about 7 percent (as indicated by chart A). The market regained confidence in the spring of this year, and the inflationary expectations indicator (chart A) fell back to just over 5 percent at Budget time, implying an IRF (chart B), of just 1½ percent.

Since the election, the IRF has moved back up to around 2½ percent, reflecting renewed concern about inflation, based on some combination of higher oil and commodity prices, faster credit growth and consumer spending and a deterioration in the balance of payments.

The IRF provides a useful barometer of these swings in market expectations about inflation. But what is more interesting in the present context is the fact that this premium has always remained positive. This means that the gilts market has continually been expecting the rate of inflation to accelerate over the medium-term, or at least has demanded compensation against the possibility of such an acceleration (in terms of higher conventional gilt yields).

This could simply be owing to the fact that inflation has been falling or stable over the period. If people form expectations adaptively, in effect basing them on a moving average of past inflation, they will tend to overestimate future inflation during such a period.

The expectation could, though, be based on explicitly perceived risks in the future, such as the possibility of a change in government – in this case the IRF acts as a political risk indicator[1]. It could also reflect doubts about the efficacy of the present macroeconomic control framework and the government's determination to secure a further fall in inflation. The IRF increases the cost of servicing the national debt, and the cost of long term borrowing by industry. But it may be still more significant if it reflects a general scepticism about the government's determination to make further progress against inflation.

1. As evidenced for example by the sharp falls in the risk premium in the second half of 1982 and the first quarter of 1987, as the opinion polls strengthened in favour of the government.

**Should the U.K. join the EMS?**

Official policy has always been that the U.K. will become a full member of the EMS when the time is right. Hitherto, the relative weakness of the U.K. economy, its openness to international economic and financial forces and its particular exposure to changes in oil prices have all been cited as reasons for delay[1].

This line has become less easy to sustain in recent years as the U.K. economy has strengthened and become less dependent upon oil production. Inflation has averaged about 4 percent a year since 1983, output has been growing at about 3 percent a year, faster than in the rest of the EC. The progress which manufacturers have made in containing their labour costs has been particularly impressive. We estimate that the *underlying* rate of U.K. labour cost inflation is now 3 percent compared with 1.2 percent in Germany[2]. Although there is clearly some way to go before full convergence is achieved, EMS membership now seems at least a feasible option for the U.K.

**The Policy of Shadow Membership**

The Bank of England's success in stabilising the sterling-DM exchange rate since the Paris Accord in February, despite strong upward pressure on sterling in the spring and the Middle East crisis of recent weeks, is very impressive. The ability to hold this rate certainly reinforces the impression that EMS membership is now technically possible without excessive instability of interest rates or credit conditions.

However, the longer this shadow-EMS policy is successfully continued, the less compelling the U.K.'s reservation about timing will become. Politically, this will make it increasingly difficult for the U.K., as a member of the EC, to follow such a policy. The option of informally pegging the exchange rate to the Deutsche mark is open to countries such as Switzerland and Austria because they are not members of the EC. Indeed, they have to 'live in sin' with the EMS because a formal marriage is ruled out. But this option is hardly sustainable for the U.K. Its EMS partners believe in formality and would eventually push it to choose between separation and some form of marriage.

What does this mean?

**The Benefits of Formal Membership**

An important attraction of ERM membership is that it might reduce expectations of inflation in the U.K., since inflation would have to fall further if a fixed link with the Deutsche mark were to be sustainable. Against a background of scepticism about the government's inflation ambitions and uncertainty about the criteria used to judge interest rate moves, EMS entry has many of the attractions of the original M3-based MTFS. Not too much should be made of this, although it could be helpful in demonstrating a determination not to let inflation rise above present rates. The evidence (see Annex 2) is that a revolution in expectations does not come simply as a consequence of ERM membership. The determination to stick with a given exchange rate, even when it becomes painful, has ultimately to be demonstrated.

1. Exchange rate movements between sterling and other EMS currencies due to changes in oil prices could in principle be eliminated by sales of oil-linked bonds from the U.K. to other EMS countries. See "La Grande-Bretagne doit-elle rejoindre le SME", Bill Robinson and Giles Keating, Economie Prospective Internationale (Revue du CEPII), 3eme trimestre 1986, no. 27, p. 5-23.

2. "Britain's Productivity Renaissance", CSFB Economics, June 1987.

Nonetheless, because the EMS is a formal institutional arrangement it would inevitably carry greater conviction than the present informal commitment to exchange rate stability, or even for that matter a monetary target range. A formal EMS parity would in practice be politically more difficult to change. And in the U.K., the Deutsche mark is such a symbol of financial rectitude that the formal link could have some influence on wage and price setting. With inflation expectations as entrenched as they appear to be at the moment, the only other way of reducing inflation would involve some deflation of the economy. That could prove very costly and if the ERM adds credibility to the commitment, so reducing deflationary costs, it would be a valuable adjunct to tight policy.

A formal commitment to EMS many of the attractions of the original M3-based MTFS. In particular, it would provide:

— A coherent framework for the operation of macroeconomic policy based on a simple target variable – in this case the exchange rate.

— Some element of discretion within the bilateral parity ranges but a firm commitment to preserve the limits of these ranges.

— A relatively simple rule with which the financial markets could live.

— A way of minimising short-run exchange rate volatility. The evidence suggests that interest rate volatility would not rise following EMS entry.

It would also be a restatement of the government's inflation ambitions. The nature of those ambitions would determine how the U.K. operated within the ERM. To this critical issue we now turn.

## The Options for the U.K. in the EMS

The EMS does not present the U.K. with a single option, but a range of alternative options. Changes in the rules, discussed in the next section could present further options. But there are three different styles of membership the U.K. could aim for under the present rules:

(i) The 'soft' option: an adjustable peg operated with a wide 6 percent margin or frequent realignments to allow for differences in inflation.

(ii) The 'middle of the road' option: a semi-adjustable peg, operated with a narrow 2½ percent margin and less frequent realignments. This is effectively the way the French have operated since 1982.

(iii) The 'hard' option: a fixed exchange rate policy operated with no realignments and an effective margin much narrower than 2½ percent. This is essentially the way the Dutch have operated within the EMS.

The first of these options would place very little additional constraint on U.K. policy, but, by the same token, would bring very little extra credibility. Indeed, such formal arrangements would be so soft that they could be seen as providing a looser framework for policy than the present largely judgmental system. Although the Italians have a 6 percent margin for floating within ERM they have been reluctant to employ this to its full extent and have not fully accommodated the inflation differential when making realignments. In practice, actual Italian operation of the system has been a harder option than (i) implies.

The effective choice is therefore between options (ii) and (iii), the 'French' and 'Dutch' options. The first of these options has its attractions and would, for example, allow the authorities some discretion over the position of sterling within the exchange rate bands, which could depend upon indications of domestic monetary and fiscal conditions. A relatively loose domestic picture would, for example, make a strong position within the band appropriate, to help maintain pressure on corporate profitability and inflation (The full 2¼ percent would of course mean a bilateral range of up to 4½ percent.) However, France (and other countries) typically operated well within the 2¼ percent limit, so the effective range open to the authorities would be less than 3 percent. These countries have also been reluctant to accommodate inflation fully when realigning.

More generally, this option is consistent with accepting inflation at its current rate or going for a gentle deceleration of prices. If the U.K. were to go in at a competitive exchange rate, current inflation differentials are small enough to permit a lengthy period of exchange rate stability before a realignment was needed to restore – or partially restore – competitiveness.

Of the three basic options, the third would imply the greatest downward pressure on inflation and ultimately the greatest enhancement of credibility. However, this would be a difficult road even with U.K. cost inflation down to present levels. Under the present rules this option would effectively mean subordinating U.K. monetary and (for the reasons discussed below), fiscal policy to those pursued by the German monetary and fiscal authorities. It would involve taking on trust not only the broad thrust of German macroeconomic policy but also its preferred response to external events like a dollar decline or recession in the United States. Even in the context of pre-commitment and a firm stance on inflation this could be viewed as giving too many hostages to fortune.

This is why the rule changes discussed in the next section are relevant to the U.K.'s decision about participation in the ERM. This extreme 'satellite' option would also be politically difficult for the U.K. and epitomises Mrs. Thatcher's objection to membership.

## The Implications of EMS for Fiscal Policy

The experience of other countries suggests that EMS membership would place limits upon fiscal and monetary policy in much the same way as the PSBR – M3 linkage did in the early days of the MTFS. Fiscal policy is likely to be tightly constrained in a fixed exchange rate system if monetary policy lacks credibility. The French experience under the Mitterand government demonstrates that. Both monetary and fiscal policy need to be consistent with a stable exchange rate.

In the absence of exchange controls, monetary policy instruments, and in particular interest rates, need to be set at a level which holds the exchange rate day to day. Given this setting, fiscal policy must then be used to ensure that the broad thrust of macroeconomic policy is consistent with an inflation rate comparable to that in other participating countries, in order to avoid longer term cost and current account pressures on the exchange rate. Thus in theory, participation in the ERM, if it is to be successful in avoiding realignments, will effectively dictate both monetary and fiscal policy. In other words, monetary policy must be used to support the value of the currency short-term in the foreign exchange markets and fiscal policy to defend its value long-term in the domestic markets for goods and services.

So much for the theory. But how would this work in the present U.K. context? Some commentators have, for example, argued that there would be a marked tendency for U.K. short-term interest rates to fall upon entry, further encouraging the growth of consumer credit and spending. The most sophisticated version of this argument is due to Sir Alan Walters, Mrs. Thatcher's former economic adviser, who has argued that with inflation initially higher in the U.K., *real* interest rates would fall below those in Germany, causing inflation rates to diverge and making membership unsustainable long-term[3].

The evidence for other high inflation EMS countries suggests that this risk is not significant: interest differentials have not narrowed faster than inflation differentials since 1979. In other words, so long as inflation rates differ, the market requires some compensation for the *risk* of an exchange rate change even in a fixed-rate system. Yet the liberalised nature of the U.K. financial system, and its openness to international capital movements could make inflows more troublesome for the U.K. Capital inflows could force a series of unwelcome base rate cuts, threatening an acceleration of credit growth.

This could put the authorities in a difficult position, especially in the middle of the financial year when it is difficult to change fiscal policy. But the logic of EMS membership would, in principle, require a tightening of fiscal policy and a reduction of public sector activity to make way for further growth in private sector borrowing and spending, triggered by lower interest rates. In other words, the macroeconomic policy 'mix' would have to be shifted temporarily towards a tighter fiscal policy stance and a looser monetary policy stance, preserving the same overall downward pressure on money GDP and inflation.

There have already been steps in this direction since 1984-85, despite two successive reductions in the standard rate of personal income tax. The government's fiscal deficit has been significantly reduced. But EMS membership would mean that further cuts in taxes would have to be made very carefully. It is too soon to speculate on the shape of next year's Budget. A lot will depend upon the strength of credit demand, earnings and consumer spending, as well as the buoyancy of tax revenues. However, there is no reason why EMS membership should not be consistent with further reductions in inflation – quite the opposite.

3. Chapter 8, "Britain's Economic Renaissance", OUP, 1985.

The original MTFS offered:

— A coherent framework for the operation of macroeconomic policy based on a single target aggregate, M3.

— A clear statement of the government's determination to reduce inflation, in the form of a series of declining target ranges for M3.

— An element of discretion within these target ranges, but a commitment to change policy once these were breached.

— A relatively simple rule which financial operators could understand.

The MTFS was seen at the outset as credible in the financial markets. This was reflected in a strong exchange rate which helped bring inflation down quickly. However, the credibility of the M3 monetary target was undermined by financial innovation which made it unrealistic to operate this as a policy rule.

Although it retained an element of automaticity through the M0 target, the MTFS became increasingly judgmental over time.

The financial markets have reason to dislike the present control framework because it leaves uncertain the criteria used to decide changes in interest and exchange rates.

People are generally sceptical about the government's ambition of eliminating inflation.

The move to an informal exchange rate target since the Paris Accord has helped to restore confidence in the financial markets, but does not seem to have had the effect of dampening inflationary expectations.

In any case, this policy of 'living in sin' with the EMS contains the seeds of its own destruction; it would be difficult for the U.K. to maintain an informal parity with the Deutsche mark as the Swiss and Austrians do.

Seen against this background, formal entry would offer many of the advantages of the original MTFS. The exchange rate commitment would provide:

— A coherent framework for the operation of macroeconomic policy, based on a single target variable (in this case the exchange rate).

— Entry could also provide a statement of the government's inflation ambition. A declaration that the U.K. would follow a 'hard' fixed exchange rate option would be consistent with a reduction in U.K. cost inflation to German rates.

— A relatively simple rule which the financial markets could understand.

— A way of minimising short-run exchange rate volatility. The evidence suggests that interest rate volatility should also fall.

# SECTION IV

## Advance or Face Retreat: the Future of the EMS

The EMS has worked asymmetrically since 1979, with the Bundesbank setting a monetary policy and other countries responding. (The evidence is reviewed in Annex 2.) In the first half of the 1980s that was acceptable to those countries, because the primary policy aim at that time was to combat inflation. When the pain of doing so became excessive, exchange-rate realignments were undertaken and the delays in negotiating such realignments were covered by use of exchange controls.

This resulted in overvaluation of some countries' exchange rates relative to Germany. In effect, Germany provided credibility to the anti-inflation policies of its trade partners and was rewarded with advantageous access to their markets. There are two reasons why this situation is now likely to change.

### A Change of Priorities

The first is that inflation has fallen during the 1980s and this has been accompanied by a substantial rise in unemployment. Given this background, most European governments have become less anxious to reduce inflation further, although they still want to restrain it.

This shift in policy priorities increases the likelihood of conflict, with Germany continuing to emphasise low inflation while others become more anxious over unemployment and hence international competitiveness. How much strain will this place on the EMS?

There is little sign of strain from countries currently seeking to reduce unemployment at the cost of more inflation. Against this, there seems to be no consensus for a renewed attack on inflation. Experience strongly suggests that such an attack could raise unemployment substantially further, particularly since a commitment to lower inflation is unlikely to be instantly credible.

So the most likely outcome is that inflation differentials persist for some while at levels dictated by current underlying inflation rates. The underlying inflation rate is below two percent in Germany, somewhat higher in France and the U.K., and some two percent higher in Italy. At these inflation rates, there will still have to be periodic exchange-rate adjustments. Because the inflation differentials are less than in the past, ostensibly realignments will be smaller and/or less frequent than before. Even so, they may be more politically contentious. With inflation lower than in the early 1980s, discussions about parities more transparently will be about relative competitiveness and trade balances – in short, about relative unemployment rates. At current unemployment levels, such discussions are unlikely to be always smooth.

The increased concern about unemployment is likely to be even more important when the system is buffeted by external events. An event that is likely to increase unemployment, such as a reduction in competitiveness due to a further weakening in the dollar, could provoke a divergence of approach. Some countries might want to protect employment, perhaps by easing monetary policy to reduce dollar decline or to expand domestic demand, while Germany might be too concerned about inflation to do either. This would lead to pressure for exchange rate realignments.

**Removal of Exchange Controls: Another Reason for Change**

The other development likely to force changes in the way EMS operates is that exchange controls have been substantially dismantled in France and are being relaxed in Italy. In the United Kingdom they do not exist. That reduces the potential for delaying realignments pending negotiation. Such delay in future would presumably mean large movements in domestic short-term interest rates, making the realignment option much more costly. To avoid that, the authorities would either need to achieve still more convergence of inflation, or they would need to make timely, indeed, anticipatory changes to exchange rates.

**Will Germany become more Flexible?**

How will the EMS operate in a situation where policy objectives diverge more than in the past? A key question is how far the German authorities will allow their domestic monetary policy to be seriously influenced by EMS considerations. If they are reluctant to do this, divergent policy objectives could threaten the stability of the system.

On the other hand, if the German authorities were willing to take trade partners' objectives into account in framing their own monetary policy[1], how would the system operate?

There would be a greater obligation on the Bundesbank to take action to prevent Deutsche mark appreciation against other currencies in the ERM. It would have to be prepared to hold the currency of a partner facing depreciation, which it acquired as a result of intervention. Most problematic of all, it would not be able to sterilise the effects of its intervention on the supply of Deutsche marks. In effect that would oblige the German monetary authorities to alter the money supply and interest rates to promote the stability of exchange rates. In contrast, the present rules, discussed in the final part of this section, effectively allow the Bundesbank to retain control over the amount of Deutsche marks in circulation.

Taken to an extreme, that would remove the ultimate nominal anchor of the EMS, namely the Bundesbank's attachment to a low-inflation policy, usually expressed through a target for German Central Bank Money (CBM).

To preserve the stability of the system, that target would have to be replaced by other nominal target variables, agreed by the countries in the system. In practice the Bundesbank would always have the last word about monetary policy, retaining the power to revert to a CBM target if the cooperative approach was failing. We consider some of the possible lines of development for the EMS.

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1. In the immediate post-war dollar-based exchange rate system, the dominant country took the situation in partner countries into account. At the time, the main concern of countries outside the U.S. was about economic growth and unemployment rather than inflation. U.S. policy-makers alleviated the tension between inflation and growth directly through development aid (such as the Marshall Plan). EC Budgetary contributions offer an analogue in the present situation, but are in practice determined by broader political and economic debate. This means that monetary and fiscal policy must be used instead.

## Co-ordination

If it is to be substituted to any extent, the Bundesbank's role could only be replaced by co-ordination and agreement among the governments and monetary authorities of the EMS. Monetary policy would need to be set either by a process of continuous co-ordination, or by each country adhering to a set of agreed targets, or by a supranational monetary authority: a European central bank.

However, it is most unlikely that a European central bank will be established for many years. The Single European Act, passed into law in all the EC member countries during the first half of 1987, gives formal recognition to the EMS but specifies that institutional changes will be subject to article 236 of the Treaty of Rome.

This means that the establishment of a European central bank will require not just agreement among Ministers but also legislation in the parliaments of all member countries. So even after negotiations to establish this supranational monetary authority, there would be a further delay of some two years before legislation, to judge from the period taken to agree and then pass the Single European Act. At present, there is no evidence that such negotiations are taking place and there is no strong political support for such a radical change in the near future.

## The Balladur Proposals[1]

However, there is evidence that the political will exists for less ambitious, but significant, development of the EMS. M. Edouard Balladur, the French Finance Minister, has submitted a memorandum to the Monetary Committee of the EC. This sets out a series of measures none of which "would require any transfer of responsibility between governments and central banks, or any change in the Treaty of Rome." Such developments would be complementary to the broader dismantling of trade barriers within Europe that is targeted for 1992.

Balladur has three proposals:

not on

(1) The EMS countries should negotiate as a block with Japan and the U.S. on target zones for dollar and yen, and those zones should be supported by "co-ordinated intervention by European central banks".

unimportant

(2) Economic policies among EMS members should be co-ordinated, with "surveillance and analysis on the basis of a small number of indicators".

(3) Intervention should be strengthened by "the extension ... of Community credit mechanisms ... endowing the ECU with the characteristics of a real reserve asset and increasing mutual holdings by European central banks of their partners' currencies".

The first proposal implicitly admits that the "G5" agreements at Plaza and since are essentially three-way deals between Germany, Japan and the U.S.. Balladur's proposal requires the Germans to give more say in these deals to the other EMS countries.

1. Balladur's proposals discussed in this section, were set out in a speech on 18th June, reported in "Les Notes Bleues", nr. 339, Ministère de l'Economie des Finances et de la Privatisation. They are summarised in English in an article in "The Financial Times", 17th June 1987, the week after the U.K. General Election. In the interests of accuracy, quotations in this section are from the FT article.

The second proposal also implies a request for Germany to share some of its power. During the first eight years of the EMS, Germany acted as leader, setting its monetary policy independently. Other countries adjusted their policies in reaction. Under Balladur's second proposal, the governments and central banks of all the EMS members would monitor a series of "indicators" in all member countries, presumably variables like nominal GNP and money supply. Policy decisions would take account of all these indicators, so the Bundesbank would no longer give so much weight to German Central Bank Money as a determinant of its monetary policy, but would also give weight to nominal GNP growth in Germany and France, for example.

This sharing of power runs the risk that the reputation of the Bundesbank for always fighting inflation is diluted or even lost. The trick would be to transfer the credibility to a broader set of indicators that ensured control over European inflation. In practice, it seems certain that the Bundesbank would always be prepared to ignore other indicators as a last resort if there were danger of an acceleration in inflation that it regarded as unacceptable.

Balladur's third proposal should not be viewed in isolation from the second. In effect, the third proposal provides an effective way of transferring power so the negotiations over indicators would be slightly more of a debate among equal partners than at present.

To see how this would work, consider the present rules. These give a disproportionate amount of power to the central bank with the strongest currency – which tends to mean the Bundesbank. The Bundesbank's influence is even greater than it would be in the absence of the EMS rules on intervention.

The reason is that at the moment, participating central banks are allowed to hold only working balances in other participating currencies. These limits can be exceeded, and the balances used for intramarginal intervention, but if this is done when the currencies are inside their ERM limit, it requires the permission of the central bank issuing the currency. The Bundesbank has usually granted this, but permission would not formally be required if the EMS rule did not exist.

So, in the case of such intramarginal intervention, a central bank with a weakening currency must either ask the Bundesbank for permission to use Deutsche marks for intervention or must rely on its reserves of other foreign currencies (usually dollars). Sales of dollars are less effective in supporting exchange rates against the Deutsche mark than are direct sales of Deutsche marks. Moreover, they insulate the money supply in Germany from the effect of intervention by partner countries.

These rules for intramarginal intervention stand in stark contrast to those for intervention at the margins of currency divergence limits, where EMS rules require obligatory unlimited support both by the central bank with the weakening currency, for example, the Banque de France – and by the one with the strengthening currency, for example, the Bundesbank. This maximises the effect of intervention on the bilateral cross rate, minimising the volume necessary to hold the parity. Unless the intervention is sterilised, which would be contrary to the spirit if not the letter of the rules, the money supply would be affected (in opposite directions) in both countries. In this case, the Bundesbank must also provide an unlimited credit facility to the weaker partner.

One reason for the different treatment of marginal and intramarginal intervention is that the originators of the EMS expected intervention at the parity limits to be important, as it was in the early years, while intramarginal intervention was expected to be less significant than it has turned out to be in recent years. The reason for the change is that recently, central banks have tended to keep their exchange rates within narrower bands than the formal 2¼ percent limits. This partly reflects the ERM rule advising inervention at the divergence limits, which are reached before the party limits (see Annex 1). It is also for tactical reasons; intervention can become very expensive and ineffective at the margins if speculators begin to think of the currency as a one way option.

Why has the greatly increased use of intramarginal intervention not led to a more comprehensive revision of the rules than the limited changes that occurred in 1985? One explanation may be that informal arrangements have worked so well that there has been no pressing need for formal change. However, Balladur's proposals suggest that the French, at least, are now anxious for the rules to be amended to reflect the altered reality of the system. Events just before the realignment of January 1987 emphasised this anxiety. Then, the French refrained from intramarginal intervention, allowing the exchange rate to move to its parity limits and obliging the Bundesbank to intervene.

The current rules effectively preserve each central bank's control over the amount of its own currency in circulation. The changes proposed by Balladur would allow the Banque de France, for example, to accumulate large quantities of Deutsche marks at a time when the German currency was weak (for example, just after a realignment) and sell them later when the French Franc was weakening, thus causing the German money supply to fluctuate.

The Balladur proposals, as they stand, would not prevent the Bundesbank neutralising these effects. This offset could be made either directly in the foreign exchange markets, or indirectly in the bond market. This could be inconvenient, and would mean a change in the reserves or elsewhere in the financial accounts. But unless it were explicitly ruled out, which would be very unlikely even in the current climate, the Bundesbank would still retain its ultimate control of the money supply.

Balladur's third proposal also suggests improved credit lines and the use of the ECU as a "real reserve asset". These changes would contribute to a further dispersal of power away from the Bundesbank and towards other participating central banks. The creation and distribution among participating central banks of extra ECU, whether backed by component currencies or not, gives the other central banks an effective holding of DMs. This element of the proposals has run into German opposition.

Balladur reports that discussions of his proposals are proceeding 'slowly'. The Bundesbank has expressed doubts about better credit lines for intramarginal intervention[1], and may also have reservations about a formal system of indicators. However, the Bundesbank does regularly give permission for the use of Deutsche mark in intervention by other EMS Central Banks, and it might be prepared to formalise this. The debate is clearly continuing.

1. See "The European Monetary System", p. 68-72, Report of the Deutsche Bundesbank for the year 1986, published April 1987.

## Conclusion

The political will does not exist for a supranational monetary authority. Yet Germany's overriding concern with inflation and the role of the Deutsche mark as an alternative to the dollar in international portfolios will make it difficult for that country to continue to lead the rest of Europe in an era of low inflation and high unemployment.

Strains are particularly likely when there are external events that emphasise the divergence of policy priorities. For example, if the dollar were to fall steeply, the Deutsche mark would probably rise faster than other EMS currencies. Traditionally, other EMS countries would then tighten monetary policy to maintain parity with the Deutsche mark. With unemployment now of greater concern, countries may find this unacceptable and may require Germany to relax monetary policy. Equally, Germany is unaccustomed to allowing an acceleration in its own inflation rate to restrain unemployment elsewhere in Europe. Moreover, it is unlikely to look with equanimity on demands by its partners for greater competitiveness via lower real exchange rates.

These tensions would be accommodated in a system, such as that envisaged by Balladur, in which the leadership of Germany alone would be moderated by a more collective decision making procedure. In practice, this would probably mean a de facto coalition of Germany and France, and perhaps the U.K. That would still leave most countries obliged to follow some leadership. However, all the problems in international economic policy co-ordination, which have arisen between the United States, Japan and Germany – such as deciding suitable 'indicators' – would now arise within the EMS.

The EMS has been attended by forecasts of its demise ever since its inauguration. But it has managed to survive. The system will continue to be subject to tension, yet we expect it to show resilience. One reason for thinking so is the political importance that attaches to it as one of the important symbols of the movement for a measure of European unity. Another reason is that the need for some anti-inflation restraint will remain in the European countries, given the nature of their labour markets. This fact is not altered by the shift in policy priorities that is currently taking place.

Whether or not the U.K. joins, the EMS system is likely to evolve either formally or informally in the direction of greater symmetry, further and more frequent consultation, and a common policy line on the dollar. The French are pressing for this to be reflected in formal changes to EMS rules. At the very least, Balladur's proposal for a jointly agreed EMS policy towards the dollar is necessary.

Participating countries will inevitably have to discuss with each other the setting of domestic monetary targets. A minimum of policy consensus will be necessary for such a system to thrive. Countries cannot take each others' views into account if these are impossibly divergent. At present, it seems that sufficient consensus exists for the system to survive and perhaps evolve towards a more coherent approach to economic policy as a whole and not just exchange rate policy. Progress will be very slow.

- In the early 1980s German policy dominated the EMS. Other countries accepted this because they wanted to reduce inflation and German policy gave them credibility. Germany benefited from an undervalued exchange rate.

- Policy priorities outside Germany have now changed with unemployment now a greater concern. This could lead to a conflict between Germany and the other countries, especially when there are external events like a fall in the dollar. Despite the greatly reduced inflation differentials, this could contribute to realignments.

- Dismantling of exchange controls also implies the need for change because the former style of reactive realignments is no longer possible.

- One possible development is for Germany to give up some of its power. This cannot be handed to a European central bank because the political consensus does not exist. Moreover, laws passed this year require that every member nation's parliament must pass further legislation before it can happen, so it remains many years ahead.

- The French envisage a more explicit co-ordination of economic policy-making in EMS countries, with joint monitoring of economic indicators and joint agreement on target zones against the dollar and yen.

- The French are also pressing for significant rule changes promoting greater equality, which do not need legislation.

- The French proposals for rules changes would allow central banks to hold other EMS countries' currencies. This would in practice mean a build-up of DM holdings outside Germany and hence a lessening of the Bundesbank's control over the immediate supply of DMs at any time. Improved credit facilities, for intramarginal intervention, and a greater role for the ECU, are also proposed and would have a similar effect.

## Conclusion

So to conclude, what are the broad policy options facing the EMS countries and in particular the U.K.? And which of these is likely to be adopted?

For the U.K. the first option is to continue with the MTFS broadly specified in the way it is at the moment, with a formal target for M0, an informal commitment to exchange rate stability, and a reliance upon supplementary indicators of financial conditions as leading indicators of inflation. This would seem to offer a proper safeguard against a resurgence of inflation and some prospect of a further reduction. However, further progress against inflation would be difficult given the entrenched nature of expectations at the current level. And uncertainty about the government's policies and objectives would mean that the high risk premia demanded by the financial markets would persist.

The move to greater exchange rate stability since the Paris Accord will help to minimise uncertainty and in particular the effect on industry. However, it would be politically difficult for the U.K. to maintain an informal parity with the Deutsche mark as the Swiss and the Austrians have.

Formal membership of the EMS could offer the U.K. some help – though the evidence suggests this would be marginal – in breaking the impasse that seems to have been reached on inflation. It seems that people believe that inflation is unlikely to fall significantly further. Although the U.K.'s industrial cost performance is now much closer to that of our European partners than in 1978, inside the EMS, further progress would have to be made if periodic realignments are to be avoided. U.K. membership of EMS would signal the government's resolve to secure further reductions in inflation. Although it would take time for full credibility to be built up, there could be some immediate effect on expectations in financial markets and, perhaps, among industrialists.

Other EMS countries greatly value the disciplinary benefits of adjustable-peg exchange rates and have been prepared to sustain overvaluation in order to maintain them. As a result, the Bundesbank has effectively set the pace and other EMS members have ultimately been prepared to follow at least part of the way. However, this situation is changing. One strong argument for British entry is that it gives the U.K. a stake in discussions about the future of EMS and a more important seat at the negotiating table.

If the current discussions bear no fruit, the EMS is likely to face as many and as frequent realignments as in the past. This is because the convergence of inflation rates will be offset by divergence in policy objectives and erosion of exchange controls.

British entry in those circumstances would add to policy credibility but only very marginally, especially if the pound was frequently devalued against the DM. On the other hand, rigid adhesion to a DM rate would be politically difficult when German economic objectives diverged from those of partner states, especially if Germany took no account of the divergence.

A system in which the commitment to exchange stability was reflected in the economic policy of all participants would be politically more acceptable in the U.K. At the same time, it would risk losing the underpinning of the Bundesbank's resistance to inflation, which is one of the main attractions of the EMS.

The circle would, in principle, be squared if the Bundesbank accepted some loss of short-term monetary control, strictly conditional on partner countries adhering to certain indicators for monetary and/or nominal GNP growth. Then the Bundesbank's credibility would be transferred to a broader range of indicators, which would guarantee control of European inflation. The Bundesbank would, of course, have the sanction of reverting to strict *domestic* monetary control if the indicators were breached. The system would nonetheless be slightly more multilateral in that setting the indicators would be a matter of international negotiations. Targets would be set cooperatively but policies reinforced by Bundesbank credibility.

The U.K. could fit into such a system, adhering closely to a fixed DM exchange rate in the knowledge that it would have some influence on collective monetary policy, especially exist at a time of external disturbances. The U.K. therefore has an interest in joining in the argument for such a development.

The resistance to change is considerable however, and progress may be slow. The chances of U.K. entry in the meantime have improved since last year but are not yet strong. A longer period of 'wait and see' is probable.

If the U.K. does join, we expect some decline in U.K. interest rates as international investors respond favourably. The immediate impact would be modest however, and not enough to threaten monetary control. U.K. rates would decline only slowly towards German rates over time with the experience of greater exchange rates stability. During this period, the volatility of U.K. interest rates would be reduced, so long as fiscal policy remained on a steady course.

## Basic Guide to the EMS, the ECU and the ERM

In this Annex we describe the technical mechanisms of the EMS. These are not only of interest in themselves, but also provide an insight into the **asymmetry** of the system, which usually encourages countries with weakening currencies to take action before countries with strengthening currencies.

### Formal Development of the EMS

The European Monetary System (EMS) was established by a Resolution of the European Council (Heads of State and Government of the European Communities) on 5th December 1978. The objective was to create a "zone of monetary stability in Europe". The system came into operation on 13th March 1979, and on that date an Agreement among the participating central banks established guidelines for operation of the system.

The original hope of those who established the EMS was that the system would develop rapidly, after two years, to a second, final phase. That "second phase" would see creation of a supranational European central bank and a more definite institutional framework for the EMS.

That hope was not realised. The creation of a European reserve currency and central bank would entail a more thorough-going surrender of national sovereignty in the area of monetary policy than, in the event, countries were prepared to undertake. Instead, there has been considerable informal development of the system, permitting a high degree of national autonomy. The participating central banks have evolved lines of communication and intervention practices. Modest technical changes were made to the formal intervention rules, agreed on 10th June, 1985 and effective at the beginning of the following month. These changes were intended to encourage the use of the ECU as an intervention currency. Also important, France has dismantled most of its exchange controls over the last year and Italy is starting the same process.

More recently, the Single European Act was agreed by Ministers late in 1985 and passed into law in the EC member countries during the first half of 1987. This Act contains various amendments to the Treaty of Rome (the original treaty establishing the European Economic Community). One of these amendments gives formal recognition to the EMS and the ECU, but specifies that institutional changes will be subject to article 236 of the Treaty of Rome. This means that the establishment of a European central bank will require not just agreement among Ministers but also legislation in the parliaments of all member countries.

### The ECU: "Fixed Amounts" versus Weights versus "Central Rates"

The ECU is central to the operation of the EMS, because it is used to determine the point at which intervention occurs. The originators of the EMS hoped that the ECU would play a further role in the EMS, as a reserve currency. However, the rules of the EMS have not encouraged this (see section on "intervention" below) and in practice the ECU has played only a limited role in the intervention system.

A quantity of official ECUs were created in 1979 when the EMS was established and the participating central banks, including the U.K., deposited 20 percent of their gold and currency reserves with the European Monetary Cooperation Fund (ECMF) and received an equivalent amount of ECUs. Being fully backed by other reserves, these ECUs do not represent an addition to liquidity, and as explained below there are limitations on their use in intervention.

In contrast to its limited official use, the ECU is now used as a major currency of denomination of Eurobond issues. There were some $19 billion of such issues outstanding at the end of 1986 and over $6½ billion issues in 1986[1]. The ECU is also the accounting unit for EEC finances and it is the currency of denomination of some travellers cheques.

## Fixed Amounts

One ECU is **defined** as the sum of fixed amounts of nine European currencies. These amounts are shown in the table below.

In other words, if I have 71.9 German pfennigs, 1 French franc and 31 centimes, 8.78 U.K. pence, 140 Italian lire, etc, then I have exactly one ECU.

At the time when they are fixed, these amounts reflect the relative GNP of the various countries, their trade and the currency's importance for short-term finance. However, changes can only be made with the unanimous agreement of the European Council of Ministers. The Council's aim in making any changes is to minimise disruption to the ECU markets, and so in practice it has been reluctant to make changes.

The amounts have only been changed once, in 1984, since the ECU was created at the end of 1978 (Council Regulation 3180/78 of 18th December 1978). By statute, they must be reviewed every five years and in 1989 they will be amended to include the Spanish peseta and Portuguese escudo. Member countries can request revisions (if currency movements have altered their weight – see below – by more than 25 percent since the last revision). Italy requested such a revision twice in the early 1980s but was turned down both times.

So in practice, the Fixed Amounts are normally changed every five years.

## ECU Central Rates

By contrast, the Central Rates have been changed 11 times in the eight years since the ECU was created. Such changes are commonly referred to as "EMS realignments".

**ECU Central Rates**

| | | | |
|---|---|---|---|
| Belgian Fr | 42.4582 | Danish Kr | 7.85212 |
| French Fr | 6.90403 | Irish Punt | .768411 |
| Lira | 1483.58 | Greek Dr | 150.792 |
| Dutch Fl | 2.31943 | Sterling | .739615 |
| D-mark | 2.05853 | | |

The current central rates, in force since 11th January 1987, are shown in the table above. These are in effect targets for the exchange rate between the ECU and each of the European currencies. The central banks use intervention and other instruments to try to keep their currencies within a narrow band around these central rates (see below).

1. See "A Guide to the ECU Bond Market", CSFB Research, September 1986.

# One Ecu is equal to:

| | |
|---|---|
|  | 71.9 pfennig |
|  | 1 Franc 31 centimes |
|  | 8.78 pence |
|  | 140 lire |
|  | 0.256 guilder |
|  | 3.85 Belgian francs |
|  | 0.219 Danish krone |
|  | 0.871 Irish penny |
|  | 1.15 Greek drachma |

Dividing one central rate by another gives the target cross rate between each pair of European currencies. These are known as "Cross Parity Rates". For example, the FFr/DM cross-parity rate is currently 6.90403/2.05853, which equals 3.35386.

Changes in the central rates (i.e. EMS realignments) usually occur when it ceases to be possible to keep market rates within the narrow bands.

**Variable Weights**

Even though the fixed amounts of each currency in the ECU normally change only every five years, the weights of the various currencies alter daily. (There is also a concept, which we will call Central Currency Weight, which is the weight of each currency computed at the central rates. The Central Currency Weights alter only when the fixed amounts are changed or when there is a realignment.)

To understand why the weights change daily, imagine what happens when the French franc weakens slightly against the ECU, while the Deutsche mark strengthens. This happened between 17th and 18th June 1987, and the relevant figures are shown below.

| | 17th June | 18th June |
|---|---|---|
| 1) French Franc per ECU—market rate | 6.93412 | 6.93574 |
| 2) Deutsche mark per ECU—market rate | 2.07751 | 2.07617 |
| 3) French Franc per DM—market rate | 3.3377 | 3.3406 |
| 4) Currency Amount for FFr—FIXED | 1.31 | 1.31 |
| 5) FFr Currency Amount converted to ECU at current market rate (i.e. 4 divided by 1) | 0.18892 | 0.18888 |
| 6) Currency Amount for DM—FIXED | 0.719 | 0.719 |
| 7) DM Currency Amount converted to ECU at current market rate (i.e. 6 divided by 2) | 0.34609 | 0.34631 |

The currency amount for the French Franc is fixed at 1.31 (line 4), but because the French Franc has weakened slightly, that amount is worth slightly fewer ECU on 18th June than it was on the 17th (line 5). Thus the French Franc's weight in the ECU has fallen, from 18.892 percent to 18.888 percent. Meanwhile, the weight of the Deutsche mark has risen (line 7).

Over a number of years, the weights can move by a large amount. This is because the Currency Amounts usually remain fixed for five years, during which time there are realignments of the central rates, allowing the market exchange rates to move substantially. Thus the weight of strong currencies such as the Deutsche mark tend to rise, while the weight of weaker currencies such as the lire tends to fall[1]. As noted above, a country can ask for a re-assessment of the Currency Amounts when its weight has altered by more than 25 percent since the last change.

1. See "The Humped Synthetic Yield Curve", CSFB Research, June 1987, for an analysis of the effect of this on ECU bond yields.

The Central Currency Weights introduced on 11th January 1987 are shown in the table below.

**Central Currency weights**

| | (1) Currency amounts in ECU (fixed) | (2) ECU% weight central rates | (3) in ECU basket |
|---|---|---|---|
| Belgian fr | 3.85 | 42.4582 | 0.07 |
| French fr | 1.31 | 6.90403 | 18.97 |
| Lira | 140 | 1483.58 | 9.44 |
| Dutch fl | .256 | 2.31943 | 11.04 |
| D-Mark | .719 | 2.05853 | 34.93 |
| Danish Kr | .219 | 7.85212 | 2.79 |
| Irish punt | .0087 | .768411 | 1.13 |
| Greek dr | 1.15 | 150.792 | .76 |
| Sterling | .0878 | .739615 | 11.87 |
| TOTAL | (with rounding errors) | | 100.00% |

*Relationship between columns:*
(3)=(1) expressed as a percentage of (2)

## The Exchange Rate Mechanism

The Exchange Rate Mechanism (ERM) is the system for keeping exchange rates close to the ECU Central Rates.

The ERM allows exchange rates to move a limited distance away from the Central Rates. There are two types of indicator which show when the movement has gone too far: the Divergence Thresholds; and the Parity Limits (these are defined later).

As the exchange rate of one currency diverges from the rest, it initially reaches its Divergence Threshold. This is a measure of its divergence from all the other currencies in the system. The Central Bank of the currency in question is expected, but not obliged, to intervene or take other action when this happens. In practice, this provision usually affects weakening currencies and not strengthening ones.

If the currency movements continue, the market exchange rate of the weakening currency will reach its Parity Limit against one (or more) of the other currencies. At this point it becomes mandatory for intervention or other action by the Central Banks of *both* the weakening currency and the strengthening currency.

Thus the ERM has an in-built *asymmetry* that tends to place a greater emphasis on early action by countries with weakening currencies, although ultimately action is required by both.

**Definitions**

Parity Limits are derived from Cross-Parity Rates, which are ratios of the ECU Central Rates (shown in table ... above). For example, the Cross Parity Rate between the French Franc and the Deutsche mark set on 11 January 1987 was 6.90402 divided by 2.05853, equals 3.35386. The corresponding Parity Limits are 2¼ percent above and below this figure, i.e. 3.42932 and 2.28006. For the Italian lira, the Parity Limits are 6 percent either side of the Cross-Parity Rates.

The Divergence Thresholds are three-quarters of the deviation that would put a currency at its limits against every currency in the ECU, and are defined in terms of the exchange rate between a currency and the ECU. However, Divergence Thresholds are not equal to the ECU Central Rates plus or minus 2¼ percent times three-quarters. Instead, the Divergence Thresholds are narrower than this, because movements in each currency affect the ECU itself, and an adjustment is made to allow for this. A further adjustment is made for all currencies apart from the lira to allow for movements in sterling and the lira of greater than 2¼ percent, and the thresholds for thc lira are adjusted when the sterling-lira rate is greater than 6 percent from its Cross-Parity Rate.

**Divergence Limits**

| | (1) Currency amounts in ECU (fixed) | (2) ECU central rates | (3) % weight in ECU basket | (4) 100 minus currency weight (%) | (5) divergence limit (%) |
|---|---|---|---|---|---|
| Belgian fr | 3.85 | 42.4582 | 0.07 | 90.93 | 1.5345 |
| French fr | 1.31 | 6.90403 | 18.97 | 81.03 | 1.3673 |
| Lira | 140 | 1483.58 | 9.44 | 90.56 | 4.0754 |
| Dutch fl | .256 | 2.31943 | 11.04 | 88.96 | 1.5012 |
| D-mark | .719 | 2.05853 | 34.93 | 65.07 | 1.0981 |
| Danish kr | .219 | 7.85212 | 2.79 | 97.21 | 1.6404 |
| Irish punt | .0087 | .768411 | 1.13 | 98.87 | 1.6684 |
| Greek dr | 1.15 | 150.792 | .76 | 99.24 | — |
| Sterling | .0878 | .739615 | 11.87 | 88.13 | — |
| TOTAL | | (with rounding errors) | 100.00% | | |

*Relationship between columns:*
(3)=(1) expressed as a percentage of (2)
(4)=100 minus each currency's weight in ECU basket
(5)=¾ of parity grid limit multiplied by (4)/100
Examples:
French franc limit=0.75 x 2.25% x 81.03/100=1.3673%
Lira limit =0.75 x 6.00% x 90.56/100=4.0754%

The resulting Divergence Thresholds and notes on calculation are shown in the above table. Typically, the thresholds are close to or just above 1 percent, with a lower margin for higher-weight currencies such as the French franc and Deutsche mark, and a higher margin for the lira because of its 6 percent band.

**The Divergence Thresholds in Practice**

The Deutsche mark has a high weight in the ECU, with this weight tending to rise over time (see above). In addition, the Dutch guilder is linked to the German currency in a "mini-EMS", under which the Dutch Central Bank normally holds the Guilder in an extremely narrow band of just ... percent against the Deutsche mark. The Central Currency Weight of the DM-guilder block is 46.01 percent and on a daily basis the weight becomes even higher when the Deutsche mark is strong.

Because of this high weight, it is usual for a weakening currency to hit its Divergence Threshold before the (strengthening) Deutsche mark hits its.

**Intervention**

Intervention under the ERM is of two types: at the parity limits (i.e. when currencies have moved the maximum permitted amount); and intervention within these parity limits (often called "intramarginal" intervention).

**Intervention at the Parity Limits**

Intervention at the parity limits operates as in a fixed exchange rate regime. When the exchange rate between a pair of currencies reaches the parity limit, then the central banks whose two currencies are involved will trade unlimited amounts at that rate with any commercial bank. This is **obligatory** under the EMS rules. The action of the central banks is thus passive. They stand ready to trade rather than taking a decision on the size of intervention to be used.

There is no reason to expect commercial banks to approach one of the two central banks involved in preference to the other. So it is likely that the central bank with the strong currency would have to provide support of the same order of magnitude as that provided by the central bank with the weakening currency.

The central bank whose currency is weakening can borrow the necessary funds from the other central bank automatically, under the "very short-term financing facility". Claims and debts arising from this borrowing are settled subject to rules laid down in the EMS 1979 Agreement (as amended in 1985), although in practice the debts are usually settled by mutual arrangement, without the need to apply the formal rules.

The debtor central bank, which would have had the weak currency, is allowed to settle up to 50 percent of such debt in ECUs. A higher proportion of ECUs can be used with permission of the creditor bank or, following the changes agreed in June 1985, to the extent that the creditor central bank is itself a net debtor in ECUs.

**Intramarginal Intervention**

In the early years of the EMS, obligatory intervention at the parity limits accounted for a substantial part of the total. More recently, central banks have moved to keep their exchange rates generally within narrower bands and so most intervention is now intramarginal, i.e. it occurs before currencies reach their parity limits. However, there are still periods of heavy intervention at the parity limits, for example in April 1986.

Intramarginal intervention is not obligatory, although the EMS rules suggest that participating central banks intervene or "take other action" (which might include changes in interest rates) when their currencies reach the divergence indicator.

The very short-term financing facility (under which the central bank with a strong currency loans unlimited amounts of its currency to a central bank with a weakening currency) is not available for intramarginal intervention. The original EMS 1979 agreement made no provision for central banks to use ECUs to settle debts arising from intramarginal intervention. The amendments made in 1985 allow central banks to make limited use of their ECU holdings for intramarginal intervention by swapping them into dollars for up to three months, but the ECUs can only be swapped into another EMS currency with the permission of the central bank issuing that currency.

Thus a central bank with a weakening currency must rely almost entirely on its own foreign currency reserves (in practice mainly dollars) to finance intramarginal intervention, unless a central bank with a strengthening currency is voluntarily prepared to help. The rules of the EMS provide almost no assistance. To some extent, the EMS rules obstruct intramarginal intervention, by restricting the holdings of other member countries' currencies.

This anomaly seems to exist because the originators of the EMS expected intervention at the parity limits to be important, as it was in the early years, while intramarginal intervention was expected to be less significant than it has turned out to be in recent years. Why has the greatly increased use of intramarginal intervention not led to a more comprehensive revision of the rules than the very limited changes that occurred in 1985? One explanation may be that informal arrangements have worked so well that there has been no pressing need for formal change. However, Balladur's proposals of June 1987 (see Section IV) suggest that the French, at least, are now anxious for the rules to be amended to reflect the altered reality of the system.

**Table 2**

| Real Exchange Rate Volatility (Against DM) | | Monthly Basis |
|---|---|---|
| U.K. | Pre EMS | 9.66 |
| | Post EMS | 9.73 |
| France | Pre EMS | 6.41 |
| | Post EMS | 4.50 |
| Netherlands | Pre EMS | 3.94 |
| | Post EMS | 1.97 |
| Italy | Pre EMS | 9.07 |
| | Post EMS | 3.74 |

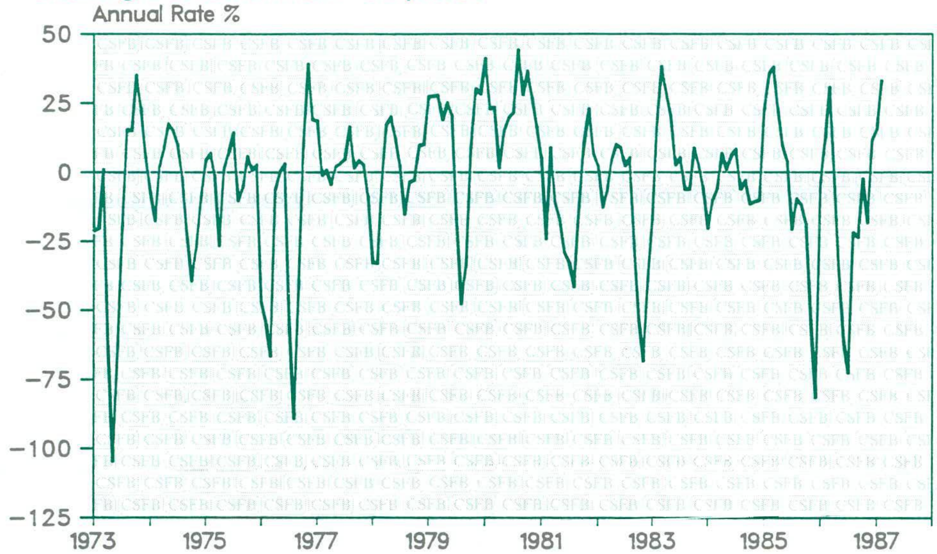
**Note:**
Exchange rates deflated by consumer Prices.
Volatility as in Table 1.

Because exchange rates move much more quickly than goods prices, volatility of nominal exchange rates translates quite directly into volatility of real exchange rates. Table 2 confirms that, showing monthly volatility of real exchange rates in four countries against the Deutsche mark.

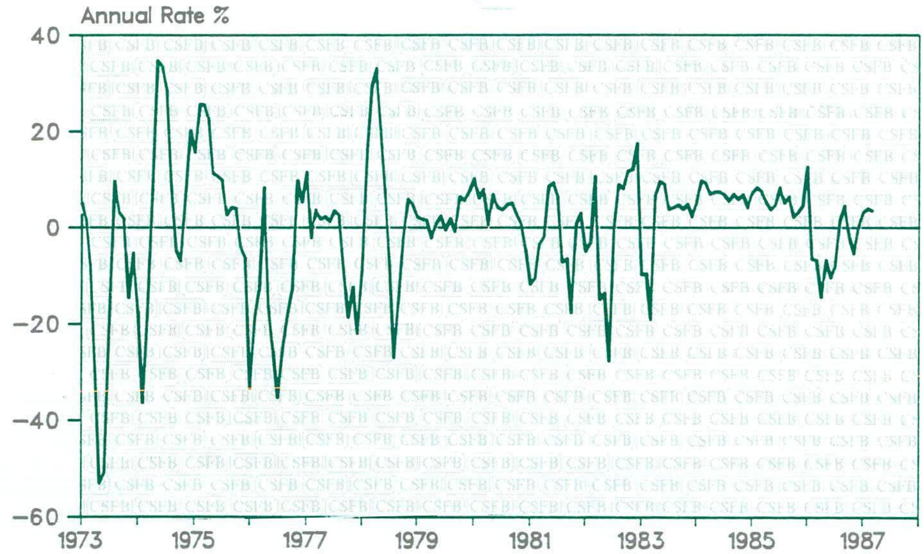
These summary measures do not control for the possibility that the determinants of exchange-rate volatility behaved differently between the two periods, so that exchange rates would anyway have been less volatile in the 1980s.The different behaviour of sterling suggests that is not so, but it is far from conclusive.

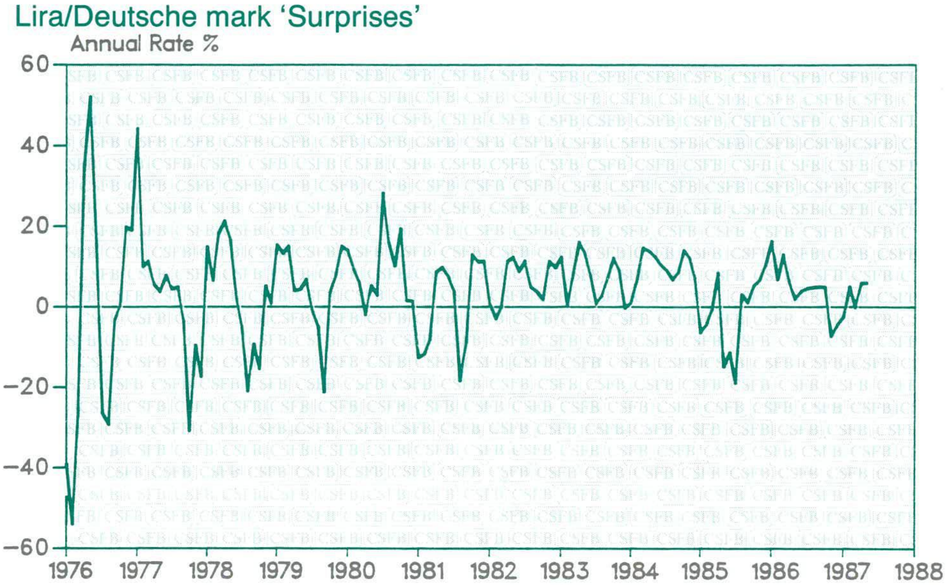
Further evidence is provided by exchange rate ''surprises'' since 1973, as shown in the charts. The amplitude of sterling surprises has not changed over the period; there has been a moderate reduction in amplitude of ''surprises'' to the franc and larger reductions for the Italian lira and Dutch guilder since institution of the EMS in 1979. These ''surprises'' are calculated as follows. The percentage difference between the spot and three-month forward exchange rate in each month is compared with the actual change of the spot rate over the following three months. Arbitrage in the market ensures that the percentage difference between spot and forward rates equals the difference between Euro interest rates in the two currencies concerned. However, the forward rate will only equal the expected future spot rate if there are enough risk-taking speculators in the market prepared to take positions to force the forward and expected spot rates together.

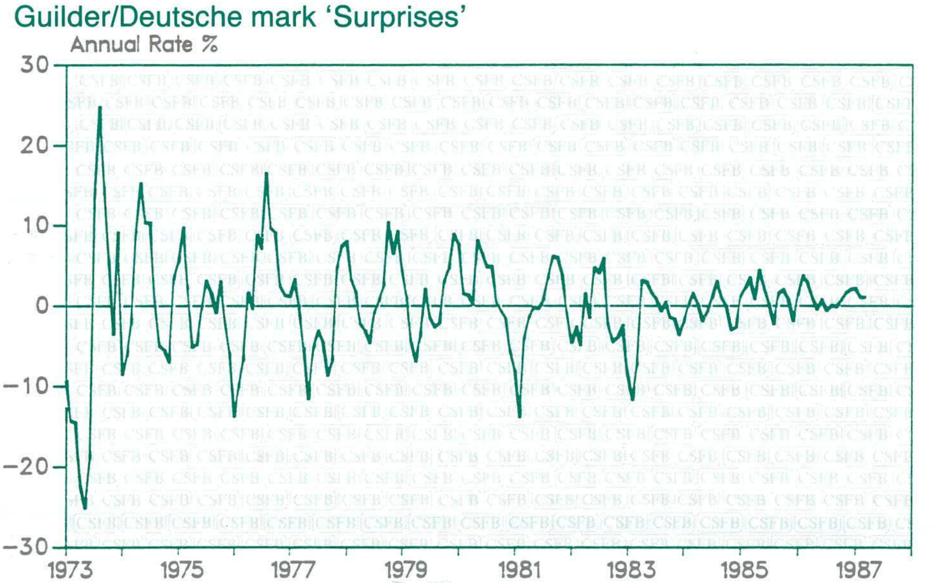
Sterling/Deutsche mark 'Surprises'




French Franc/Deutsche mark 'Surprises'






Much academic research has tended to the conclusion that frequently this condition is not met and that there are systematic divergences between forward rates and expected spot rates. That means that the measure of "surprise" used here not only embraces genuine surprises, but also possible risk premia that prevent market operators equalising forward rates and expected spot rates. It is most unlikely that these risk premia would be large and variable enough to upset the conclusion suggested by the charts. It is reasonable to conclude that exchange rates have become generally more predictable within the EMS.

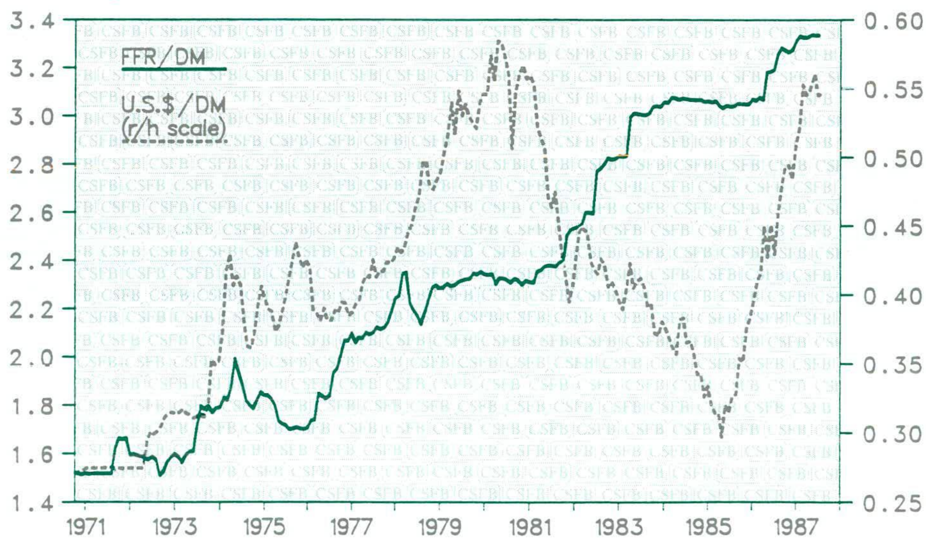
(ii) *Longer-run volatility*

It is frequently asserted that volatility of real exchange rates is bad for trade as it makes businessmen more uncertain about the returns to exporting and forces them to expensive and perhaps difficult exchange-market hedging. In fact, academic research has been unable to trace any substantial effect on trade of short-run exchange rate volatility.

Much more worrying is the tendency for exchange rates under a floating rate regime to make large medium-term swings, which cannot always be explained in terms of fundamentals. It is widely accepted that such swings do distort trade, leading to the elimination of export industries that might be viable in the long run. Furthermore, it is possible that such swings are unstable. If an appreciation eliminates industries and generates a current account deficit, a subsequent depreciation may need to exceed the original appreciation to give enterprises an adequate incentive to re-establish themselves in the affected country.

The most often-cited example of a medium-term exchange rate swing is that of the dollar, which rose between 1980 and 1985 only to fall subsequently. While much of that movement can be explained by fiscal and monetary policy in important countries, not all of it can be. The rise of the dollar through 1984, when the interest differential in favour of dollars had begun to narrow and most market participants were aware that the dollar was fundamentally over-valued, looks like a substantially market-generated movement (though factors such as changes to withholding taxes and exchange controls may also have contributed). What bearing does the EMS have on that sort of phenomena?

Exchange Rate Variations: A Tale of Two Parities



The EMS may well have eliminated some medium-term exchange-rate swings. Since the 1970s, the French franc and the U.S. dollar have depreciated against the Deutsche mark by similar percentage amounts. The dollar has done so with large appreciations and larger depreciations while the franc has done so in a series of steps, all going in the same direction. (See chart.) Since 1979 this could be because the EMS has restricted French fiscal policy while that of the United States has been unrestrained; it could also be due to the role of the EMS in restraining market speculation divorced from fundamentals.

The EMS certainly appears to have had some effect in limiting the size of secular or medium-term exchange rate movements. While the depreciation of the franc against the Deutsche mark in the period 1979-87 has been much the same as in the period 1973-79, the medium-term changes in Italian and Dutch exchange rates have been reduced – considerably so in the case of the lira. In comparison, the change in the sterling exchange rate has been slightly greater in the recent period.

This reduction in cumulative exchange-rate movements has not simply been the result of a narrowing of inflation differentials among EMS countries; there have been important movements in "real" exchange rates. On the other hand, it cannot simply be ascribed to the reduction of destabilising speculation either. Inauguration of the EMS in 1979 marked a more general change of policy regime for some countries. This is examined further in a later section.

## *Interest Rates*

(i) *Variability*

It is often asserted that pegging exchange rates merely transfers volatility elsewhere in the system, specifically to interest rates. They have to absorb shocks to real variables, like fiscal policy, or fluctuations in private sector demand for different currencies.

Interest rate volatility is measured by looking at changes in the average monthly value of the most important three-month interest rate in each country. A complication is the existence of exchange control in European countries, which could prevent interest rate fluctuations. Account is taken of this by looking both at domestic interest rates in each country and Eurocurrency rates in London.

Domestic rates are uniformly *less* volatile in the EMS period than they were before (Table 3). Volatility is reduced in the United Kingdom, which remained outside the EMS, but the reduction in all EMS countries, except France, has been proportionately greater. Exchange controls do not explain that finding. Eurocurrency rates are considerably more volatile than their domestic counterparts but in all cases except one their volatility has also fallen since the set up of the EMS (Table 4). The exception is that of France, where the volatility of the Eurocurrency 3-month rate has greatly increased. This reflects techniques that the French authorities have used to counter speculation against the franc in periods leading to a realignment. Exchange controls have been applied rigorously and Euro-franc rates driven up to squeeze and discourage speculators.

Notably, most of the volatility in Euro-franc interest rates occurred in the period 1981-82 when France was following expansionary fiscal policies, radically out of step with those being pursued elsewhere. During that period, the exchange rate itself was more volatile than at other times, with three realignments in close succession. The volatility of Euro-franc rates for the period 1979-80 and 1983-87 was less than in the pre-EMS period.

Just as interesting are the other dogs that failed to bark – the absence of increased interest-rate volatility in Italy and the Netherlands. In the case of Italy, the permissible bands of deviation for the lira against the ECU are wider than for other currencies – 6 percent. It is possible that this permitted the authorities to manage the exchange rate without any increase in interest rate volatility. That does not seem a satisfactory explanation however; note that weekly exchange rate volatility for the lira did fall. Moreover, the reduced volatility of Dutch interest rates can owe nothing to wider bands of fluctuation; bands of 2¼ percent apply to the guilder and the currency has generally moved well inside them.

It is of course possible that other determinants of interest rates were more stable in the 1980s than they had previously been. An attempt to assess that has been made by two Italian economists in academic work. Giavazzi and Giavannini estimated equations for interest rates in EMS countries and then measured the volatility in the residuals of those equations – the part not explained by systematic influences like government fiscal and monetary policy[1]. They found that the residuals in French interest rate equations were more volatile in the EMS period but the Italian residuals were less volatile.

**Interest Rate Volatility**

| | | Eurocurrency Rates | Domestic Rates |
|---|---|---|---|
| U.K. | Pre EMS | 45.41 | 36.65 |
| | Post EMS | 26.15 | 28.96 |
| France | Pre EMS | 46.11 | 22.79 |
| | Post EMS | 58.26 | 20.54 |
| Netherlands | Pre EMS | 73.36 | 70.67 |
| | Post EMS | 26.05 | 22.79 |
| Italy | Pre EMS | 90.54 | 26.53 |
| | Post EMS | 63.08 | 13.61 |

**Note:**
Eurocurrency Rates are London 3 month deposits.

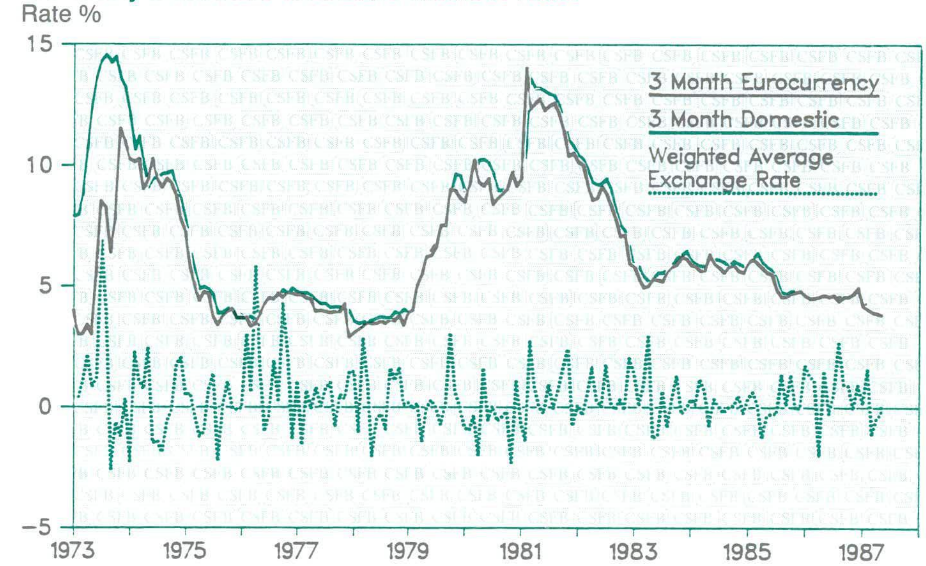
Domestic Rates are:
U.K., France and Italy: 3 month treasury bills;
Germany: 3 month money market average;
Netherlands: 3 month treasury paper.

Volatility is defined as the standard deviation of month-to-month changes in average interest rates.

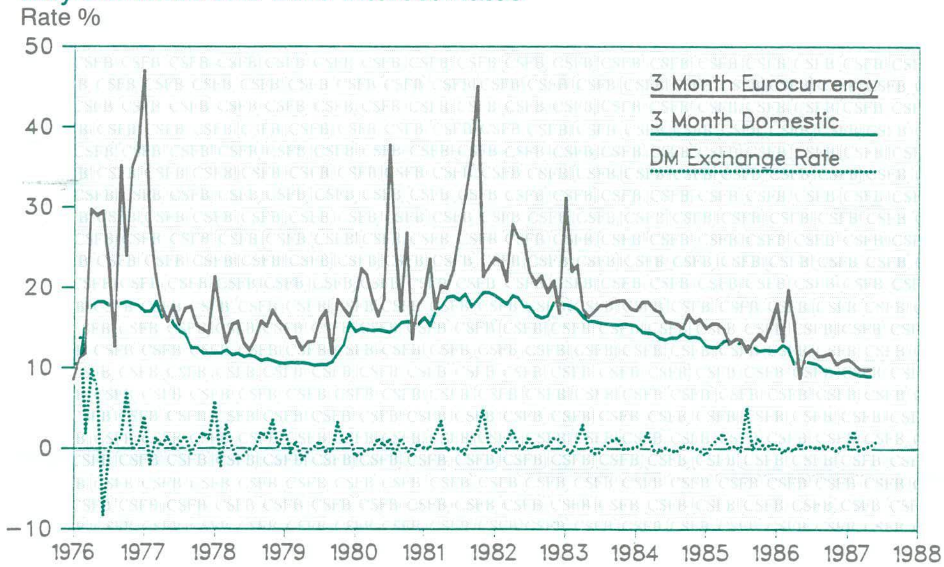
Source: Datastream.

1. ''Models of the EMS: Is Europe a Greater Deutsche mark Area?'', Francesco Giavazzi and Alberto Giovannini, paper to International Economic Association Conference on: Global Macroeconomics: Policy Conflict and Cooperation, London, February 1987.

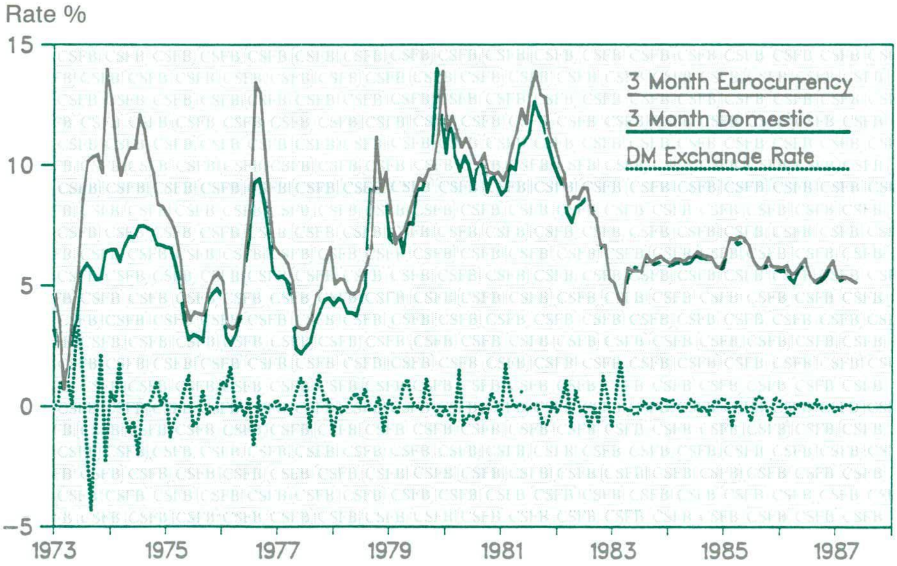
Germany Domestic and Euro Interest Rate




Italy Domestic and Euro Interest Rates



Netherlands Domestic and Euro Interest Rates

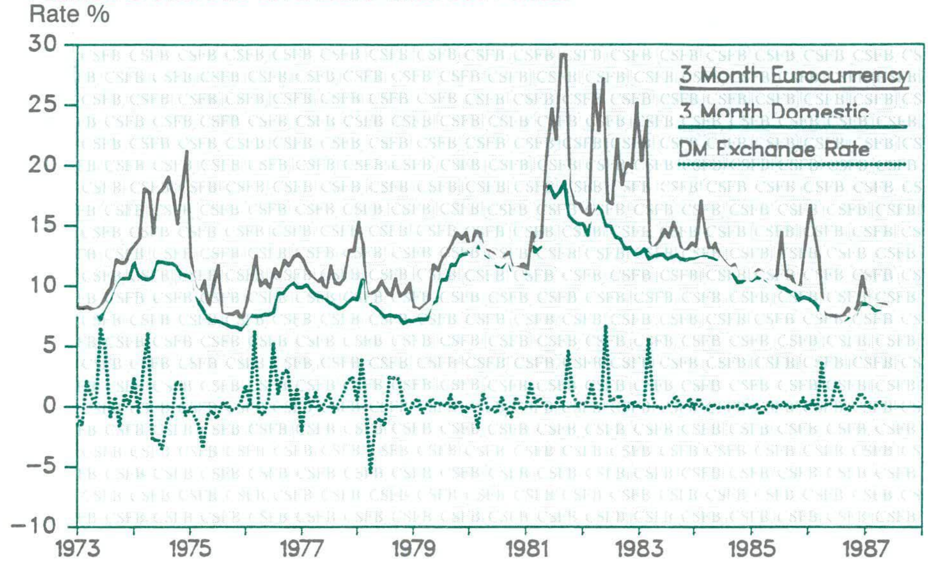



That means the greater stability of Italian interest rates cannot be explained simply. It also means, ostensibly, that measured policy variables alone cannot explain the greater volatility of French interest rates.

Nonetheless, it is quite clear that the presence of exchange controls has succeeded in damping fluctuations in domestic interest rates in some European countries.Table 3 shows the greater volatility of Euro-currency rates. The charts graph domestic and Euro three-month rates against monthly movements in the exchange rate. For all countries except Germany, the exchange rate is measured as units of domestic currency per DM (so a rise in the index represents a dcpreciation of the currency against the DM). For Germany the exchange rate index is a trade-weighted average of the rates against the other four currencies.

While the German, British and Dutch Euro rates closely follow the domestic interest rate, at least over the present decade, for France and Italy there are large discrepancies between the two rates. This is confirmed statistically. The correlation between the pairs of interest rates is well above 95 per cent in thc first three countries this decade. In France it is 84 pcrccnt and in Italy only 72 percent.

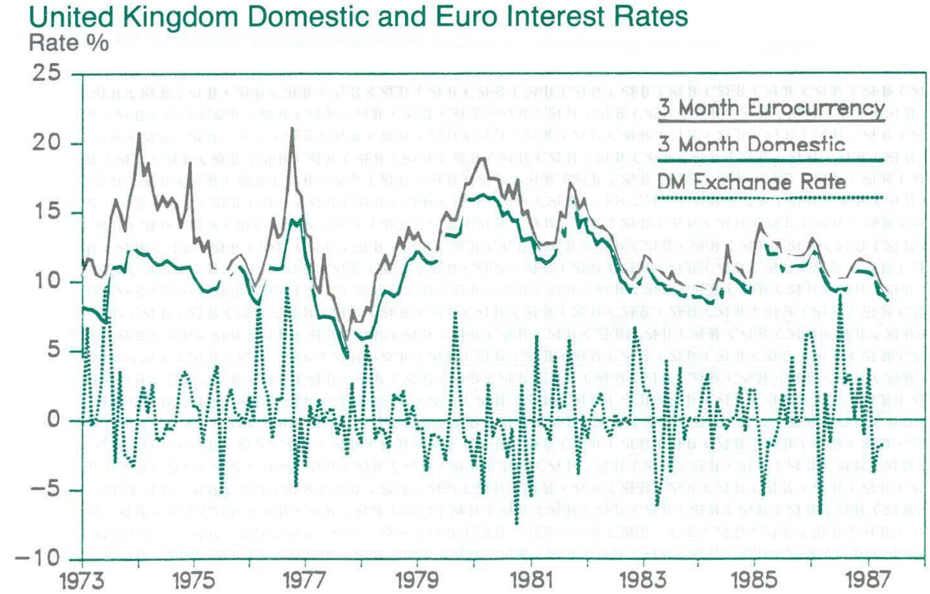
France Domestic and Euro Interest Rates




The chart for France also shows that the largest discrepancies between franc domestic and Euro interest rates occurred in 1981-1982 and again in 1984, immediately before EMS realignments. The link is much less evident between changes in lira parities and spikes in Eurolira interest rates.

It may well be that most movements in exchange rates are either market-generated (i.e. consisting of shifts in asset preferences) or occasioned by shifts in government policy. Other substantial real shocks are rare. If so, and if governments' own policies are steady and compatible with a fixed exchange rate, and if they accommodate shifts in asset preferences, rather than attempting to target the exchange rate and monetary aggregates simultaneously, then more stable exchange rates would imply more, not less, stable interest rates.

United Kingdom Domestic and Euro Interest Rates



As the United Kingdom balance of payments is affected quite differently from that of most other industrialised countries by oil-price movements, sterling tends to be more volatile in the face of such movements. That could rebound on interest rates in a fixed-exchange-rate system. It does not appear to have been a factor in the Netherlands, however, which has extensive exports of natural gas.

(ii) *Level*

It appears to follow from those propositions that assets in different currencies should be closer substitutes under a fixed exchange rate system because reduced volatility implies less risk to holding one currency rather than another. The differential between interest rates should fall or be eliminated.

**Table 4**

**Exchange Rate "Surprises"**

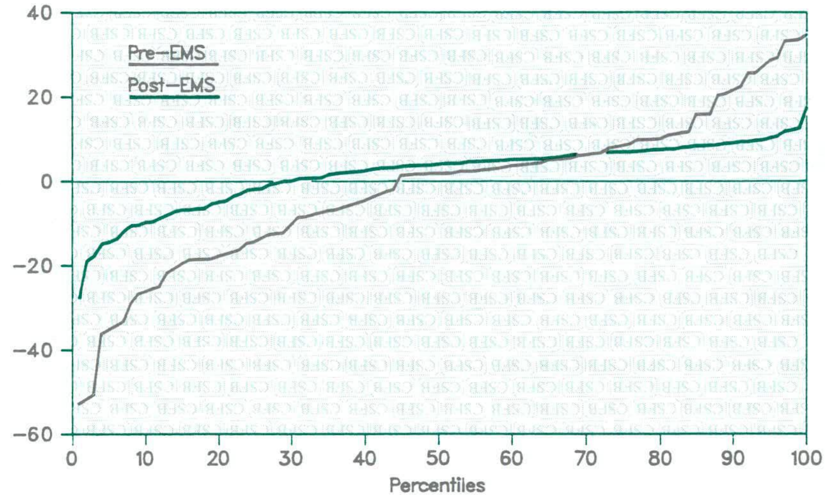
| | | Standard Deviation | Mean |
|---|---|---|---|
| U.K. | Pre EMS | 27.64 | −1.53 |
| | Post EMS | 25.21 | −6.05 |
| France | Pre EMS | 16.12 | −0.80 |
| | Post EMS | 8.35 | 1.55 |
| Netherlands | Pre EMS | 8.19 | 0.26 |
| | Post EMS | 3.17 | 0.12 |
| Italy | Pre EMS | 7.07 | 0.26 |
| | Post EMS | 2.15 | 1.21 |

**Note:**
"Surprises"=3 month Eurocurrency interest rate differentials minus annualised percentage change in the exchange rate in the following 3 months.

Yet that has not generally happened. Consider the exchange-rate "surprises" discussed above. The mean and standard deviation of these is shown in Table 4. The mean is always very small in relation to the standard deviation, implying that markets do not make large systematic mistakes and that any risk premia are small. While the amplitude of the surprises has declined, as shown above, their average value has actually risen in France and Italy. This suggests that, if there is a risk premium, it could have increased in those countries.

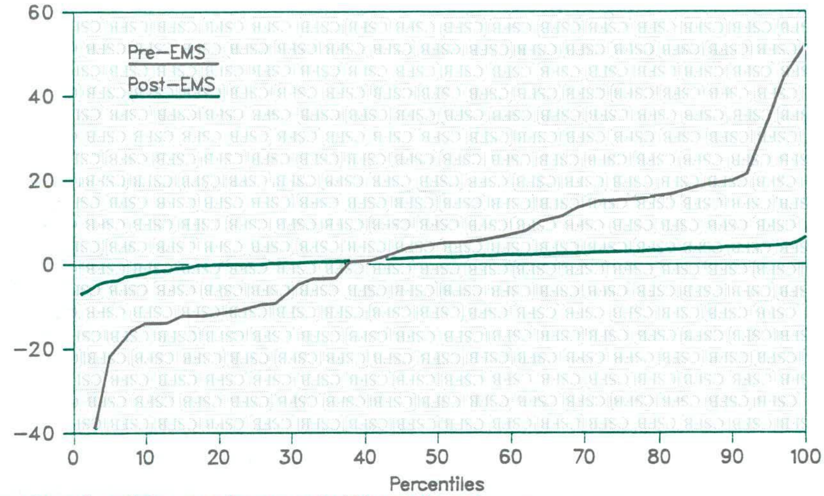
## French Franc/Deutsche mark 'Surprises'

Annual Rate %



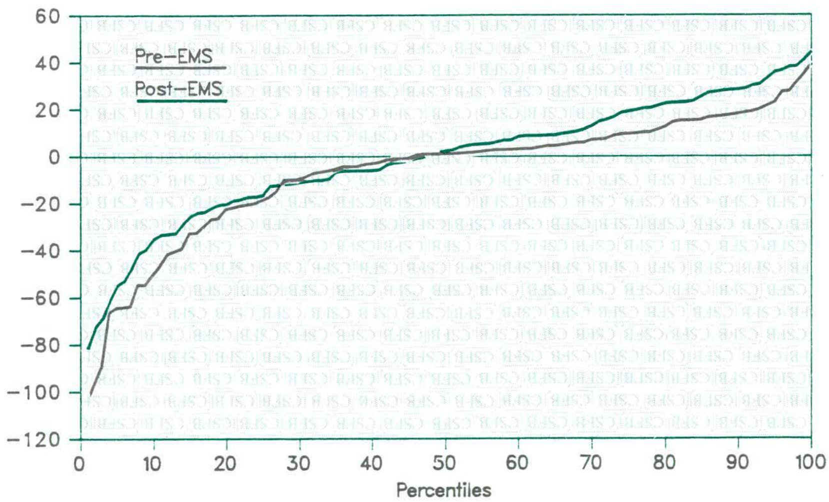

## Lira/Deutsche mark 'Surprises'

Annual Rate %




## Sterling/Deutsche mark 'Surprises'

Annual Rate %



The charts plot the size of surprises against percentiles for the pre-EMS and EMS period. For the lira, before EMS entry, about 36 percent of exchange rate surprises were negative – that is to say, the lira depreciated more than the interest differential and forward exchange rate implied. The biggest errors were also negative. After the EMS, the picture changes radically. Now only 28 percent of the errors are negative. The market usually over-estimated subsequent depreciations of the lira. And the average error becomes clearly positive in the EMS era.

Why should this be so? The change in the percentiles is easily explained if the timing of realignments is not predictable. Then the market has to discount a low probability of a large change (a realignment) in the exchange rate in the coming month. Most months that realignment does not happen and there is a small positive "error". In those months when a realignment occurs the error will be negative and larger, hence the pattern of many small positive errors and a smaller number of larger negative ones.

Less easily explained is why the average error should be larger in the post-EMS period. Why should the market apparently have more difficulty predicting something which has become, if anything, more predictable? The interest differential is systematically implying more depreciation than occurs. The real value of the lira has risen but the market may continue to expect former "real" exchange rates to be re-established.

Alternatively, there may not be a forecast error; the market could be exacting a risk premium for holding lira assets. This risk premium could have been masked by sample bias in the pre-EMS era of larger exchange-rate swings and could merely have become more obvious in a period of relative stability. Alternatively, it could have become larger. The latter would be very surprising. However, there is at least no sign of a *reduced* risk premium for Italy in EMS.

Similar conclusions follow for France. In the U.K., on the other hand, most errors in period since 1979 have been negative (53 percent compared with 35 percent in the 1970s). The mean error has become negative, suggesting that there is a risk discount on holding sterling! At the very least, there is no evidence in these data that sterling assets have to pay a premium for being outside the EMS.

*Symmetry*

There is no visible link between German interest rates and monthly changes in the DM. That is an interesting finding because it bears on the symmetry of the EMS. For most of the period of the EMS, Germany has had lower inflation than its partners and its exchange rate has generally been under upward pressure. If the EMS were a symmetrical system, tending to impose conformity of all countries to some Community norm, there would be reductions in interest rates in appreciating countries as well as rises in depreciating countries.

There is no sign of that. The EMS essentially operates on a Deutsche mark standard. Some corroboration is also provided by studies of movements in official reserves[1]. Of course, that might be an historically specific finding. Over the life of the EMS, inflation has been the chief policy priority in all European countries (apart from a brief period in France in 1981-1982). In those circumstances it is natural that other countries should progressively adapt their policy to that of the least inflationary country.

More recently, Germany has come under increasing international pressure to take more expansionary policy action. That shows two things: first that in other countries, though not in Germany itself, other policy objectives, such as growth and employment, are now regarded as being of comparable importance to inflation; second the belief that further reductions in inflation might conflict with the objectives of growth and employment, at least in the short- to medium-term, has become fashionable once more. These developments pose problems for the future of the EMS which are considered in earlier sections.

## II Policy Harmonisation

Throughout the EMS period, Italy and the Netherlands have used monetary policy to support the exchange rate peg as a means to resist inflation.

**Table 5**

**Past Realignments in the EMS***

| | (1) 24/9/79 | (2) 30/11/79 | (3) 23/3/81 | (4) 5/10/81 | (5) 22/2/82 | (6) 14/6/82 | (7) 21/3/83 | (8) 22/7/85 | (9) 7/4/86 | (10) 4/8/86 | (11) 12/1/87 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| DM | +2 | | | +5.5 | | +4.25 | +5.5 | +2 | +3 | | +3 |
| HFl | | | | +5.5 | | +4.25 | +3.5 | +2 | +3 | | +3 |
| FF | | | | −3 | | −5.75 | −2.5 | +2 | −3 | | |
| BFr | | | | | −8.5 | | +1.5 | +2 | +1 | | +2 |
| LFr | | | | | −8.5 | | +1.5 | +2 | +1 | | +2 |
| LIT | | | −6 | −3 | | −2.75 | −2.5 | −6 | 0 | | |
| DKR | −3 | −5 | | | −3 | | +2.5 | +2 | +1 | | |
| I£ | | | | | | | −3.5 | +2 | 0 | −8 | |

**Note:**
Individual revaluations (+) or devaluations (−), expressed as percentage parity changes against the currencies that did not move (columns (1) to (6), (10) to (11)) or as changes against a fictitious reference rate (columns (7) to (9)).

Source: Commission of the European Communities.

The Netherlands followed a "hard" version of the policy, pegging closely to the Deutsche mark. Every realignment of the DM was followed exactly by the guilder – except one. Only the realignment of March 1983 saw the DM revalue by 5.5 per cent against the ECU, while the guilder went up by only 3.5 per cent (See Table 5).

1. See Giavazzi and Gionvannini, op.cit.

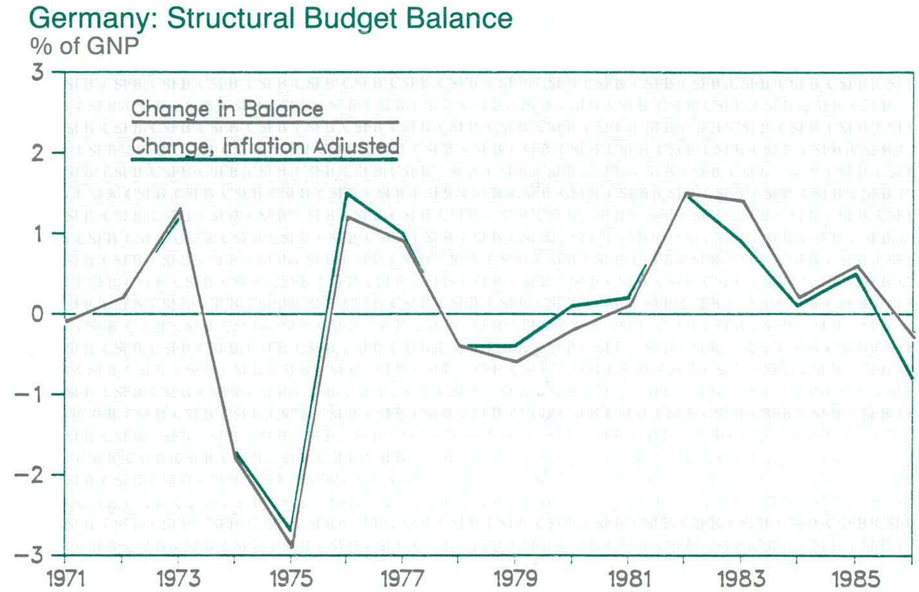
Cumulative depreciation of the guilder over the EMS period has been just 2 percent; with inflation similar to Germany's, the real depreciation, adjusted for consumer inflation, has been much the same.

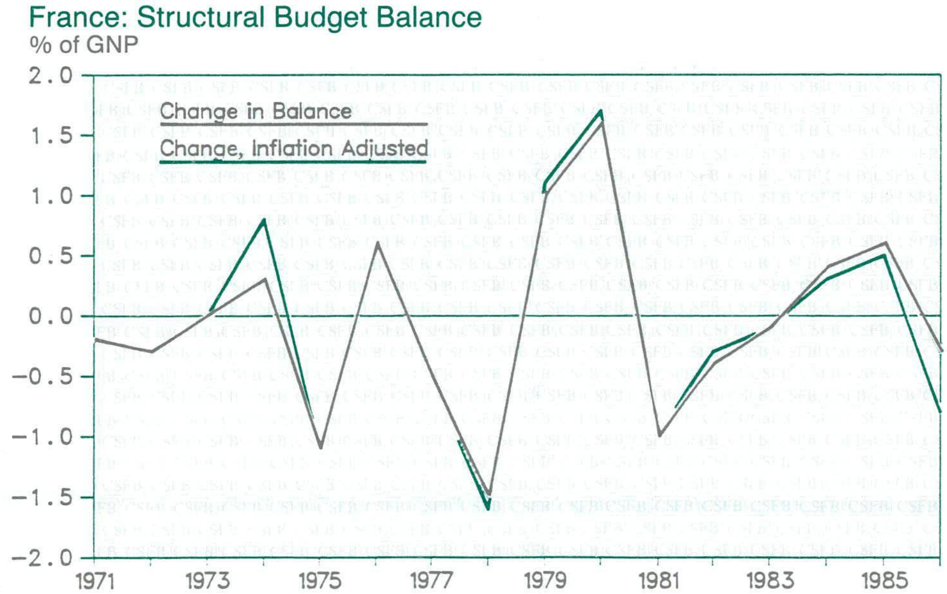
With their higher inflation rate, the Italians followed a more flexible policy, in which, nonetheless, the lira depreciated by less than the inflation differential. Between 1974 and 1979, for example, cumulative lira depreciation of nearly 160 percent resulted in a "real" depreciation, adjusting for differential rates of consumer price inflation, of over 11 percent against the DM. In the subsequent period, the lira depreciated by "only" 48 percent resulting in a real appreciation of 24 per cent.

France in the early 1980s attempted to "buck the trend" of slow growth and recession in the world economy with expansionary fiscal policy. That resulted in a current balance deficit. Monetary policy had no credibility and there were three depreciations of the franc. After 1982, however, France followed a policy more like the Italian one: flexible but causing the franc to appreciate in real terms. For the EMS period as a whole, the franc has appreciated against the DM by nearly 5 percent, adjusted for consumer-price inflation.

At first glance, therefore, it appears that the EMS has had an effect on exchange rates by encouraging a change in government policy. However, it is more correct to look at the EMS as exemplifying a change of policy. After the second oil shock in 1979, governments of industrialised countries were almost unanimous in giving priority to the reduction of inflation. The EMS, operating as an adjustable-peg Deutsche mark standard fitted in with that intention.

Not all countries within the system followed the policy with the same rigour, however. Only the Netherlands followed a hard currency option with full rigour. And countries outside the EMS have also followed a policy of pegging the exchange rate – with or without an occasional discrete parity change. The EMS is neither necessary nor sufficient for such a policy. It might contribute to credibility but that is not sure. It is unclear, for example, that monetary policy in Belgium or Denmark has greater credibility than that in Switzerland or Austria. All those countries in effect peg to the Deutsche mark.

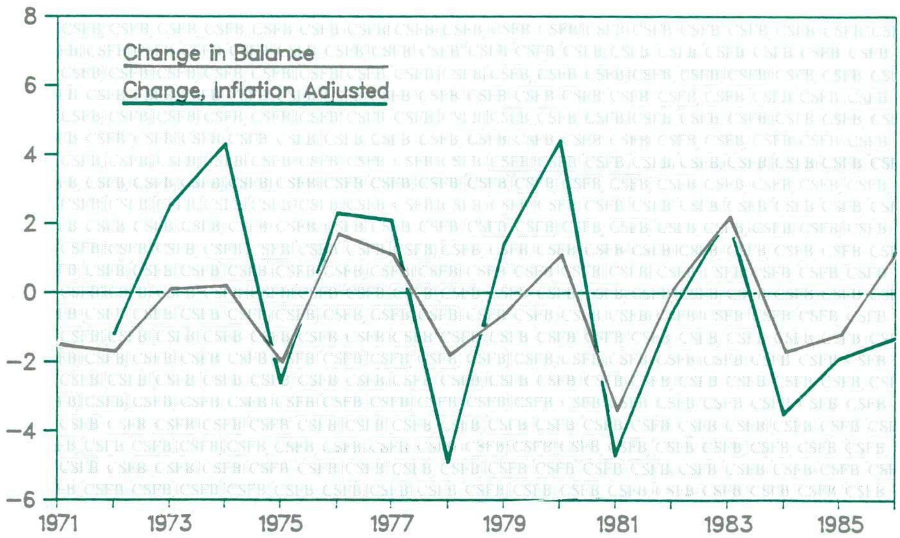


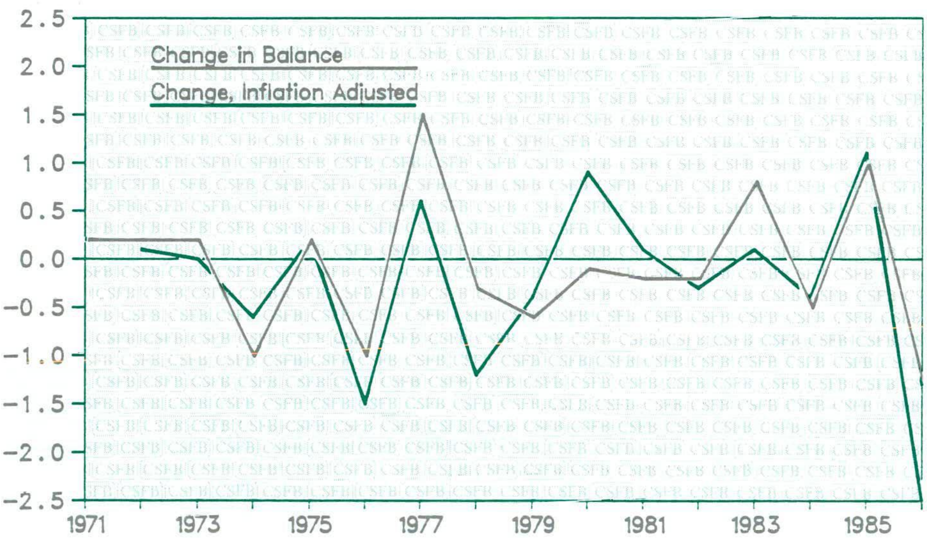

Note: Changes in the structural (i.e. cyclically-adjusted) budget balance are a measure of fiscal policy impulses. For data source see table 6.

## Italy: Structural Budget Balance

% of GNP

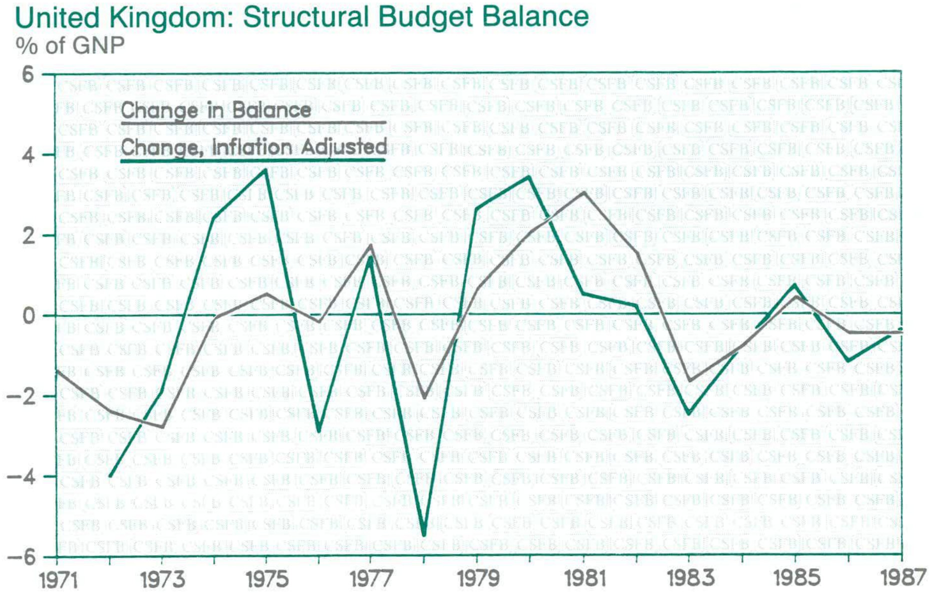



% of GNP




The main instrument used to preserve EMS paritics has been monetary policy, where there has been a convergence compared with the 1970s, in terms of interest rates and growth of monetary aggregates.

It appears there has been little convergence of fiscal policy – though it is hard to measure fiscal policy impulses. As noted, France's fiscal policy stood out for a while before falling into line with that of Germany. For the 1980s as a whole, neither Italy nor the Netherlands has had a net fiscal contraction. Both countries have had periods of contraction and ease. Germany, on the other hand, followed a consistently restrictive fiscal policy between 1981 and 1985, easing only in 1986 (See charts).




The United Kingdom swung to fiscal restriction, beginning in 1979, a couple of years before Germany. It subsequently eased earlier as well.

**Table 6**

**Standard Deviations of Fiscal Impulse**
(per cent of trend GDP)

| | Germany | | France | | Italy | | Netherlands | | U.K. | |
|---|---|---|---|---|---|---|---|---|---|---|
| 1972-78 | 1.5 | 1.5 | 0.8 | 0.7 | 3.1 | 1.4 | 0.7 | 0.8 | 3.2 | 1.6 |
| 1979-1987 | 0.7 | 0.7 | 0.9 | 0.8 | 1.4 | 1.7 | 1.0 | 0.7 | 2.8 | 1.7 |

**Note:**
First column relates to fiscal impulse adjusted for effects of inflation on the stock of government debt; second column is unadjusted. Source of fiscal impulse data; Patrice Muller and Robert W. R. Price, ''Structural Budget Deficits and Fiscal Stance'', OECD Economics and Statistics Department Working Papers No. 15; and Economic Outlook Nos. 40 and 41, OECD, Paris.

In Germany the consistent push to restriction has implied a steady policy in the sense of a similar fiscal impulse each year. In other EEC countries there was no increase in steadiness; standard deviations of annual fiscal impulses were not substantially lower than in the pre-EMS period, 1972-78 (Table 6).

While the EMS has secured monetary convergence it has not really achieved the same thing for fiscal policy. It is very arguable that radically divergent fiscal policies are not in the long run consistent with a fixed exchange rate system but they appear to be not inconsistent in the short- to medium-run with an adjustable peg system.

## III. Macroeconomic Performance

It is unreasonable to look at macroeconomic data for the 1970s and 1980s and hope to find evidence bearing on the efficacy of the EMS. Too many other factors have been at work on the growth and inflation performance of European countries.

**Table 7**

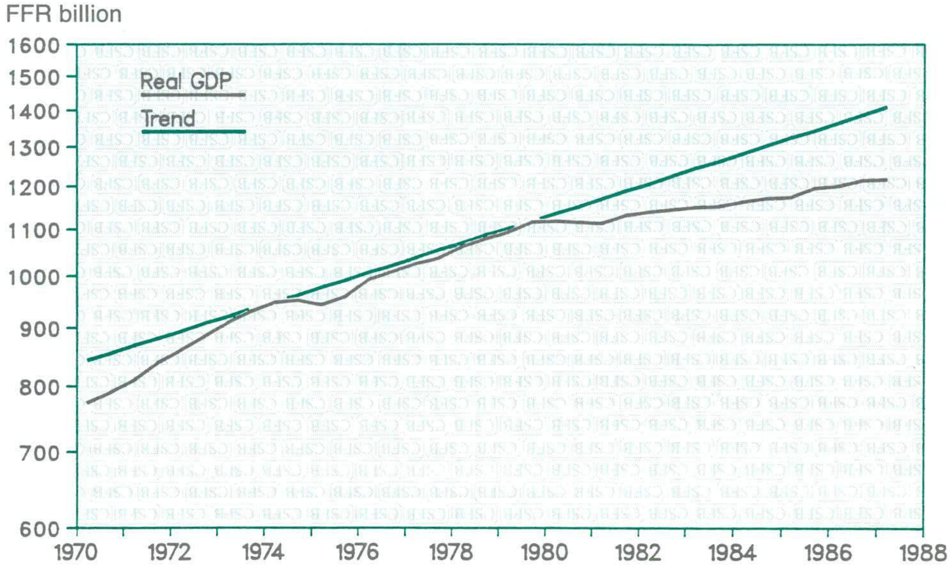
**Ratio of Trade to GNP** (percent)

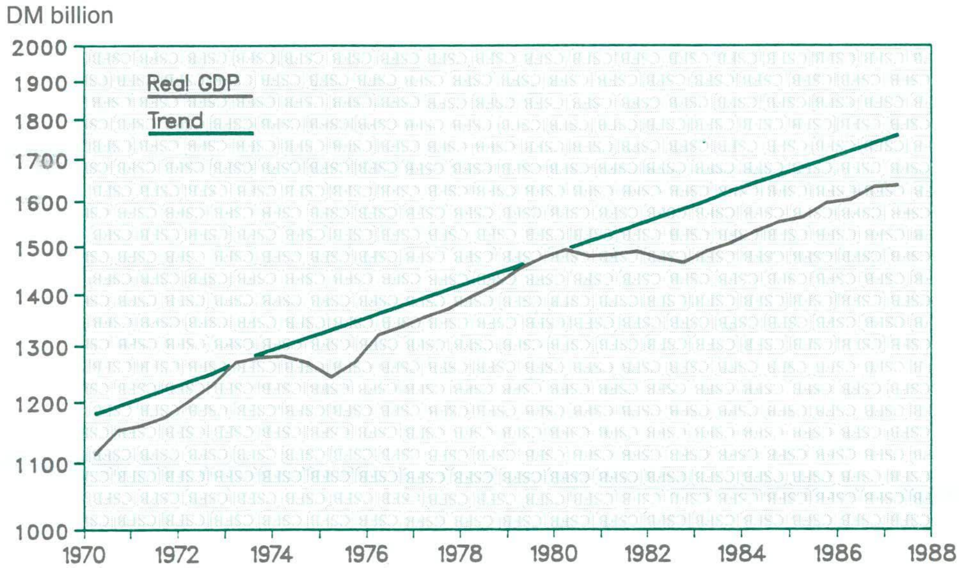
| | 1972 | 1979 | Change | 1986 | Change |
|---|---|---|---|---|---|
| Germany | 47.1 | 54.5 | 7.5 | 63.4 | 8.9 |
| France | 34.2 | 45.1 | 10.9 | 52.5 | 7.4 |
| Italy | 36.2 | 45.7 | 9.5 | 51.9 | 6.2 |
| Netherlands | 96.3 | 106.0 | 9.7 | 118.1 | 12.1 |
| United Kingdom | 44.9 | 52.1 | 7.2 | 57.6 | 5.5 |

**Note:**
Trade is sum of exports and imports of goods and services. Ratio to GNP is at constant prices.
Data Source: OECD Economic Outlook.

The creation of the EEC has had a considerable effect on trade patterns, with intra-European trade growing rapidly. An additional EMS effect is not detectable. As to total trade (the sum of exports and imports), its ratio to GNP has risen to a remarkably uniform extent in Britain and the EMS countries (Table 7).

## France GDP


FFR billion
Real GDP
Trend
1600
1500
1400
1300
1200
1100
1000
900
800
700
600
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988


DM billion
Real GDP
Trend
2000
1900
1800
1700
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1500
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1000
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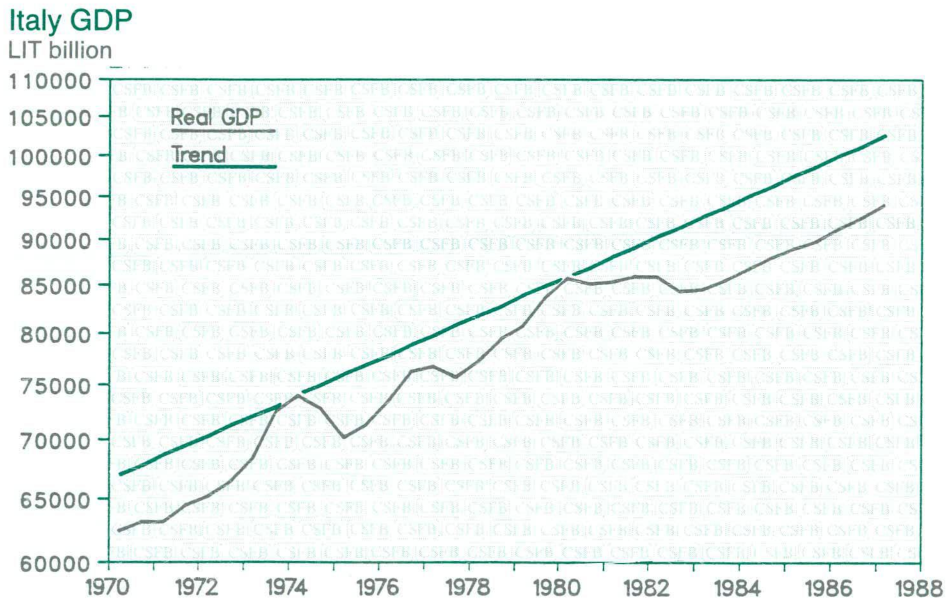
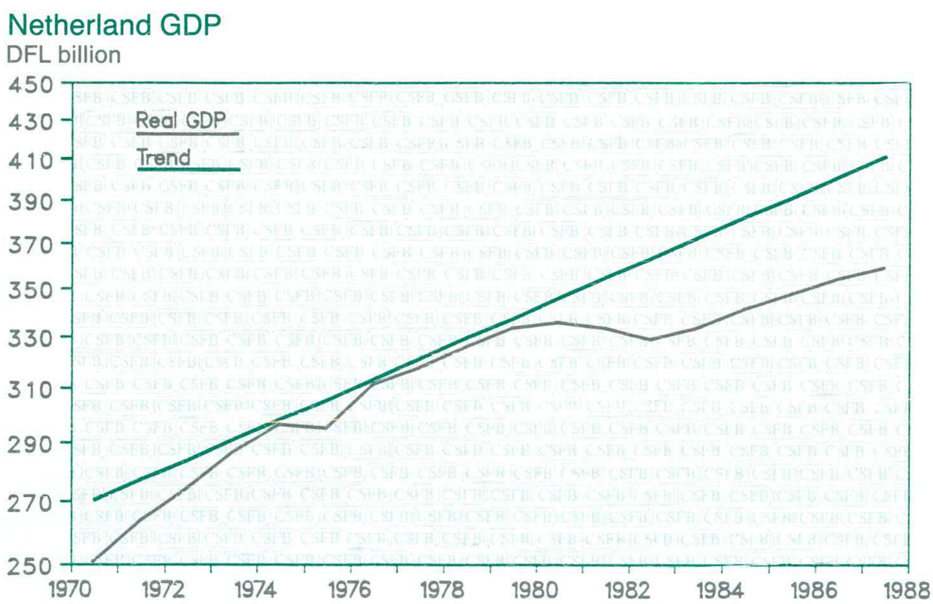
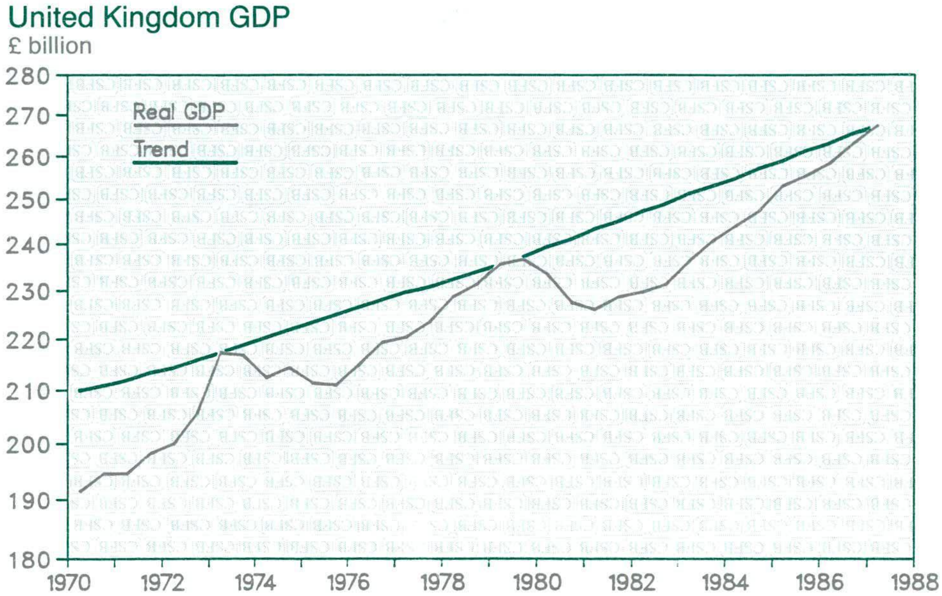



With the EMS having little or no perceptible impact on trade, it is not surprising that it has had no visible effect on growth. Indeed, a striking facet of the 1980s has been the slow-down in the growth of the Continental European economies, below anything which could be described as a trend rate. The charts show that Germany and Italy have recovered from the 1981-82 recession only in the sense that growth has resumed at roughly the trend rate, with no sign of a catch-up to previous trend levels. The output (and employment) loss of the recession looks permanent. France alleviated the recession with expansionary policy but has been paying with slower growth ever since and the Dutch growth rate has also been lower than in the disturbed and inflationary 1970s.

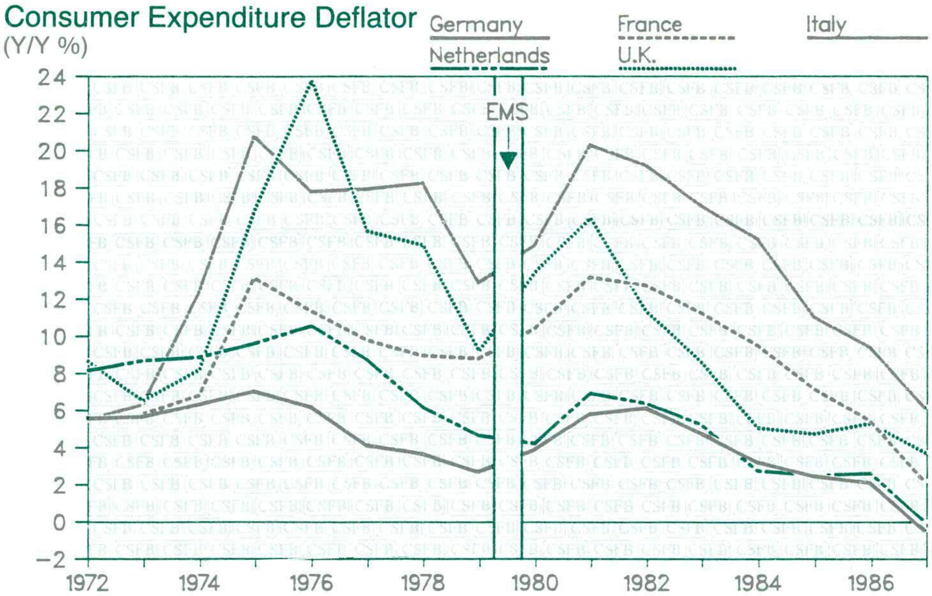



The United Kingdom is the only country of the five to see faster growth on average in the 1980s than in the 1970s and has got back to the trend line obtained by extrapolating 1970s growth. In the case of the U.K., this trend line implies relatively slow growth. It is probable that there will be some acceleration in the trend of UK growth as compared with the 1970s, though this could simply give the UK similar trend growth as other European economies achieved in the 1970s.

The key to slower growth in Continental Europe has been the policy in Germany aiming to restore balance to public sector finances and reduce inflation. German monetary and fiscal policy has been consistently restrictive, markedly slowing the growth rate of domestic demand. That in itself has been sufficient to explain slow growth in the Netherlands, given its dependence on the German market.

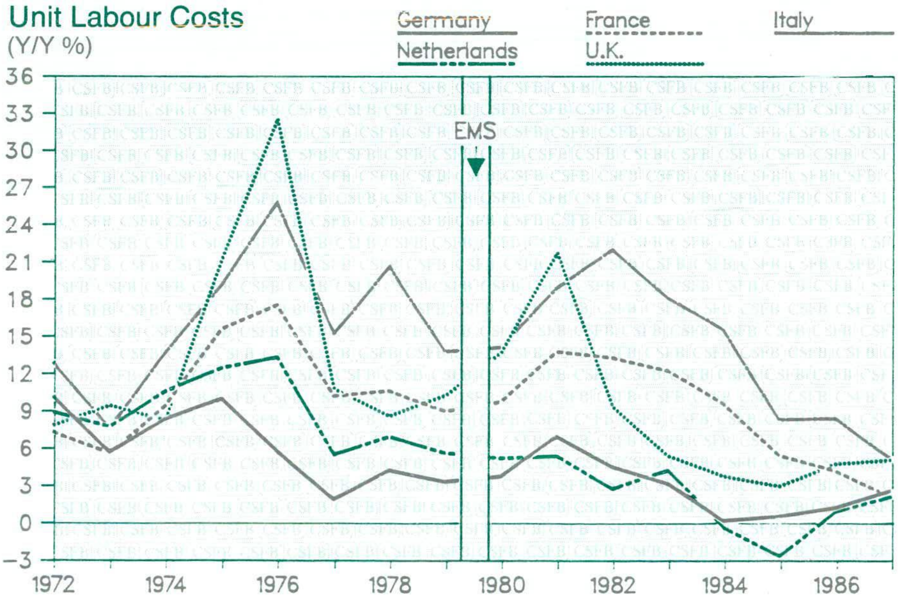
EMS entry betokened the readiness of France and Italy to follow similarly restrictive policies. In the case of Italy, the political situation has left fiscal policy out of control and restriction has been entirely by monetary policy; the EMS has been a crucial ingredient. In France, after 1981-82, both fiscal and monetary policy have been restrictive.

Consumer Expenditure Deflator
(Y/Y %)




The effect on inflation is shown in the charts, depicting consumer prices and unit labour costs in five countries. Since the start of EMS, there has been a fall and convergence of inflation rates. Notably, however, the decline in British inflation has been the same order as that in Italy and France. The initial British unemployment cost of this fall was certainly greater but British unemployment has now peaked – albeit at a very high level – while that in France and Italy continues to climb. It is still too soon, therefore, to conclude that the "sacrifice ratio" (the increase in unemployment accompanying a given fall in inflation) is lower in countries in the ERM. In any case, labour market institutions are likely to be more powerful in determining that ratio than the fact of ERM membership.

Unit Labour Costs
(Y/Y %)



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ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 15 September 1987

PWP

MR PERETZ

cc PS/Chancellor
PS/Sir P Middleton
Sir G Littler
Mr Kelly
Ms Goodman

EMS

The Economic Secretary has seen the comment on Reuters yesterday (attached) that "nothing in the pact is binding." He wonders whether this is correct.

PB

P D P BARNES
Private Secretary

NRFE

EC TO STRENGTHEN =2 NYBORG

THE PACKAGE FOCUSES ON INCREASING LENDING BETWEEN CENTRAL BANKS TO FINANCE INTERVENTION BEFORE PARITIES REACH PERMITTED LIMITS AND ON NARROWING DISPARITIES BETWEEN MEMBER STATES' ECONOMIC PERFORMANCES TO STOP EXCHANGE RATE TENSION BUILDING UP.

DANISH FINANCE MINISTER PALLE SIMONSEN, HOST OF THE INFORMAL TALKS, SAID MINISTERS CONSIDERED THE AGREEMENT "A MILESTONE FOR COOPERATION IN THE MONETARY FIELD WITHIN THE COMMUNITY."

EC COMMISSION PRESIDENT JACQUES DELORS SAID IT TOOK THE EMS INTO A PHASE IN WHICH NOT ONLY WEAK-CURRENCY COUNTRIES BUT ALSO THOSE WITH STRONG UNITS, LIKE WEST GERMANY, MAY HAVE TO SHOULDER SOME OF THE BURDEN OF ADJUSTING POLICIES TO STABILISE RATES.

13-SEP-1116 MON976 MONJ

CONTINUED ON - NRFF

CONTINUED FROM - NRFD

P

QUOTE/MON-AAQA/AAAA0831

NRFF

EC TO STRENGTHEN =3 NYBORG

NOTHING IN THE PACT IS BINDING AND BUNDESBANK PRESIDENT KARL OTTO POEHL SAID ITS PRACTICAL IMPACT WAS LIKELY TO BE LIMITED.

ALTHOUGH BALLADUR WELCOMED THE AGREEMENT, IT IS LESS CONCRETE THAN RADICAL EMS REFORMS HE PROPOSED EARLIER THIS YEAR.

DANISH NATIONAL BANK DIRECTOR ERIK HOFFMEYER SAID STRONG-CURRENCY COUNTRIES IN THE SYSTEM HAD AGREED TO PROVIDE THEIR OWN MONEY FOR EXCHANGE MARKET INTERVENTION WITHIN THE PERMITTED MARGINS BY CENTRAL BANKS OF COUNTRIES WITH WEAK CURRENCIES.

HE SAID THIS SHOULD CUT THE COST OF INTERVENTION BY DOING IT BEFORE MARKETS FORCE IT ON CENTRAL BANKS, WHO CAN ONLY HOLD OUT SMALL AMOUNTS OF EACH OTHERS' CURRENCIES, HAMPERING ACTION.

?

is that so?

13-SEP-1123 MON980 MONJ

CONTINUED ON - NRFG

CONTINUED FROM - NRFE

P

QUOTE/MON-AAQA/AAAA0831

CONFIDENTIAL

pup

From : D L C Peretz
Date : 16 September 1987

ECONOMIC SECRETARY

cc PS/Chancellor
PS/Sir P Middleton
Sir G Littler
Mr C W Kelly
Ms H Goodman

**EMS**

I imagine that Poehl's public reference to the weekend agreement not being "binding" was a reference to the first sentence of the Central Bank Agreement on access to the VSTF for intramarginal intervention. I attach the full text of the relevant paragraph. As you will see the text creates a "presumption" that the Bundesbank will agree to VSTF financing for intramarginal intervention : but leaves them the ultimate right to say no.

2. As I say, I imagine Poehl was referring to that. It is however true that in more general terms the Bundesbank does not necessarily regard the ERM arrangements as "binding", if it believes the ERM obligations to be in conflict with its constitutional duty to maintain sound money. When I visited the Bundesbank earlier this year I was told that there had been an exchange of letters with the Finance Minister at the time the EMS was created, recording the Bundesbank's view that if faced with a conflict between maintaining ERM margins and the Bundesbank's constitutional duty to prevent inflation, the Bundesbank reserved the right to cease to defend the margins.

DLCP

D L C PERETZ

"The Governors have agreed that automatic VSTF for intramarginal intervention should not be introduced. They point out that such financing of intramarginal intervention through the EMCF is already possible if the central banks directly involved concur. They accept a presumption that intramarginal intervention agreed to by the central bank issuing the intervention currency will qualify for financing via the EMCF on the following conditions :

- the cumulative amount of such financing does not exceed double of the debt quota of the debtor central bank in the Short-Term Monetary Support arrangement;

- the debtor central bank is also prepared to use its existing holdings of the currency to be sold for intervention in amounts to be agreed;

- repayment shall be in accordance with the rules specified in Article 16(1) of the EMS Agreement. The creditor central bank reserves the right to request payment in its own currency if this appears necessary in the light of its own monetary conditions, taking account of the reserve position of the debtor central bank."

3766/030

pup

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 13 October 1987

MR KELLY

cc PS/Chancellor
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Mr Mortimer
Ms Goodman
Mr Dyer

**STRENGTHENING THE EMS : CENTRAL BANK GOVERNORS' AGREEMENT**

The Economic Secretary was grateful for your submission of 13 October.

2. The Economic Secretary is content that you should proceed as you suggest.

PB

P D P BARNES
Private Secretary

3887B/038

1 ~~DEST~~
2 PUP

FROM: C W KELLY

DATE: 13 October 1987

ECONOMIC SECRETARY

cc: Chancellor
Sir P Middleton
Sir G Littler o/r
Mr Cassell
Mr Peretz
Mr Mortimer
Ms Goodman
Parliamentary Clerk

**STRENGTHENING THE EMS : CENTRAL BANK GOVERNORS' AGREEMENT**

It might be courteous to inform Parliament by written PQ of the changes to the EMS operating arrangements agreed by the central bank governors on 8 September and subsequently endorsed by the informal ECOFIN. This would follow the precedent set the last time changes to the central bank agreement were made, in 1985 (though on that occasion the changes went rather wider).

2. I attach a draft PQ for this purpose, which has been agreed with the Bank of England. It deliberately does not refer to ECOFIN's endorsement, to avoid complicating the understanding that informal ECOFINs are not reported to Parliament.

3. If you are content, it would be helpful if Parliamentary Section could make arrangements for the PQ to be answered as soon as the House returns, and for a copy of the communique (also attached) to be deposited in the House of Commons Library.

Ch
This makes the PQ read v oddly – it's all about what central banks agreed, & makes it sound as if Ministers have no role
AA

CWK

C W KELLY

enc

[illegible]

**DRAFT PQ**

To ask Mr Chancellor of the Exchequer whether any changes have been made to the agreement of 13 March 1979, as amended by the Instrument of 10 June 1985, between the central banks of the European Community which lays down the operating procedures for the European Monetary System.

**DRAFT REPLY**

At their monthly meeting on 8 September 1987, the Governors of the central banks of the member states of the European Community agreed on a number of measures to strengthen the operating mechanisms of the European Monetary System. These relate to the duration of the very short-term financing on which central banks can draw through the European Monetary Cooperation Fund (EMCF), the availability in certain circumstances of very short term financing for intra-marginal interventions, and the acceptance of the official ecu in settlement of outstanding claims resulting from very short-term financing. The Governors also agreed to strengthen the procedure for joint monitoring of economic and monetary developments and policies. The details are set out in a communiqué from the Committee of Central Bank Governors dated 18 September, a copy of which is in the House of Commons Library.

COMMITTEE OF GOVERNORS OF THE CENTRAL BANKS
OF THE MEMBER STATES
OF THE EUROPEAN ECONOMIC COMMUNITY

EUROPEAN MONETARY CO-OPERATION FUND

18th September 1987

# PRESS COMMUNIQUÉ

At their monthly meeting on 8th September 1987, the Governors of the Central Banks of the Member States of the European Economic Community agreed on measures to strengthen the operating mechanisms of the European Monetary System, which are as follows:

1. The duration of the very short-term financing on which central banks can draw through the European Monetary Co-operation Fund (EMCF) to finance interventions in EMS currencies will be extended by one month, taking the maximum duration from two and a half to three and a half months. The ceiling applied to the automatic renewal for three months of these financing operations will be doubled, i.e. it will amount to 200 per cent. of the central bank's debtor quota in the short-term monetary support mechanism instead of 100 per cent. as at present.

2. The Governors point out that very short-term financing through the EMCF of intramarginal interventions in EMS currencies is already possible if the central banks directly involved concur. While there will be no automatic access to such financing, a presumption that intramarginal interventions in EMS currencies agreed to by the central bank issuing the intervention currency will qualify for very short-term financing via the EMCF will be established under certain conditions; the cumulative amount of such financing made available to the debtor central bank shall not exceed 200 per cent. of its debtor quota in the short-term monetary support mechanism, the debtor central bank is also prepared to use its holdings of the currency to be sold in amounts to be agreed and the creditor central bank may request repayment in its own currency taking into account the reserve position of the debtor central bank.

3. The usability of the official ECU will be further enhanced. The central banks will accept settlements in ECUs of outstanding claims in the very short-term financing in excess of their obligation (50 per cent.) and up to 100 per cent. as long as this does not result in an unbalanced composition of reserves and no excessive debtor and creditor positions in ECUs arise. After two years of experience, the formal rules relating to the official ECU will be subject to review.

These measures form part of a comprehensive strategy to foster exchange rate cohesion within the EMS. The Governors are convinced that greater exchange rate stability depends on all Member States achieving, through their economic and monetary policies, sufficient convergence towards internal stability. In the light of this basic understanding they have agreed in particular to exploit the scope for a more active, flexible and concerted use of the instruments available, namely exchange rate movements within the fluctuation band, interest rates and interventions. To promote this more effective use of the instruments, the Committee of Governors will strengthen the procedure for joint monitoring of economic and monetary developments and policies with the aim of arriving at common assessments of both the prevailing conjuncture and appropriate policy responses.

This strategy and these measures were presented by the Governors to the EEC Ministers of Finance at the informal meeting in Nyborg on 12th September 1987. The changes to the operating mechanisms of the EMS will come into effect following the formal amendment of certain provisions of the central bank Agreement of 13th March 1979 which lays down the operating procedures for the EMS and consequential changes to the rules governing the operations of the European Monetary Co-operation Fund which will take place in the coming weeks.

NOTE OF A MEETING HELD IN ROOM 50/2, HM TREASURY ON FRIDAY, 23 OCTOBER 1987

Present: Paymaster General

Mr Ben Patterson MEP
Sir Fred Catherwood MEP
Sir Jack Stewart-Clark MEP
Mr Brian Cassidy MEP
Mr Alan Reid, EDG Tax Consultant
Ms Julia Harrison, Mr Patterson's Research Assistant

**EXCHANGE RATE MECHANISM OF THE EMS: TAX APPROXIMATION**

**ERM**

Given the Chancellor's unforeseen absence, the Paymaster General took the meeting. He explained that because the EMS was not a subject within his direct responsibilities, he would be unable to discuss it at any length, but would willingly listen to what was said and report back to the Chancellor.

2. According to Mr Patterson the issue had not changed from two years ago when they had seen the Chancellor. Sir Fred Catherwood said that then it was not considered to be the right time for the UK to join the exchange rate mechanism because (a) the exchange rate had been too high; (b) had we needed to hold the rate, the mechanism was not sufficient but would have needed bolstering by full economic and monetary union; and (c) the Plaza accord had only just been agreed and so it was better to wait for wider currency stability. Sir Fred thought that now, with the General Election over, everything pointed to the time being ripe for the UK to join. When the deutschmark had risen, the whole mechanism had become unstable and there had been concern that a falling dollar would increase these pressures, but now, like most of his colleagues in the European Parliament, Sir Fred thought that there should be a complete EMS with a strong second stage of economic and monetary union.

3. Mr Patterson echoed this: he thought it was also the right time politically to join because (a) we had been tracking the deutschmark, and (b) the French wanted us to join in order to reform the EMS in a less rigid, less Germanic direction. Sir Jack Stewart-Clark asked to what extent a barrier to our joining was still the exchange rate level.

4. Sir Jack Stewart-Clark said that in recent discussions the Japanese had said that if the dollar fell and was no longer the most widely traded currency, another currency would need to replace it. They did not want the yen to take its place and thought that the only possible replacement would be the ECU. Sir Jack asked what the Treasury's view would be of this. Mr Cassidy thought there was merit in pricing commodities in ECUs, but apparently the banks did not find this a commercially viable proposition.

**The Cockfield proposals**

5. Mr Patterson thought that on the whole MEPs went along with Lord Cockfield's ideas and found them logical. However, they were not convinced that they would work in practice. He thought that some tax approximation should take place, and would be prudent. Nevertheless there were certain goods and services whose tax rates clearly did not need to be approximated - eg buildings, which cannot be traded across frontiers.

? holiday homes

6. He continued that he and his colleagues were committed to zero rating, although there was a strong body in their group who thought that this was the opportunity to abolish zero rates. If zero rates were maintained, the MEPs would argue for a Community zero rate rather than allowing zero rates only by derogation.

7. The Paymaster General said that, as Lord Cockfield had not yet presented his package formally to the Council, we did not know how he would pitch the various elements of it. The Paymaster thought it likely that, when the Germans took over the Presidency, the pace would quicken. He indicated that it was already clear that the UK had considerable problems with some of the details.

8. Mr Patterson asked the Paymaster General whether he thought that tax approximation could be dealt with separately from a clearing mechanism. The Paymaster acknowledged Customs' concern about the clearing mechanism and how it would operate in other Member States. Although the total package was unlikely to have a great net effect on revenue, there were other obvious problems: other Departments such as the DHSS, the Home Office and DTp would be alarmed at the prospect of reducing duties on alcohol, and the DHSS on tobacco. In addition, there was the major issue of the loss of Parliamentary sovereignty.

9. Mr Cassidy said that, in a recent exercise in which he had been involved, all Member States had shown reservations about the package; in some ways, the UK had a more positive attitude. Mr Patterson thought that they were all minor reservations. His own fear was that we could end up with a two-stage Europe where some countries could be derogated out of the mainstream Community.

10. The Paymaster General pointed out that there would still be a need for Customs controls for drugs and rabies. Sir Jack thought that the flying Customs squads which were envisaged would be more effective than fixed Customs control points.

11. The Paymaster General enquired how the fiscal problem of revalorising duty rates when inflation rates were so divergent could be handled. Mr Patterson thought that this would resolve itself if the rates were fixed in ECU and parities were adjusted. There would also still be scope to alter VAT rates within the bands.

12. The Paymaster General emphasised that we were still in the very early stages and, despite the vivid problems he had mentioned, would consider the package with an open mind. We would need to listen to the reactions of the other Member States.

13. Mr Patterson mentioned his concern at the dearth of statistics available from the Commission. Theoretically a model tax system was needed in order to experiment. This reflected one of the Paymaster's misgivings about just how much real practical knowledge

underlay the proposals. Mr Patterson added that he and his colleagues could build a model themselves but this would need a lot of mental energy and financial backing. Sir Jack mentioned a MORI poll in the UK about people's attitudes to the EC and in particular their reaction to harmonisation. Perhaps surprisingly, the majority of people had said that they thought it a good thing. Apparently they were also in favour of a single currency. Sir Jack promised to write to the Paymaster if he discovered anything else of interest from the poll.

14. Returning to the issue of drugs, Sir Jack said that he thought there was not enough co-operation between Customs authorities in the Member States. For example, the British computer system CEDRIC was not compatible with any other system on the Continent. He thought that a totally international intelligence service was needed. Mr Patterson could envisage drug control within the Community without having frontier controls for other goods and services. The Paymaster General drew attention to Herr Aigner's account of agricultural fraud in the EC. Mr Patterson wondered whether the cost of policing all goods and services was really worth it in comparison with the cost of approximation. In concluding the meeting, the Paymaster agreed to keep in touch with the MEPs; they would share any useful statistics obtained.

27/10

pp **MISS D L FRANCIS**
Assistant Private Secretary

cc
PS/Chancellor
PS/Economic Secretary
PS/Sir Peter Middleton
Sir Geoffrey Littler
Mr Cassell
Mr Peretz

Mr Scholar
Mr Edwards
Ms Goodman
Mr Cropper

PS/Customs & Excise
Mr P R H Allen - C&E

Mr Bostock - UKREP

DB 231200Z.

PS/Chancellor

HM. Treasury.

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|---|---|
| REC. | 23 OCT 1987 ✓23/10 |
| ACTION | MR CASSELL |
| COPIES TO | SIR P MIDDLETON |
| | SIR T BURNS |
| | ~~SIR G LITTLER~~ |
| | MR H P EVANS MR PERETZ |

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OF 230853Z OCTOBER 87

[ I wd like a mtg on int. co-operation on Tues.

CONFIDENTIAL AND PERSONAL FOR PS/CHANCELLOR OF THE EXCHEQUER

TELECON JAY/MRS RIDING: MESSAGE FROM BALLADUR

1. MIFT CONTAINS THE ENGLISH VERSION OF THE PERSONAL MESSAGE FROM BALLADUR TO THE CHANCELLOR OF THE EXCHEQUER WHICH TRESOR HAVE ASKED US TO ENSURE REACHES THE CHANCELLOR AS SOON AS POSSIBLE. ORIGINAL COPIES IN FRENCH AND ENGLISH FOLLOW BY THIS EVENINGS BAG.

FERGUSSON

YYYY

PCLNAN 1970

PSr - ask Sir GL to provide an agenda in.

DB 231200Z

PS/Chancellor
HM. Treasury

2309[illegible]Z

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OF 230857Z OCTOBER 87

CONFIDENTIAL AND PERSONAL FOR PS/CHANCELLOR OF THE EXCHEQUER

MIPT: MESSAGE FROM BALLADUR

1. TEXT IS AS FOLLOWS:
BEGINS....
MY DEAR COLLEAGUE, CHER NIGEL
AFTER THESE PAST FEW DAYS, DURING WHICH OUR FINANCIAL MARKETS HAVE BEEN UNDER HEAVY PRESSURE, I WOULD LIKE TO SHARE WITH YOU SOME OF MY THOUGHTS AND REMARKS.

WE HAVE SUCCEEDED SO FAR IN OVERCOMING OUR FIRST DIFFICULTY. WE REAFFIRMED, IN THE CLEAREST POSSIBLE WAY, OUR RESOLUTION TO PRESERVE AND REINFORCE THE COOPERATIVE STRATEGY OF THE LOUVRE AGREEMENT. THANKS TO THE REAFFIRMATION OF THIS COMMON WILL, WHICH THE MARKETS MAY HAVE WRONGLY UNDERESTIMATED, OUR RESPECTIVE FINANCIAL CENTERS HAVE BECOME SOMEWHAT QUIETER.

I WOULD NEVERTHELESS LIKE TO CALL YOUR ATTENTION TO WHAT WE MAY LEARN FROM THE RECENT EVENTS.

THREE MAIN LESSONS SEEM TO BE RELEVANT TO ME :

1) FIRST OF ALL, THE FACT THAT WE ARE NOW, WITH THE INTERNATIONALISATION OF ALL MARKETS - MONETARY AND EXCHANGE MARKETS, BUT ALSO BOND AND STOCK MARKETS - IN THE PRESENCE OF A TRULY UNIFIED WORLD FINANCIAL SYSTEM, COMPELS US TO RELY ON BOTH PERMANENT CONSULTATION AND EVEN CLOSER COORDINATION THAN BEFORE.

THE MODERNIZATION OF ALL OUR MARKETS, THE INTRODUCTION OF NEW FINANCIAL INSTRUMENTS, THE PROGRESS MADE IN THE FIELDS OF TELECOMMUNICATIONS AND COMPUTER TECHNOLOGY HAVE TO BE VERY THOROUGHLY EXAMINED. SPECIAL ATTENTION SHOULD BE DEVOTED TO THE BOND MARKET AND TO THE ROLE THAT FINANCIAL FUTURE MARKETS NOW PLAY IN SEVERAL OF OUR LARGE FINANCIAL CENTERS.

THEREFORE, I WISH TO ASK OUR DEPUTIES TO PREPARE, IN CLOSE COORDINATION WITH THE CENTRAL BANKS, AND TO SUBMIT TO US AS RAPIDLY AS POSSIBLE, A COMMON ANALYSIS OF THE EVENTS THAT HAVE RECENTLY OCCURRED ON THE MARKETS. WHERE APPROPRIATE, THEY MIGHT PUT FORWARD SOME PROPOSALS SO AS TO ENABLE US BETTER TO CONTROL THE SITUATION AND BE READY TO FACE ANY CONTINGENCY.

2) SECONDLY I BELIEVE THAT WE HAVE TO MAKE FURTHER PROGRESS ON

THE PATH TO BETTER CONVERGENCE OF OUR ECONOMIC POLICIES. IT IS TRUE THAT THE TRIGGERING OF THE STOCK EXCHANGE CRISIS THAT WE HAVE JUST BEEN THROUGH MAY BE EXPLAINED BY SPECIAL CIRCUMSTANCES. BUT, MORE DEEPLY, THIS CRISIS REVEALS THAT THE PROGRESS ACHIEVED IN THE REDUCTION OF IMBALANCES SINCE OUR MEETING LAST FEBRUARY MEETING IS PROBABLY TOO SLOW TO BE TOTALLY CONVINCING FOR THE MARKETS.

THIS LEADS ME TO THINK THAT IT WOULD BE OF UTMOST INTEREST FOR EACH OF US TO EXAMINE WHICH ECONOMIC POLICY MEASURES, IN THE SHORT AND MEDIUM TERM, WOULD MOST LIKELY CONTRIBUTE TO A REDUCTION OF DEFICITS ON ONE SIDE AND SURPLUSES ON THE OTHER SIDE.

I CONSIDER THAT SUCH A REVIEW SHOULD BE MADE WITHOUT ANY BIAS, GIVEN THE RISKS WE HAVE JUST ENCOUNTERED. IN PARTICULAR, IT SEEMS TO ME THAT WE SHOULD NOT PRECLUDE RELYING ON NEW TAXATION, WHERE HUGE FISCAL AND CURRENT ACCOUNT DEFICITS ARE FACED, OR, WHERE NECESSARY, FOREIGN CURRENCY FINANCING OF THE FISCAL DEFICIT. SIMILARLY, SURPLUS COUNTRIES SHOULD CONSIDER VARIOUS MEANS DESIGNED TO ACCELERATE A RETURN TO A NEARLY BALANCED SITUATION : NO MEASURE SHOULD BE EXCLUDED, INCLUDING A REDUCTION IN SHORT AND LONG TERM INTEREST RATES. WE SHOULD NEVER FORGET THAT TOO WEAK A GROWTH RATE IN SURPLUS COUNTRIES IS AS HARMFUL AS THE PERSISTENCE OF THE TRADE DEFICIT IN THE UNITED STATES.

AS WE REALIZE NOW MORE THAN EVER BEFORE, IT IS NOT ONLY THE HEALTH OF OUR ECONOMIES, ALL DEEPLY INTEGRATED, THAT WE MUST ACTIVELY SEEK TO RESTORE. BEYOND THAT, THE VALUES OF THE FREE MARKET ECONOMY TO WHICH WE ARE ALL ATTACHED ARE AT STAKE. THEREFORE, LET ME STRESS AGAIN THAT I BELIEVE THAT WE SHOULD APPROACH THE REVIEW OF MEASURES TO BE TAKEN WITH AN OPEN MIND.

3) FINALLY, CONCERNING EXCHANGE RATES, I AGREE WITH A NUMBER OF OUR COLLEAGUES THAT IT IS NECESSARY FOR US TO DO OUR BEST IN ORDER TO ACHIEVE PROGRESS IN THIS SECTOR AS WELL. SOME PROPOSALS WERE MADE AT THE OF OUR RECENT MEETINGS IN WASHINGTON. THEY ARE AIMED AT IMPROVING THE SURVEILLANCE MECHANISM WITH THE USE OF NEW INDICATORS, AND AT FORMULATING GROUND RULES WITH GREATER PRECISION.

I DO NOT INTEND TO DISCUSS HERE THE APPROPRIATENESS OF THESE PROPOSALS. IN ANY CASE, IT SEEMS TO ME THAT THEY STEM FROM A VERY TIMELY WILLINGNESS TO IMPROVE OUR MONETARY ARRANGEMENTS.

AS FAR AS I AM CONCERNED, I AM CONVINCED THAT WE MUST ATTEMPT TO MAKE PROGRESS IN THE FOLOWING THREE AREAS :

- EFFECTIVE IMPLEMENTATION AND IMPROVEMENT OF MULTILATERAL SURVEILLANCE, NOTABLY THROUGH THE ADDITION OF A CLEAR AND CREDIBLE INDICATOR OF WORLD INFLATION, POSSIBLY ACCORDING TO NEW CRITERIA TO BE DEFINED TOGETHER.

- DIVERSIFICATIN OF THE RESERVE ASSETS OF EACH COUNTRY, NOTABLY BY WAY OF A STRENGTHENING OF THE SWAPS NETWORK, AND ENHANCEMENT OF COOPERATION AMONG CENTRAL BANKS :

- IF NECESSARY, IMPROVEMENT OF THE ''LOUVRE SYSTEM'' WITH A MEDIUM-TERM PERSPECTIVE.

IT IS ESSENTIAL THAT WE STAY CONTINUOUSLY IN CONTACT, DIRECTLY AND THROUGH OUR DEPUTIES. IT SEEMS TO ME THAT IT COULD BE USEFUL FOR US TO MEET, WHEN THE TIME COMES, IN ORDER TO REVIEW THE SITUATION

TOGETHER, EXAMINE THE REPORT OF OUR DEPUTIES AND, IF NECESSARY, DECIDE ON NEW MEASURES. BUT IT IS CLEAR THAT SUCH A MEETING CAN BE CONVENED ONLY AFTER CAREFUL PREPARATION AND IF WE ARE ALL CONVINCED THAT IT WILL BE FRUITFUL : IN ANY OTHER CIRCUMSTANCES, IT COULD HAVE NEGATIVE EFFECTS.

I AM SENDING THE SAME MESSAGE TO THE OTHER COLLEAGUES OF OUR SMALL GROUP OF ''FIVE''.

PLEASE ACCEPT MY BEST REGARDS.

SIGNED:
EDOUARD BALLADUR

....TEXT ENDS

FERGUSSON

YYYY

PCLNAN 1971

**BRITISH EMBASSY**
35, rue du Faubourg Saint-Honoré - 75383 Paris Cedex 08

Telephone : 42 66 91 42

Your reference

Our reference

Date 23 October 1987

Mrs C A Riding
Assistant Private Secretary/
Chancellor of the Exchequer
LONDON SW1

Dear Cathy,

MESSAGE FROM M. BALLADUR TO THE CHANCELLOR

1. I attach the top copies in English and French of the letter from Balladur to the Chancellor which we sent you by telegram this morning.

Yours sincerely,

Michael Jay

M H Jay

CH/EXCHEQUER

REC. 26 OCT 1987

ACTION MR CASSEL

COPIES TO PS/EST
SIR P MIDDLETON
SIR T BURNS
SIR G LITTLER
MR H P EVANS
MR PERETZ

*Le Ministre d'Etat*

*Ministre de l'Economie, des Finances*

*et de la Privatisation*

Paris, October 22nd 1987

My Dear Colleague, cher Nigel

After these past few days, during which our financial markets have been under heavy pressure, I would like to share with you some of my thoughts and remarks.

We have succeeded so far in overcoming our first difficulty. We reaffirmed, in the clearest possible way, our resolution to preserve and reinforce the cooperative strategy of the Louvre Agreement. Thanks to the reaffirmation of this common will, which the markets may have wrongly underestimated, our respective financial centers have become somewhat quieter.

I would nevertheless like to call your attention to what we may learn from the recent events.

Three main lessons seem to be relevant to me :

1) First of all, the fact that we are now, with the internationalisation of all markets -monetary and exchange markets, but also bond and stock markets- in the presence of a truly unified world financial system, compels us to rely on both permanent consultation and even closer coordination than before.

The modernization of all our markets, the introduction of new financial instruments, the progress made in the fields of telecommunications and computer technology have to be very thoroughly examined. Special attention should be devoted to the bond market and to the role that financial future markets now play in several of our large financial centers.

Therefore, I wish to ask our Deputies to prepare, in close coordination with the Central Banks, and to submit to us as rapidly as possible, a common analysis of the events that have recently occurred on the markets. Where appropriate, they might put forward some proposals so as to enable us better to control the situation and be ready to face any contingency.

Rt. Hon. Nigel LAWSON
Chancellor of the Exchequer

2) Secondly I believe that we have to make further progress on the path to better convergence of our economic policies. It is true that the triggering of the stock exchange crisis that we have just been through may be explained by special circumstances. But, more deeply, this crisis reveals that the progress achieved in the reduction of imbalances since our meeting last February meeting is probably too slow to be totally convincing for the markets.

This leads me to think that it would be of utmost interest for each of us to examine which economic policy measures, in the short and medium term, would most likely contribute to a reduction of deficits on one side and surpluses on the other side.

I consider that such a review should be made without any bias, given the risks we have just encountered. In particular, it seems to me that we should not preclude relying on new taxation, where huge fiscal and current account deficits are faced, or, where necessary, foreign currency financing of the fiscal deficit. Similarly, surplus countries should consider various means designed to accelerate a return to a nearly balanced situation ; no measure should be excluded, including a reduction in short and long term interest rates. We should never forget that too weak a growth rate in surplus countries is as harmful as the persistence of the trade deficit in the United States.

As we realize now more than ever before, it is not only the health of our economies, all deeply integrated, that we must actively seek to restore. Beyond that, the values of the free market economy to which we are all attached are at stake. Therefore, let me stress again that I believe that we should approach the review of measures to be taken with an open mind.

3) Finally, concerning exchange rates, I agree with a number of our colleagues that it is necessary for us to do our best in order to achieve progress in this sector as well. Some proposals were made at the end of our recent meetings in Washington. They are aimed at improving the surveillance mechanism with the use of new indicators, and at formulating ground rules with greater precision.

I do not intend to discuss here the appropriateness of these proposals. In any case, it seems to me that they stem from a very timely willingness to improve our monetary arrangements.

As far as I am concerned, I am convinced that we must attempt to make progress in the following three areas :

- effective implementation and improvement of multilateral surveillance, notably through the addition of a clear and credible indicator of world inflation, possibly according to new criteria to be defined together.

- diversification of the reserve assets of each country, notably by way of a strengthening of the swaps network, and enhancement of cooperation among central banks ;

- if necessary, improvement of the "Louvre system" with a medium-term perspective.

*

* *

It is essential that we stay continuously in contact, directly and through our Deputies. It seems to me that it could be useful for us to meet, when the time comes, in order to review the situation together, examine the report of our Deputies and, if necessary, decide on new measures. But it is clear that such a meeting can be convened only after careful preparation and if we are all convinced that it will be fruitful : in any other circumstances, it could have negative effects.

I am sending the same message to the other Colleagues of our small Group of "Five".

Please accept my best regards.

Signed:

Edouard BALLADUR

*Le Ministre d'Etat*
*Ministre de l'Economie, des Finances*
*et de la Privatisation*

22 OCT. 1987

Monsieur le Chancelier et Cher Nigel,

Après ces quelques jours où nos marchés financiers ont été soumis à de fortes tensions, je souhaiterais vous faire part de mes réflexions et de mes observations.

Nous avons réussi jusqu'à présent à surmonter une première épreuve. Nous avons réaffirmé de manière très claire notre volonté de préserver ou de renforcer la stratégie coopérative du Louvre. Grâce à la réaffirmation de cette volonté, qui avait pu être mise en doute, à tort, par les marchés, nos diverses places financières ont retrouvé un peu plus de calme.

Je voudrais cependant appeler votre attention sur les leçons à tirer des évènements récents.

Pour ma part, j'en retire trois enseignements principaux :

1) D'abord, le fait que nous soyons désormais, avec l'internationalisation de tous les marchés -marché monétaire et marché des changes mais aussi marchés des obligations et des actions-, devant un véritable système financier mondial unifié, nous contraint à une concertation permanente et à une coordination plus étroite encore qu'auparavant.

La modernisation de l'ensemble de nos marchés, la mise en place d'instruments financiers nouveaux, les progrès faits dans le domaine des télécommunications et de l'informatique demandent à être analysés de très près. Une attention particulière devrait être portée au marché obligataire et au rôle que jouent désormais les marchés à terme d'instruments financiers sur plusieurs de nos grandes places financières.

Je souhaite pour ma part que nos Suppléants, en liaison très étroite avec les Banques Centrales, puissent nous soumettre très rapidement une analyse commune de l'ensemble des évènements intervenus récemment sur les marchés. Le cas échéant, ils pourraient faire des propositions susceptibles de nous permettre de mieux maîtriser la situation et de faire face à toute éventualité.

Monsieur Nigel LAWSON
Chancelier de l'Echiquier

2) Ensuite, je pense que nous devons progresser encore sur la voie de la convergence de nos politiques économiques. Il est vrai que le déclenchement de la crise boursière que nous venons d'essuyer s'explique par des circonstances particulières. Mais, plus profondément, cette crise nous révèle que les progrès enregistrés dans la réduction des déséquilibres depuis notre réunion de février sont probablement trop lents pour être pleinement convaincants aux yeux des marchés.

Ceci me conduit à penser qu'il y aurait de très grands avantages à ce que chacun d'entre nous examine les mesures de politique économique à court et moyen terme qui paraîtraient les plus propres à réduire les déficits, d'une part, et les excédents, d'autre part.

Je pense qu'un tel examen doit être effectué sans aucun préjugé, compte tenu des risques que nous venons d'expérimenter. Il me semble qu'il ne faut en particulier écarter ni le recours à des impôts nouveaux lorsqu'il y a de très forts déficits budgétaires et des paiements courants, ni, le cas échéant, le financement en devises étrangères du déficit budgétaire. De même, il convient dans les pays à surplus d'envisager les différents moyens susceptibles d'accélérer le retour à une situation voisine de l'équilibre en n'en excluant aucun, et notamment pas la baisse des taux d'intérêt, courts et longs. Nous ne devons jamais perdre de vue que la trop faible croissance dans les pays à surplus est aussi pernicieuse que la persistance du déficit commercial des Etats-Unis.

Ce n'est pas seulement le salut de nos économies, toutes profondément solidaires, nous le savons plus encore maintenant, que nous devons très activement rechercher. Au-delà, c'est la confiance dans les valeurs de liberté auxquelles nous sommes tous attachés qui est en cause. C'est pourquoi, je le répète, nous ne devons avoir aucun a priori dans l'examen des mesures à prendre.

3) Enfin, en ce qui concerne les changes, je pense comme plusieurs de nos collègues qu'il est nécessaire que nous nous efforcions également de progresser en ce domaine. Des suggestions ont été faites par certains de nos collègues à l'issue de nos récentes réunions de Washington. Elles visent à améliorer les mécanismes de surveillance grâce à des indicateurs nouveaux et à mieux codifier certaines règles.

Je n'en discuterai pas ici le bien-fondé. Il me semble, quoi qu'il en soit, qu'elles procèdent d'une volonté de perfectionnement de nos accords monétaires qui me paraît très opportune.

Je suis, pour ma part, convaincu que nous devons envisager de progresser dans les trois domaines suivants :

- mise en oeuvre opérationnelle de la surveillance et perfectionnement de celle-ci en retenant, en particulier, un index d'inflation mondiale clair et crédible, en fonction de critères éventuellement nouveaux à choisir d'un commun accord ;

- diversification des avoirs de réserve de chacun des partenaires notamment par le perfectionnement du réseau de swaps, et renforcement de la coopération entre banques centrales ;

- amélioration, le cas échéant, du "système du Louvre" dans une perspective à moyen terme.

Il est indispensable que nous demeurions en contact permanent, directement et par l'intermédiaire de nos Suppléants. Il me semble qu'il pourrait être utile que nous nous rencontrions, le moment venu, pour que nous puissions, ensemble, faire le point, examiner le rapport de nos Suppléants et, le cas échéant, prendre des mesures nouvelles. Mais il va de soi qu'une telle réunion n'est envisageable que si elle est soigneusement préparée et que si nous avons tous la conviction qu'elle sera fructueuse : elle pourrait, dans toute autre hypothèse, avoir des effets négatifs.

J'adresse le même message à nos Collègues de notre petit groupe des "5".

Je vous prie d'agréer, Monsieur le Chancelier et Cher Nigel, l'expression de mes sentiments les meilleurs.

Cordialement

E Balladur

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ADVANCE COPY

cc PS/EST
Sir P. Middleton
Sir G. Littler (o/r)
Sir T. Burns
Mr Cassell
Mr H.P. Evans
Mr Peretz

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FM PARIS
TO IMMEDIATE FCO
TELNO 1041
OF 261221Z OCTOBER 87

PERSONAL FOR PS/CHANCELLOR OF THE EXCHEQUER FROM AMBASSADOR.

MY TELNOS 1029 AND 1030.

1. I PAID A QUOTE COURTESY UNQUOTE CALL ON BALLADUR THIS MORNING. IT PROVIDED HIM WITH THE OPPORTUNITY TO SEND TWO ORAL MESSAGES TO THE CHANCELLOR OF THE EXCHEQUER, FOLLOWING THE WRITTEN MESSAGE IN MY TUR.

2. INTERNATIONAL ECONOMY. AFTER REFERRING TO HIS LETTER TO THE FINANCE MINISTERS OF THE GROUP OF FIVE, HE SAID THAT HE WOULD LIKE TO HAVE AN EARLY CONTACT WITH THE CHANCELLOR OF THE EXCHEQUER. MOVEMENT WAS NEEDED ON THREE POINTS:-

(A) THE US NEEDED TO TAKE FIRM ACTION ON THE BUDGETARY DEFICIT AND ON RAISING TAXES. THE PRESIDENT'S STATEMENT HAD BEEN A MOVE IN THE RIGHT DIRECTION BUT IT WOULD CLEARLY TAKE SOME WEEKS AT LEAST BEFORE THE MARKETS WOULD START RESPONDING TO US DECISIONS, GIVEN THE TIME WHICH IT WOULD TAKE FOR THE US ADMINISTRATION TO RESOLVE LIKELY INTERNAL DISAGREEMENTS, EG WITHIN CONGRESS, ABOUT THE NATURE OF ANY NEW TAX PROPOSALS:

(B) THE FRG HAD TO MAKE A MOVE OVER INTEREST RATES. THAT ALSO WAS DIFFICULT BECAUSE OF THE WAY IN WHICH THE MINISTER OF FINANCE PASSED THE BUCK TO THE BUNDESBANK AND NEXT TWO WORDS UNDERLINED VICE VERSA:

(C) THE FIVE MUST REAFFIRM THEIR COMMITMENT TO THE LOUVRE ACCORD. THE CREDIBILITY OF THIS, HOWEVER, AND THE TIMING OF ANY MEETING, AND BY IMPLICATION THE TIMING OF ANY SUBSEQUENT PUBLIC AFFIRMATION BY THE SEVEN, DEPENDED ON ACTION ON (A) AND (B). IN OTHER WORDS, IT WAS A MATTER OF WEEKS RATHER THAN DAYS. IN HIS VIEW, IT REMAINED ESSENTIAL TO KEEP THE DOLLAR AT MORE OR LESS ITS PRESENT LEVEL. A DROP IN THE DOLLAR'S VALUE WOULD NOT RESOLVE CURRENT US PROBLEMS AND WOULD CREATE PROBLEMS FOR EVERYONE ELSE.

3. EC ISSUES. M. BALLADUR WENT ON TO STRESS HIS ANXIETY THAT

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AGREEMENT SHOULD BE REACHED ON EC BUDGETARY ISSUES AT COPENHAGEN. HE SAID THAT THE FRENCH PRIME MINISTER HAD RECENTLY HELD A MEETING OF MINISTERS WHICH HAD REACHED AN AGREED FRENCH POSITION (HE IMPLIED BY ENDORSING HIS OWN VIEWS):-

(A) GREECE AND ITALY HAD HAD MORE THAN ENOUGH BENEFIT FROM EC STRUCTURAL FUNDS: ANY INCREASED STRUCTURAL FUNDS SHOULD BE ORIENTED IN FAVOUR OF SPAIN AND PORTUGAL:

(B) THERE SHOULD BE FIRM QUOTE REGULATION UNQUOTE OF AGRICULTRUAL EXPENSES:

(C) EC REVENUE MUST BE MORE STRICTLY CONTROLLED AND DISCIPLINE MAINTAINED. HE UNDERSTOOD THE ARGUMENT FOR MOVING AWAY FROM A VAT BASE BUT IT WAS ESSENTIAL TO ENSURE THAT A GNP BASE WAS NOT SET AT TOO HIGH A LEVEL.

4. FAILURE TO REACH AGREEMENT AT COPENHAGEN WOULD HAVE DAMAGING EFFECTS ON THE COMMUNITY AS A WHOLE. HOW COULD THAT BE AVOIDED? AN ECOFIN COUNCIL MEETING MIGHT BE NECESSARY BUT IN HIS VIEW THAT WAS TOO LARGE A FORUM. HIS CONCLUSION THEREFORE WAS IN FAVOUR OF A VERY SMALL TRI-PARTITE MEETING BETWEEN THE THREE PRINCIPAL FINANCIAL ACTORS, FRANCE, FRG AND UK, IN THE NEAR FUTURE: HE WOULD LIKE TO HAVE MR LAWSON'S REACTION. HE DID NOT PROPOSE ANY TIME FOR THE MEETING. IF IT TOOK PLACE, HOWEVER, IT WOULD BE ESSENTIAL TO AVOID ANY PUBLIC LINKAGE WITH INTERNATIONAL MONETARY QUESTIONS (I HAD THE CLEAR IMPRESSION THAT HE WOULD PREFER A PURELY PRIVATE MEETING BUT RECOGNISED THAT - WERE IT TO TAKE PLACE - THERE WOULD BE A RISK OF LEAKS AND PUBLICITY). M. BALLADUR SAID THAT IF A TRI-PARTITE MEETING OF FINANCE MINISTERS LOOKED TOO DIFFICULT HE WOULD BE READY TO HAVE A BILATERAL MEETING WITH MR LAWSON.

5. IN A QUOTE THROW AWAY ASIDE UNQUOTE, HE COMMENTED THAT THE INEVITABLE TREND IN THE EC AGRICULTURAL BUDGET WAS FOR A NATIONAL MEANS OF SUPPORT.

6. BALLADUR WAS ACCOMPANIED BY HIS CONSEILLER TECHNIQUE, PATRICE VIAL.

FERGUSSON

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(1038/730/428)

# KEYNES AND ECONOMIC POLICY: THE RELEVANCE OF THE GENERAL THEORY AFTER FIFTY YEARS

Edited by Walter Eltis and Peter Sinclair

## C O N T E N T S

(1038/730/431)

KEYNES AND ECONOMIC POLICY: THE RELEVANCE OF THE GENERAL THEORY AFTER FIFTY YEARS

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(1038/730/417)

# THE CONTINUING RELEVANCE OF KEYNES TO ECONOMIC POLICY

Walter Eltis

Six years after publication, half the citations there will ever be to an ordinary piece of economics will have appeared. The half life of the average economics article in an academic journal is a mere six years, and very little economics lasts 50 years. The fact that Keynes and Keynesian are part of our language after 50 years and that there is so much interest in present day interpretations of how relevant what he had to say is to our world is a testimonial to his greatness as an economist, and to the importance of his achievement. It is interesting to examine what happens to the economic classics after a long period. In 1826, fifty years after the publication of Adam Smith's Wealth of Nations there was a conference to assess its continuing significance and the participants agreed that Smith had been superseded by David Ricardo and that all kinds of errors in his work had been uncovered. But Smith's reputation rose in the 150 years from 1826 to 1976. It is chastening to bear this precedent in mind when we consider the assessments that the participants to this conference have made of the significance of Keynes' General Theory to economic policy after its first 50 years.

Unemployment has been far higher in the 1980s than in any previous post war decade so the economic environment has moved closer to the one that persuaded Keynes to produce a theory to explain chronic underemployment. Because we once again have high unemployment, it is natural that policy makers and professional economists should wish to scrutinise Keynes's work extremely carefully. To the uninitiated it must appear that he was right and that the economic theorists of the 1970s who based powerful economic models on the supposition that markets clear and that governments have no role in the maintenance of high employment were mistaken.

It does not follow from the fact that we again have high unemployment that Keynes's explanation of how this can arise is still the appropriate one. There have been great changes in the world's advanced economies since 1936 so it is rather unlikely that the assumptions about the economic and financial environment on which Keynes based his theory will still be the most appropriate ones. But his theory is clearly a valuable point of departure for our efforts to explain unemployment and to find policies to reduce it today. The distinguished participants to this conference have honoured Keynes by using his 1936 book as a starting point for their own contributions.

But those who are actually concerned with economic policy have moved a long way from him. There is an interesting correspondence between the contributions of Ernst Helmstadter, Member of the West German Council of Economic Experts since 1983, and Sir Terence Burns, Chief Economic Adviser to the United Kingdom government since 1980, and the opening statement by the Rt Hon Nigel Lawson who has been Chancellor of the Exchequer since 1983. All three are immediately responsible for practicalities and they are actually agreed that the principal object of fiscal policy is to create a stable tax structure which will help to produce an economic environment which is helpful to the supply-side of the economy, while excessive unemployment, if it exists, is attributable to microeconomic considerations, which will often include inappropriately high real wage costs. This latter explanation of unemployment is precisely the one that Keynes was determined to refute in 1936, but 50 years later the British and German Treasuries and Finance Ministries are entirely unconvinced. In view of the success of German economic policy in achieving high growth with an inflation rate that has gradually been reduced to zero, the consistently non-Keynesian approach to economic policy formation that the German Council of Economic Experts has adopted since 1963, which Helmstadter outlines, deserves close attention. The almost identical United Kingdom approach which Burns describes has similarly proved compatible with seven years of uninterrupted growth and some downward pressure on inflation.

Support for a non-Keynesian approach to economic policy is reinforced by the very important article on the Italian economy by Giampaolo Galli and Rainer Masera of the Bank of Italy which outlines and discusses the embarrassments that Italy now suffers from a government debt to GNP ratio of more than 100% which, according to their projections, is likely to double with the most favourable economic assumptions. With Italy's present debt to GNP ratio, almost 10% of the Italian national income is required to pay interest on government debt and this neither promotes economic welfare in the manner of other elements of government expenditure, nor stimulates the supply-side of the economy by contributing to the rewards of workers or companies. If Italy's government debt to GNP ratio rises to 200% in the next 15 years, it is likely that some 20% of the national income will have to be paid to rentiers and therefore become unavailable to assist either production or social welfare. And if some future Italian government does not wish to continue to make this 20% of the national income available to non-producers and non-welfare recipients, it will be driven to destroy the real value of government debt through a hyper-inflation with untold social repercussions. That account which Galli and Masera set out brilliantly, describes the trap into which a country can be drawn by a persistent pursuit of Keynesian deficit financing policies. In his very helpful article on what Keynes actually said about economic policy, Nicholas Dimsdale makes it very clear that he would not have lent support to the Italian policy of running persistent budget deficits of more than 10% of GNP. He recommended that the budget should be balanced over the cycle as a whole,[1] but since the Second World War many Keynesians in contrast to Keynes himself have been prepared to regard a persistent structural deficit as an acceptable element in Keynesian policies to maintain high employment.

Germany and the UK have avoided that trap by pursuing the policies which Helmstadter and Burns describe, but two of the articles with a UK authorship which are primarily concerned with macroeconomic policy are considerably more sympathetic to the practical use of fiscal expansion to reduce unemployment. Lord Peston, one of the most senior economic advisers to the British Labour Party, has provided a marvellously lucid account of the theory of fiscal policy with strong Keynesian elements. He sets out the case for fiscal reflation when unemployment is judged to be excessive, and explains how difficulties in financing government borrowing should not stand in its way. If a country's GNP can only be raised through spending financed by extra borrowing, either companies will be willing to borrow and spend in which case the momentum for expansion will come from the private sector, or else the market will prefer to lend to the government which will then have to incur the responsibility of borrowing without which there will be insufficient effective demand to permit high employment. He recommends that output and employment be raised, either by private or public borrowing until the Phillips curve begins to slope upwards steeply, at which point further expansion will involve severe inflationary difficulties. But Peston fails to address the consequences of an indefinite continuation of structural government borrowing on which Galli and Masera are so enlightening.

The other policy oriented supporter of a Keynesian approach is Bill Callaghan, the Head of Economic Research of the UK Trades Union Congress, who outlines the close connection between Keynes and the TUC in the 1930s when he and Ernest Bevin both sat on the Macmillan Committee where they were closely allied. Callaghan criticises sharply the view that unemployment depends mainly on the level of real wages, and the articles of those contributors who believe that high employment will be achieved via the operation of market forces without government intervention.

Most of the contributors do not of course have the direct and immediate concern with policy questions of Burns, Callaghan, Helmstadter, Masera and Peston. They are concerned to elucidate, clarify, update and assess the underlying economic theory on which policy decisions are based and they have examined the continuing relevance of Keynes's contribution to some of the issues which are central to modern economics.

The first main theoretical issue which the contributors address is whether market forces can generally be expected to produce high employment, or whether, as Keynes believed, there are likely to be persistent market failures which create a general need for macroeconomic intervention. Michael Artis and Bennett McCallum address this question, and Artis provides a powerful account of the Keynesian case that there are significant wage rigidities which preclude a downward adjustment of money wages if that is what is needed to sustain high employment. There are, of course, also various nominal and real price rigidities and Artis sets out the microeconomic reasons for their prevalence, while Robin Matthews and Alex Bowen assess the actual impact on unemployment of real wage rigidities in the 1970s and the 1980s. If as a consequence of these rigidities markets fail to clear or else clear very slowly, there is a case for government intervention of various kinds to arrive at acceptable levels of employment somewhat more quickly. McCallum can find no logical basis for such rigidities (though he acknowledges that they sometimes exist) and he therefore believes that there is no case for piecemeal macroeconomic intervention.

He prefers instead to put macropolicy onto an autopilot aimed to produce a steady rate of growth of nominal GNP, equal to the long term rate of growth of productive capacity. This would then be compatible with steady expansion at the economy's natural rate of growth with zero inflation. The means he proposes to control nominal GNP is strict control of the rate of growth of the monetary base, and his autopilot will immediately reduce the growth of this if nominal GNP starts to accelerate, and increase it if nominal GNP slows. McCallum's control mechanism will only permit continuous growth at zero inflation if there truly are no money wage rigidities so that wage increases fall off until the inflation of unit wage costs declines to zero and so becomes compatible with high employment at stable prices. If economic theory says that there are no rigidities, then it must be right to base policy on the supposition that there are none, but as McCallum rightly says, there are difficulties in the way of ascertaining whether his policy rule would actually produce the result he expects because, "To determine whether this rule would indeed keep nominal GNP close to the desired growth path, one must experiment with the economy or with a model. The former possibility is too expensive and the latter suffers from the absence of any reliable model." McCallum's rule that the rate of growth of nominal GNP should be held down by means of strict control of a narrow money aggregate resembles extremely closely one of the central features of the UK's Medium Term Financial Strategy, so Britain may provide some of the evidence that McCallum seeks. It could be held that UK inflation has undoubtedly fallen with reductions in the rate of growth of nominal GNP (and some of the data is presented in Burns's article) but there was also a considerable adjustment cost in the early years because the pace of wage increases only fell when unemployment became very high, so the application of a formula resembling McCallum's to the UK brings out the evidence that here at any rate there are wage rigidities of the kind that Artis describes.

Patrick Minford seeks to explain these rigidities and he reminds us that Keynes stated very clearly in the 1930s that wages will not adjust in the manner required to produce high employment if unemployment benefits are unduly close to the wages that workers receive. There are further passages which Dimsdale quotes which support the contention that this well known position of Minford's was also held by Keynes. Minford provides a clear account of the significance of the influence of unemployment benefits for the equilibrium level of employment. But Stephen Nickell reminds us that there will be circumstances where there will be high unemployment, whatever the level of wages, for these are not the sole determinant of employment. There will be circumstances where lower real or money wages will significantly assist a move towards higher employment and others where they will not, for the interconnection between wages and employment is complex.

We come therefore to the central policy implication of Keynes's analysis, namely that there will be circumstances where changes in wage behaviour will not suffice to produce high employment, and where policy to raise effective demand will also be needed. Whether this is most effectively influenced by fiscal or by monetary expansion has become controversial. John Flemming reminds us that in a good deal of the General Theory interest rates are, in effect, fixed, while Dimsdale explains that while Keynes on several occasions regarded a lowering of the long term rate of interest as the ideal way of expanding the economy, he believed that this would be extremely difficult to achieve. Terence Mills and Geoffrey Wood underline how very difficult it is to reduce interest rates by showing that the theoretical General Theory means of achieving this, repeated increases in the money supply, appears actually to have the opposite effect: they present evidence that increases in the rate of growth of the money supply have generally been associated with higher rates of interest in the UK. The difficulties in the way of using low interest rates to stimulate economic expansion are underlined further by the strong case that Flemming presents that interest rates are a desirable element in policy to control inflation via their influence on the exchange rate, a policy stance which is not far from David Currie's.

Because he judged that interest rates would be very difficult to reduce to the full extent required, Keynes turned to fiscal expansion via extra public works, etc, as a more practical second best means of expanding effective demand. But even the impact of extra public expenditure upon real aggregate demand - the central Keynesian policy plank - has become controversial. Sir Alan Walters argues powerfully that in the UK after 1956 the real rate of monetary expansion has had far more powerful effects upon aggregate demand than changes in the government's fiscal stance. The precise nature of the fiscal stance and how this may be corrected for inflation and the cycle is carefully examined by Marcus Miller and Alan Sutherland and there is no significant disagreement between them and Walters (on this occasion) about whether fiscal policy in particular years was loose or tight. Walters argues that in the moves into recession and the subsequent recoveries in 1956-58, 1973-75 and 1979-82 the development of narrow money determined the course of the cycle while fiscal policy was often working in the opposite direction. The extreme case for his argument was the huge move into recession in 1979 when real monetary growth was sharply reduced but fiscal expansion continued, and the recovery of output which began in 1981 when the budget was actually tightened by 7% of GNP on a cyclically adjusted basis, but output nonetheless expanded because real M1 began to grow. Currie agrees with Walters that monetary expansion has powerful effects but questions whether control of any particular monetary aggregate (such as Walters' preferred non interest bearing M1) would ensure a smooth expansion of demand. He emphasizes that monetary policy and the fiscal stance must be compatible, with which Walters is in broad agreement, but Currie would prefer to apply cyclical corrections to the fiscal stance so that the budget would automatically move into larger deficit in recession, while Walters would not wish to adjust the deficit in this way.

The efficacy of fiscal expansion in raising demand is examined anew by Alan Budd and three colleagues from the London Business School. Until recently, Budd has taken Walters' view that monetary expansion is far more effective than fiscal reflation, and it aroused considerable interest at the Conference that he now agrees with Keynes that fiscal policy can have powerful effects. Rightly or wrongly the London Business School is often thought to parallel thinking in the Treasury because Alan Budd and Sir Terence Burns were close colleagues before Burns became Chief Economic Adviser in the Treasury in 1980. The London Business School say in their paper that until recently they have taken the view that fiscal reflation would not have a significant impact on output and employment but they have now changed their model slightly and believe that fiscal reflation will have the quite significant effects they set out.

But will the increase in employment last? Since 1968, when Milton Friedman initiated the concept of the natural rate of unemployment there has been a school in economics which has taken the view that the unemployment rate will tend towards an equilibrium or natural rate which is not significantly influenced by macroeconomic considerations: any attempt to get away from that equilibrium rate would lead to rapidly accelerating wage inflation. Minford is a notable supporter of that point of view, but six of the papers refer to a rather interesting new development in the subject which gives more scope for Keynesian reflationary policies and that is the concept of hysteresis. The suggestion in the hysteresis literature is that a society can become accustomed to any unemployment rate that chance events produce. For instance, if there is a major recession, then as effective demand is reduced, unemployment will rise sharply, and after a time people will become used to being unemployed, and social attitudes will alter so that to be unemployed will become more acceptable, and the economy will reach a temporary equilibrium in which it appears to be locked into far higher unemployment than before. The counter example would be the second world war where, because an enormous demand for labour was created and every able bodied person was found something useful to do, there was no belief that a significant number of people needed to be unemployed for 20 years after the war, and there was no social culture which took a significant fraction of unemployment for granted. The unemployment rate averaged 2% from 1945 to 1965.

The hysteresis literature which is at an early stage leaves considerable scope for a Keynesian approach to the creation of employment, because it signifies that whatever high unemployment rate an economy has temporarily settled into as a result of adverse shocks is in principle reducible, for with favourable shocks or stimuli it should be possible for the society to become accustomed to a lower rate of unemployment once again. There is widespread agreement that the hysteresis literature deserves a great deal of careful attention because it gives a society that has high unemployment opportunities to reduce it. If the hysteresis hypothesis is well founded, reflation of the kind the London Business School sets out could have lasting effects on employment.

But would such policies have inflationary effects which could undermine their adoption? If rising demand and employment have a tendency to raise the inflation rate, political judgments would have to be made as to whether the price that had to be paid for cutting unemployment was too high. That fiscal expansion will raise employment is something that has never been doubted by Keynesians but they have been concerned that it might well begin to raise the inflation rate long before the economy reached a high level of employment. It was Keynes's own view that:

> in general, supply price will increase as output from a given equipment is increased. Thus increasing output will be associated with rising prices, apart from any change in the wage-unit. (General Theory, page 300)

As it is generally agreed that the wage-unit (ie money wage rates) will tend to rise too as employment increases, it is to be feared that fiscal expansion will doubly raise prices, both because it raises wages and in addition because it raises profit margins. This general propensity for fiscal reflation to increase the inflation rate is set out most helpfully in the paper by Christopher Taylor of the Bank of England. Peter Sinclair reminds us however that while we should accept Taylor's presumption and Keynes's own that any expansion of demand will tend to produce a price level which is higher than it otherwise would be, there are further possible effects which might counteract this influence. If fiscal expansion is achieved by lowering taxes, this might well have a favourable impact upon wage behaviour and the price level. If fiscal expansion is combined with tight monetary policy as in the United States in 1980-83, the combined effect of a loose budget and high interest rates might well be to raise the exchange rate, at least for a time, and so produce a lower domestic price level (though this will rise again if the exchange rate subsequently collapses as the dollar has in 1986-88). Fiscal reflation combined with either of these countervailing influences might have a net impact on the price level that is actually favourable.

In the discussion of the paper by Budd and his colleagues at the Conference, it was proposed that if a particular policy mix which can be derived from the information in their paper is followed, then the inflationary effects of fiscal expansion could be rather slight. The combination of policies suggested was a simultaneous increase in public expenditure and in income tax which could then expand the economy with a balanced budget and no increase in borrowing.(2) That would avoid the difficulties with a growing debt to national income ratio from which Italy is so obviously suffering after 15 years of large structural deficits. The London Business School equations suggest that this particular balanced budget policy mix would reduce unemployment with no significant impact on inflation. If we accept that this line of argument is well founded, the question of political choice again arises, because whether it is worth acquiescing in an increase in income tax in order to cut unemployment is a matter for the electorate to decide.

There is however considerable doubt as to whether a balanced increase in public expenditure and income tax would have a zero impact on inflation. It is to be noted that this corresponds to neither of Sinclair's principal cases where fiscal reflation might lead to a lower price level. His countervailing influences include lower income tax rates which might reduce money wages, and not higher taxes which can be expected to increase them. Sinclair also attaches weight to the possibility that the higher interest rates associated with fiscal reflation financed by borrowing might raise the exchange rate, but much of this effect would be blunted if higher government spending was accompanied by higher taxation. Their belief that these particular reflationary policies should not raise the inflation rate therefore receives little support from Sinclair: rather the contrary, because according to his argument, higher taxation should increase both money wages and inflation. There is also a good deal of published work which finds that increases in personal taxation are associated with faster wage inflation.(3) If there is a tendency for workers to pass on any part of an income tax increase so that their real net of tax incomes fall by less than the full amount of the tax, the money wages that companies have to pay will become higher than they otherwise would be, which will lead to some increase in final product prices. For this reason, income tax increases will raise the price level unless the entire increase in taxation is absorbed by the labour force, and there are no grounds to expect this in view of the statistical evidence from several countries which suggests the contrary.

If this evidence is well founded, the long term implications of a balanced budget expansion in public expenditure and taxation will be even more discouraging because the adverse effects will not be confined to a higher price level. If the entire income tax increase fails to be absorbed by labour, then the real cost of employing a worker will become higher after taxes are increased, and at that higher cost fewer workers will be employed whenever the economy is actually in long term equilibrium, so the eventual impact of fiscal reflation financed by an income tax increase could actually be to reduce output and employment.

There is therefore a sharp dichotomy between the short term impact on demand of a balanced budget expansion in public expenditure and taxation which will be favourable, and its long term impact on the equilibrium level of output and employment which will be unfavourable. Budd and his co-authors from the London Business School have considered only the short term effect of these policies so, as with all demand-oriented economic models, they have arrived at a result which is broadly in line with Keynesian theory.

Budd's former co-author, Burns, is in contrast concerned about the possible adverse effects on supply of higher levels of taxation. Where two economies with similar technological and productive opportunities and an equally skilled labour force are both in long term macroeconomic equilibrium, and one has a higher level of public expenditure and taxation than the other, its companies will generally have to pay more for labour and its workers will at the same time receive less (for there will be a larger tax 'wedge' between the wage costs that companies incur and the wages that remain in workers' paypackets) so with conventional assumptions about the demand and supply curves for labour, equilibrium output and employment will be lower.

In the long term there is therefore a reverse-balanced budget multiplier theorem which states that a balanced expansion in public expenditure and taxation will reduce equilibrium employment and GNP. It is evident from the articles by Burns and Helmstadter that UK economic policy since 1979 and

German policy since 1963 has placed more weight on the line of argument that leads to this reverse-balanced budget multiplier, than to the short term Keynesian balanced budget multiplier which predicts employment benefits from extra public expenditure financed by taxation.

It is an interesting question whether it will be judged right to take advantage of these short term employment and output benefits if an inflationary price needs to be paid. The economics profession is very much aware of the compensation test that economic changes can be judged worthwhile if the gainers increase their incomes sufficiently to enable them to compensate the losers and still be better off. Any change that raises real GNP must pass this test for with a higher national income there will always be more gainers than losers. This is one reason why until recently most UK economists have viewed with bewilderment any suggestion that the potential output gains which Keynesian reflation can confer when the economy is in recession should be sacrificed because these policies might also raise inflation. If it actually reduces output in the long term as Burns and Helmstadter imply, that could be regarded a good reason for abstaining from reflationary policy, but what if it raises output and also has some tendency to increase the inflation rate? Could this high inflation rate actually have sufficient adverse effects on economic welfare and efficiency to justify a failure to take advantage of the opportunities to produce more which is offered by Keynesian reflation?

A number of economic issues associated with inflation are very helpfully discussed in the paper by Matthews and Bowen who suggest that if the inflation rate accelerates, each percentage point increase may raise the number of bankruptcies by 6%, Stock Exchange asset valuation ratios will fall and there will be a number of other adverse supply side effects which will actually reduce employment. This will clearly add to the long term damage to employment which a decision to benefit from the short term advantages of Keynesian policies could entail. In addition to these possible adverse long term effects, it is beginning to appear that there may be a political case against Keynesian reflationary policies if they have a tendency to raise the inflation rate. The Chancellor makes it very clear in his opening statement that in his judgement, the electorate does not take kindly to policies which raise the rate of inflation. In fact no British government which has significantly raised the rate of inflation since the Second World War has been re-elected, while four governments which have not raised inflation or have managed to bring it down have achieved re-election; so it may indeed be that the electorate votes out governments which increase the inflation rate.

If that is in fact the case, it would be possible to take the rather simple view that when Keynesian policies were universally adopted in the United Kingdom, politicians had the belief that the achievement of low unemployment was far more important than the containment of inflation. In the 1960s and the 1970s the electorate reacted by voting out a succession of governments which presided over an increase in the inflation rate, while as Matthews and Bowen explain, the acceleration of inflation in the 1970s discredited the use of Keynesian reflationary policies to limit unemployment in several countries. There is therefore a widespread belief today that the inflation price of fiscal expansion is not worth paying. Perhaps the most damaging scenario is a zig-zag political course in which one government pursues Keynesian policies which raise the rate of inflation and a successor government is then elected to reduce inflation again. Inflation may then end up where it started but there will be an enormous loss of GNP when that sequence takes place because the gain in GNP when effective demand is expanded by the first government in order to raise employment but which also raises inflation is far less than the subsequent loss of GNP when inflation has to be brought down again by the next governement. The money wage rigidities which are so helpfully explained in Artis's paper make it very clear that the extra unemployment required to lower inflation is very great. Hence whenever Britain follows a cycle in which one government puts inflation up and the next pulls it down again, there will be a significant loss of national income in the aggregate because unemployment will need to be high for many years to overcome the wage rigidities which stand in the way of slower inflation.

Does that mean that we are locked in and cannot pursue Keynesian policies because these are bound to have an inflationary impact to which the electorate will react unfavourably? It is in fact possible to conclude on a rather more hopeful note, for the hysteresis literature suggests that the upward impact on inflation when employment is raised is not inescapable, for a country's 'equilibrium' unemployment rate, or NAIRU, will tend to adjust to any actual unemployment rate which a society becomes accustomed to. The problem is to persuade a society to adjust to a lower unemployment rate. To achieve this, the actual unemployment rate must be reduced which Keynesian reflationary policies can bring about, at least in the short term, and these will then need to be reinforced with micro-policies to bring some of the long term unemployed who have become accustomed to being unemployed back into the labour market. Such micro policies which include retraining, encouragements to mobility, job counselling, the provision of better information about vacancies, short term employment opportunities in public schemes and improved administration of the provision of unemployment benefits can get some of the long term unemployed back into permanent employment. If employment can be raised in a way that brings the long term unemployed back into the mainstream labour market, which is now very much an objective of UK government policy and of a great deal of academic thinking (and of Taylor's paper) expansion can be achieved without the inflationary pressures that would be experienced in the absence of these microeconomic policies. There is a further consideration which must be borne in mind. It cannot be true that in general all economic expansion which significantly reduces unemployment must raise inflation. In the UK in 1981-88, economic expansion has been accelerating and unemployment has been falling since 1986, but inflation has been stable. The government has been using microeconomic policies of the kinds described to bring the long term unemployed back into the mainstream labour force, and long term unemployment has been falling about as fast as total unemployment. There is likely to be a limit to the speed with which such favourable structural changes in the labour force can be achieved, so there will be limits to the rate at which the long term unemployment associated with hysteresis can be reduced, but within those limits expansion which gradually reduces unemployment need not be inflationary provided that appropriate micropolicies are pursued at the same time.

The UK's non-inflationary expansion in 1981-88 has had a strong supply side element, and the budget deficit has been reduced from 6% of GNP in 1980-81 to approximate balance (excluding privatisation proceeds) in 1987-88 so the growth of the economy has owed nothing to fiscal reflation. But the real money supply has advanced very fast indeed, by more than 5% per annum according to Walters' preferred measure, so the government has made some use of macroeconomic monetary policy to reflate the economy.

The fact that a sustained non-inflationary expansion which substantially reduced unemployment was possible means that this may also be achievable with the support of fiscal reflation (together with compatible real monetary growth) if appropriate labour market policies are adopted at the same time. A balanced budget expansion may not be the ideal fiscal way to reflate the economy because of the possible impact of rising tax rates upon wage and price inflation, and fiscal reflation financed by borrowing risks adding to inflation because of the difficulties associated with financing persistent deficits and the possibility that these will in due course be monetised.

The scope for Keynesian fiscal reflation may therefore be limited to taking advantage of a small stable cyclically corrected deficit as an element in policies to reduce unemployment in periods of recession, along the lines so helpfully set out by Miller and Sutherland: a tolerance of such deficits was really all that Keynes himself actually recommended, as Dimsdale makes clear. A modest fiscal reinforcement to the economy's natural recovery forces need be no more inflationary than the substantial real monetary expansion that has been so important in the UK since 1981. What we know today that was less clearly understood in 1936 is that such 'Keynesian' reflationary stimuli need to be accompanied by appropriate microeconomic labour market policies, so as to limit the upward pressure on wage inflation.

A problem that remains is that if only a few countries in the world pursue such policies, their imports are liable to expand far faster than their exports, with the result that these governments' reflationary policies may need to be reversed in order to bring their balance of payments under control.

Max Corden, Helmstadter and Currie address some of the problems which must be solved if a coordinated expansion which will permit all countries' exports to advance in line with imports is to be achieved. It will be evident from a careful reading of their articles that no more than international discussion to achieve consistency between the exchange rate policies of the various countries is actually to be hoped for in the 1980s. Germany in particular regards Keynesian policies as entirely irrelevant to the amelioration of unemployment and there is no way in which Germany will agree to a faster rate of monetary or fiscal expansion than domestic considerations call for.

The German approach to employment creation is entirely supply oriented and Helmstadter's emphasis on the need for a country's industry to create new products where value-added will be high in relation to wage costs points to an approach to employment creation which individual countries acting alone can adopt without foreign exchange risks. Successful new products perform well enough in world trade to allow an economy which develops them to expand employment and increase exports in line with imports in the same manner as a successful region within a national economy which can prosper, even when its parent economy is in recession.

The UK's post 1981 recovery owes a good deal to successful supply side developments. For an economy which fails to achieve success in the development of new products, properly arranged demand corrections with compatible monetary and fiscal expansion in order to ameliorate adverse cyclical influences (which was really all that Keynes advocated) offers the possibility of modest potential gains to economic welfare which a country should surely take advantage of.

## Footnotes

(1) See also N H Dimsdale, "Keynes on British Budgetary Policy, 1914-46" in M J Boskin, J S Flemming and S Gorini (eds), Private Saving and Public Debt, Blackwell, 1987, for a more detailed account of Keynes's approach to deficit financing.

(2) The effects that Alan Budd and his colleagues predict from a balanced budget increase in public expenditure and income tax can be derived from Tables 3 and 4 of their simulations.

(3) The UK and international evidence on the impact of personal taxation on wages together with an account of the very large journal literature is summarised in, Anthonie Knoester and Nico van der Windt, "Real Wages and Taxation in Ten OECD Countries", Oxford Bulletin of Economics and Statistics, Vol 49, 1, 1987.

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# THE IRRELEVANCE OF KEYNES TO GERMAN ECONOMIC POLICY AND TO INTERNATIONAL ECONOMIC COOPERATION IN THE 1980s

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Revised Version - February 1988

Paper prepared for the conference
KEYNES' GENERAL THEORY AFTER 50 YEARS
London, 15-18 September 1987

# THE IRRELEVANCE OF KEYNES TO GERMAN ECONOMIC POLICY AND TO INTERNATIONAL ECONOMIC COOPERATION IN THE 1980s

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The West German economy has a very significant impact on the world economy, so the potential international repercussions of all domestic economic measures must be taken into account. Such repercussions may occur at two levels: they may concern the world at large, or they may be restricted to Europe. West Germany produces a relatively small fraction of world output, but a considerable proportion of the output of the European Economic Community. However at the world level the D Mark has become a key currency with an importance that transcends Germany's relatively modest share of world production, and West Germany has become one of the principal participants in international discussions which seek to arrive at the gradual evolution of new approaches to policy at both the European and the world level.

In the 1980s the European Monetary System has continued to evolve and considerable progress towards monetary stabilisation and fiscal consolidation has been achieved at the European level. This progress would have been impossible without West Germany's lead in the implementation of appropriate domestic measures within the context of its monetary and fiscal policies. There has in contrast been no such progress in the world economy

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* I am grateful to Walter Eltis for his help in the preparation of an English language version of this paper, and for drawing my attention to Herbert Giersch's account of the development of his thinking on economic policy for an English readership.

where the tendency has been towards fiscal and exchange rate destabilisation. Owing to fluctuations in exchange rates and in the prices of essential raw materials, payments balances on current account have been in significant disequilibrium for more than a decade; the former international debtors have found it impossible to reduce what they owe, while the United States has added a further dimension to international debt through its enormous borrowings.

The United States is now hoping that the relatively stable European economies will give some stimulus to global trade. It is believed that Germany could lead this move towards expansion and some of our European partners have joined their voices to the international chorus which is requesting that we take this initiative. They believe that the generally high rate of world unemployment calls for new expansionary forces, and the solution is believed to lie in concerted action in favour of economic growth and employment.

What is being asked could in one sense be regarded as what Max Corden calls "International Keynesianism Mark I" in his paper, viz., concerted action to expand aggregate demand by a number of countries in a financial system where exchange rates are fixed, for this is broadly the situation within the European Monetary System. With regard to the world economy as a whole however, the most significant exchange rates are variable, so Corden's "International Keynesianism Mark II" appears to provide a more appropriate description of what is being proposed. What would be our chances of success if an economic strategy based on concerted expansion by those of the world's economies which now enjoy payments surpluses were to be adopted? Is such a Keynesian strategy the most appropriate approach to the world's financial imbalances and higher general levels of unemployment, or is it also possible to stimulate growth through a non-Keynesian economic strategy?

An attempt to answer this question is put forward in this paper on the basis of West German experience. It draws heavily on the accumulated analysis of the German Council of Economic Experts of which I became a Member in 1983. Since 1963 this Committee has been appointed to advise West German governments on the development of the economy. There has been a remarkable continuity of thought since the first report in 1964 which was strongly influenced by the analysis of Herbert Giersch, one of the Council's three academic Members when it was set up by Chancellor Adenauer. The views and findings in the Council's most recent report follow naturally from those which have been advocated over a period of years. The Council's advice has occasionally been critical of the policy stance of German Socialist-Liberal coalition governments, while its position has coincided to a considerable extent with those of the present Christian Democrat-Liberal coalition government and of the Bundesbank.

In this paper the approach to economic policy which has guided the thinking of the Council since Giersch's seminal contribution in 1963-69 will first be set out, because it is an approach to economic policy which is not widely understood outside Germany (although other countries including Britain appear to have begun to adopt a quite similar approach in the 1980s). It will then be explained how Germany is likely to react to international pressures to cooperate in an international Keynesian approach to the world's present economic imbalances, and what the outcome of such cooperation would be likely to be.

## The Approach to Economic Policy of the German Council of Economic Experts

In its annual report for 1976/77 the German Council of Economic Experts deliberately assumed a position which went beyond a Keynesian approach. The Council insisted that 'demand-oriented overall management' should be supplemented by a 'supply-oriented policy'. "The main purpose of aggregate demand management is to ensure that existing productive potential remains as well-balanced as possible and is utilised sufficiently; and by the same token the aim of a supply-oriented policy is to improve conditions for investment and to modify the structure of production so that adequate growth and a high level of employment appear once more within the realms of possibility." (para. 284)

We can go back to the Council's first reports in Giersch's time to see the origins of our belief that the level of employment depends primarily on supply-side and not demand-side considerations. Giersch has told us that he took advantage of a period of enforced leisure in the United Kingdom in 1944-45 to read the two great English economic classics, Smith's <u>Wealth of Nations</u> and Keynes' <u>General Theory</u>. His reading of Adam Smith's book became "crucial for my view of the world" (Giersch, p. 255), but he responded less favourable to <u>The General Theory</u>, and still less favourably to Joan Robinson who came to Munster shortly after the war to "expound a vulgar Keynesianism... It was like Hamlet without the Prince of Denmark: a theory and a policy of full employment without wages" (Giersch, p. 257). At the same time American Keynesians were visiting Germany and recommending "expansionist policies, erroneously assuming that we had Keynesian unemployment rather than the classical variety arising from the influx of refugees and the physical destruction of the capital stock" (Giersch, p. 257).

By the time he became a founder Member of our Council of Economic Experts Giersch had evolved an approach to the assignment problem which was very different from that of the Keynesian Americans who would have created massive inflation in the Germany of the late 1940s if their advice had actually been followed. In this approach which gradually evolved after 1963 it was believed that the prime responsibility for the control of inflation rested with monetary policy, so the Bundesbank had to achieve rates of growth of the money supply which were compatible with a gradual fall in the inflation rate to zero. With the Bretton Woods fixed exchange regime that then prevailed, there was a fixed exchange rate between the D Mark and the dollar, so in 1960 German inflation could only fall towards zero if United States inflation also fell, and the Americans, influenced from time to time by Keynesian policies, have permitted a persistent upward trend in their price level. It was therefore indispensable to the objective that Germany's inflation rate be reduced towards zero that the D Mark be decoupled from the dollar and hence be allowed to rise so that Germany's inflation rate could fall below America's. This proved to be the most controversial element in the Council's proposals. German industrialists were appalled by the prospect of revaluations of the D Mark and even Chancellor Erhard accused the Council of offering "stones to a public in need of bread" (Giersch, p. 264). But the policy of freeing the D Mark from the dollar was adopted and German inflation has indeed fallen towards zero as a result of the prudent monetary policies that the Bundesbank has thereby been free to adopt.

While the role of monetary and exchange rate policies is to control inflation, the German version of the assignment problem attributes the level of employment to how high money wage costs are in relation to the price level (which is determined by the money supply and the exchange rate). In Giersch's words, "the medium run level of employment was seen to be essentially determined by the level and structure of real wages" (p. 269). The role of fiscal policy was then to determine the growth of potential output through its influence on the supply side of the economy. It exercised such influence via the following transmission mechanisms:

> "(i) the aggregate supply of savings for (productive) capital formation via the budget surplus or deficit, the tax system and the structure of public expenditures; (ii) the marginal efficiency of autonomous (i.e. not demand induced) private investments via the tax structure and the complementary character of public investments, and (iii) the supply of labour and society's general motivation level via the level and rate and structure of direct taxes." (p.270)

Giersch took the view that "In a medium run perspective, the Finance Minister is regarded as responsible for the population's economic mentality and the national economy's dynamism and attractivity on world capital markets." (p.270).

Germany has indeed gone on to follow this course of action. We have used fiscal policy to create a supply-side environment that is favourable to growth, monetary policy to control inflation, while for the achievement of high employment we have relied on the moderation and good sense of the German trades unions (which has generally been forthcoming) to hold wages down to a level which is acceptable in relation to the price levels that the Bundesbank's price and exchange rate policies impose on German industry. The countries which have followed Keynesian policies have in contrast assigned to fiscal policy the creation of sufficient demand to permit the attainment of high employment and since this has often involved budget deficits their productive saving has been squeezed with the result that their economic growth has suffered. Their central banks have often been willing to finance whatever wage levels emerged at the employment levels their fiscal demand oriented policies generated, and these countries have then lacked a monetary brake to inhibit inflation. They have therefore been without policies to achieve low inflation and medium term economic growth. Germany would not wish to depart from our quite successful solution to the assignment problem, and there is naturally concern in Germany (which will emerge in the latter part of this article) that pressures to adopt elements of international Keynesianism would implicitly oblige us to go over to a domestic policy mix which has hitherto proved (by the countries which chose it after 1945) considerably less appealing than our own.

The continuity of thought on German economic policy can be demonstrated by showing the extent to which Giersch's solution to the assignment problem is precisely the one set out in the Council of Economic Experts' 1986-87 Report. Thus, we wrote in 1986 that:

> "Monetary policy's task is to protect the value of money. This necessitates expanding the money supply at a rate which is in line with growth in productive capacity at approximately stable prices. If monetary policy is steady in this sense, it simultaneously contributes to stabilising expectations on the foreign exchange markets.... Adjustment problems stemming from an abrupt change in the pace of money supply growth can be avoided by making the return to the target path take place gradually. When the actual development surpasses the target, our suggestion to announce a

target path for a period of several years is superior to a procedure whereby a monetary target is fixed anew each year and thus contains a discretionary element regarding the starting point. Commitment to a multi-year monetary target requires no more from the central bank than commitment to a promise to keep the value of money stable."

"The role of fiscal policy in the offensive strategy against unemployment consists essentially of removing distortions of economic incentives. First of all this applies to the heavy tax burden, and particularly to the high marginal rates of the income tax and the corporation tax, and secondly to the many and varied government subsidies. Both the tax burden and the subsidies impair the willingness to work harder and to assume more risk. The reduction of tax burdens must not however be financed via increased public deficits."

"By their wage settlements, employers and employees strongly influence economic performance. It is part of our policy conception for a self-sustained upswing that they reach agreements which keep unit labour costs stable. Otherwise the level of costs would rise again because another fall in import costs cannot be expected. Wage bargaining would then conflict with monetary policy, as the latter would be bound to view the goal of stability as being in danger. The consequence would be that either employment or price stability - if not both - would suffer, and the continuation of the upswing would become uncertain". (English Language version: paras. 31, 33, 34, 37)

The German Council of Economic Experts sees growth and the medium term change in employment as depending mainly on supply-side developments, and it is this aspect of our policy analysis that may appear most surprising to those inclined to think along Keynesian lines. The Council is concerned, not merely to utilise existing productive potential, but that present production facilities should be continuously modernised which actually matters far more in the long term. The Council has often pointed to the lessons which can be learned from economic history which underscore the fact that "the primary impetus for expansion often originates in supply, which automatically creates equivalent demand."

This wording is reminiscent of Say's Law, a principle which is often misunderstood. What is meant here is that the right kind of supply creates its own demand. Indeed many of the present day problems involving growth and employment can be illuminated by the simple formula of Say's Law provided that this is interpreted qualitatively: "The right kind of supply invariably creates its own demand". If producer and consumer goods are supplied which incorporate modern developments in science and technology, which work reliably, and most crucially of all, which fulfil a need that is felt by populations somewhere in the world, then the supplier will be able to obtain a price which more than covers his costs. This kind of supply is created in efficient and well managed factories and workplaces, and these, by designing and producing such goods, create more employment. This is the crux of supply-oriented anti-unemployment therapy.

Economically viable goods must be marketable at prices which more than cover costs, so a cost-cutting strategy is a necessary element in their creation. It is therefore helpful if a country can reduce the costs that stem from taxation, social insurance contributions and above all labour costs, and there is clearly a limit to the extent to which increases in such costs can be tolerated if companies are to continue to sell at prices that cover them.

It is naturally also vital that the firms that make up an economy be flexible, adaptable, and receptive to innovation which are all crucial elements in the improvement of the supply side of the market.

Competitive conditions in industry naturally have much to contribute to bring about this state of affairs, and the Council of Economic Experts considers "dynamic competition to be the model (Leitbild) of a forward-looking economic policy aimed at promoting growth and employment" (Annual Report 1985/86, para. 308). The Council is well aware that economists and governments have only limited means to control developments in the domain of dynamic competition. They can widen the range of markets in which firms have to compete, but they cannot control the extent to which firms subsequently behave more competitively. But the Council has found that something can be achieved by all the time opening up more markets to competitive forces, and by encouraging innovation at every available opportunity.

It is the Council's view that the strength of competitive forces and the pressure to innovate which are vital elements in an economy's <u>basic</u> economic drive are the key factors that influence the growth of employment that an economy achieves. Fluctuations will be smoothed out in the course of time, and these long term considerations will then exercise the dominant impact.

The basic paradigm that guides policy makers should therefore not be one where the principal object is to spread cyclical stimuli more evenly through time. Stimuli should on the contrary be continuously reinforced so that dynamic forces are created which provide a sustained boost to the economy.

A mature economy can only continue to expand if industries which have become moribund are replaced through the expansion of a sufficient number of new industries, and if out-of-date products which can only be sold at prices which barely cover costs are driven out of the market by a sufficient number of new products which can be sold at prices which satisfactorily cover costs.

In the last resort it is the ratio of value-added to costs of production which is crucial. Imitative competition in which more and more producers enter the market in order to supply older products will gradually force their prices downwards (and so the value-added that these products can earn in the marketplace) towards the level of their unit costs. In an economy with growing competition (and this is something we consistently support), and especially competition which takes the form of a willingness to imitate the products of successful existing producers, the revenues that can be obtained from these in the marketplace will all the time fall in relation to their costs of production. There is only one remedy for this law of rising costs and squeezed margins: innovative competition through the creation of new and superior products to compete with the older ones that are becoming unprofitable. Only new products and the development of new markets can permit the achievement of a more favourable ratio of value-added to costs of production. (Helmstadter 1987)

If an economy has an unfavourable mix of old and new products, too many old models and designs, and too little to offer that is modern and redesigned, costs of production will inevitably be high in relation to the prices that can be obtained for these goods in world markets, so the economy's profits will be low, and it will provide insufficient growth and employment. Such deficiencies cannot be remedied by macroeconomic policy measures because these will be unable to modify the ratio of value-added to costs of production. A government induced rise in prices (via a Keynesian expansion in demand accompanied by devaluation) could of course reduce the real wage for a few months and so temporarily reduce costs of production, but any such advantages to manufactures would be unsustainable. Wages would soon start to chase prices upwards once again and so restore the formerly inadequate ratio of value-added to costs of production. The only solution is the creation of new products which offer a more favourable ratio of value-added to costs of production, and this goal will be best attained via dynamic competition. Governments can assist its operation by removing obstacles to competition through the elimination or simplification of government regulations, and improvements to incentive structures. Every political measure which stimulates innovative activity without inhibiting competition will enhance the process by which new high value-added products are created.

That completes my brief outline of the supply-oriented policies that the German Council of Economic Experts has been advocating since 1963. The present Council and our predecessors have regarded the competitive process itself as the driving force for the achievement of sustained growth and employment. We have argued that Germany should direct its attention in several directions for the achievement of this goal. We have been especially concerned to encourage the development of small and medium sized businesses, and the process of dynamic development through competition may be compared to a millipede. Locomotion is ensured by a large number of small cogs functioning on an all-wheel-drive principle. The concept beloved by international Keynesians of a "locomotive" as the draught horse of dynamic development is erroneous.

The Council naturally assesses the scope for concerted international action on the basis of this fundamental analysis of the appropriate economic policies for the promotion of economic growth and employment, and this will be the subject of the next section.

International Cooperation at the European Level

International cooperation to reduce the degree of fluctuation in exchange rates is pursued with two particular aims in mind: first, so that movements of exchange rates should be to the greatest possible degree predictable, and second to support national efforts to prevent the collapse of particular currencies. Since 1979, these objectives have to a large extent been attained at the European level. At the world level, the system of freely flexible exchange rates, which superseded the Bretton Woods system of fixed exchange rates in 1973 has lagged far behind the European System for the attainment of these objectives. It is an important question why the smaller system should have been successful, while the larger world system has fallen so far short of expectations, and the answer to this question will provide interesting insights into the implications of the two systems for employment (Mattes, 1987b, Schlesinger 1987).

Although the national currencies represented in the EMS are confined within a system of fixed rates, they can be adjusted up or down, and these modifications have depended on the success of national price stabilisation policies. Divergences between currencies and especially between inflation rates have on several occasions led to corrective adjustments to official EMS exchange rates. Nevertheless, the overall tendency of the European

Monetary System has been to reduce inflation in the higher inflation European economies. As Jacques Delors, the French President of the European Commission, has recently remarked, the European Monetary System "has brought most of the countries concerned back to the path of virtue, the circulus virtuosus where inflation and disequilibria are anathema" (cf Mattes, 1987a).

The instrument which has made this possible has been the stable D Mark whose "absolute postulate of stability" (Mattes) serves like a linkage to gold. The dimensions of the trading area within which the D Mark functions as an internal currency more or less meet the non-monetary requirements for a key currency. Legally, the European Monetary System has no key currency, but in reality the D Mark has assumed this role. Its ability to fulfil this function properly depends on the extent to which it can achieve a greater degree of stability than the other currencies in the system, which depends to a considerable extent upon the achievement of a stable price level by Germany.

At present the European Monetary System is still functioning "asymmetrically" (Mattes): in terms of stability it does not constitute a homogeneous block. In the centre there is the stable D Mark around which other less stable currencies form a group. By initiating its price stabilisation policy in 1983, France considerably reduced the gap between French and German inflation rates and the Italian inflation rate has also fallen very considerably in the 1980s. There has clearly been a growing tendency for the inflation rates of the countries which participate in the EMS to converge towards Germany's now zero inflation rate. President Delors regards this trend as an indication that the initial phase in the functioning of the European Monetary System has been completed, and suggests that as a next step "the European Monetary System must form the nucleus of an economic system which is more efficient in terms of growth, competitiveness and employment. In view of the spectacular progress that has been made with respect to the liberalisation of capital transactions within the Community, we have no choice but to make further headway by extending the domain of group discussion concerning economic and monetary policy" (cf. Mattes 1987a).

During the initial phase toward's Europe's concerted currency stabilisation process, the D Mark has tended to be undervalued on a purchasing power parity basis in relation to other European currencies because of Germany's comparatively low inflation rate. This tendency has favoured West Germany's export trade and had a positive impact on employment: at any rate this is how West Germany's European partners see the situation. Conversely, France and Italy with their faster inflation rates have tended to have overvalued currencies but gained stability advantages which have had favourable supply side effects. That is the counterargument put forward by the Germans. The fact is that the corrective exchange rate adjustments which have been needed are becoming less and less significant and they are tending to closely follow relative inflation rates with the result that Europe's relative real exchange rates have been quite stable.

Now that this has been accomplished what is the next phase? Some economic policy makers believe that the D Mark may now be too stable and warn against the danger of deflation. In our own discussions about the consolidation of the government budget in the early eighties some spoke more drastically of the danger of what they described as "Kaputtsparen" (ruinous saving), a form of Keynesian saving that reduces the circular flow of money, goods, etc. Is this to be countered by an expansionist monetary and fiscal policy, or is it possible to devise some other means of pursuing a "cooperative growth strategy aimed at raising the level of employment" within the institutional framework of the European Community? (Annual Economic Report 1985/86 of the Commission of the European Community).

A proposal has been put forward by the European Commission based on a strategic paper written by a group of experts who want to attain a higher level of growth and employment by means of a so-called "two-handed approach". (Blanchard et al). This strategy aims at promoting both supply and demand in order to increase growth and employment.

"Neither supply nor demand will by themselves create and sustain employment growth. This simple point forms the basis of our approach: structural changes on the supply side are required if employment growth is to be sustained, but a boost is needed to start the process. This boost must come from timely supply measures, sustained and validated by demand." (Blanchard et al, p. 31).

The strategy envisaged in their paper provides for investment incentives and employment subsidies accompanied by a very slight increase in real wages (1-2%). In the first half of the eighties businesses hardly expanded plant capacity, they merely adjusted to improvements in input prices. Now they are to be vitalised by a complementary expansion of demand, and monetary policy is to permit this. The group of experts do not say exactly what real growth rate is to be attained by such measures, but they stress that unemployment can only be reduced by a period of accelerated growth.

The European Commission in contrast (1986) ventures to give figures to indicate the dimensions that "more dynamic growth" might attain. Between

1986 and 1990 the real growth rate in Europe is to average 3-3.5%. The level of employment is to increase by 1-1.5% per annum. This means that by 1990 the unemployment figure would decrease by 4 percentage points: in the original ten EEC countries unemployment would fall from 11% to 7%, and in all 12 present-day member states it would drop from 12% to 8%.

Without the measures envisaged within the framework of the "cooperative Community strategy", the Commission estimates that the real growth rate of the 10 older member states for the same period would be 2.7% per annum. Thus the growth strategy aimed at promoting employment is supposed to result in an increase in the rate of growth of just under 1%.

In its latest annual report the German Council of Economic Experts unequivocally contests the view that government economic policy can effect a sustained increase in the real growth rate by means of expansionary monetary and fiscal policy measures (Annual Report 1986/87, para. 211). In the meantime, the Commission's proposals for a cooperative Community strategy have been put on ice. They cannot expect any support from West Germany inasmuch as the proposals put forward threaten to trigger an upsurge in inflation. Moreover, the authors of the paper do not indicate how the measures on the supply side are to be put into practice. In this respect the group of experts who have advocated the "two-handed approach" are just as vague as the Commission.

The underlying explanation of our opposition to the Commission's proposals is of course that a faster rate of expansion of Germany's money supply would be inflationary which runs counter to the principles which have guided German economic policy so successfully since 1963 which I have set out in the previous section of this paper. At the same time, the proposed use of fiscal expansion to stimulate demand runs counter to our judgment that this should be used to create a fiscal framework to encourage medium term growth. The larger German budget deficit which the Commission proposes would reduce the aggregate saving that is available to finance productive investment in Germany and so have a long term tendency to reduce employment.

The Commission's proposal for a concerted economic policy of the member states has some inglorious predecessors, eg the "locomotive or convoy approach", which was taken up at the economic summit in Bonn in 1978, and which was commented on as follows in an IMF staff paper: "In retrospect, it can probably be said that the Bonn measures placed insufficient emphasis on the medium-term consequences of fiscal expansion, and failed to provide sufficient flexibility for anti-inflationary monetary policies...:". (Horne, Masson 1987)

The "hardest and most difficult form of policy coordination: a concerted action as agreed at the Bonn Summit in 1978" (Wegner 1987b) was doomed to failure from the outset, and most German economists appreciated this: "The majority of German economists saw in this episode a grave policy error, a verdict which explains also why German policy makers today are vehemently opposed to a similar concerted effort, this time to ease the adjustment burden of the United States" (Wegner 1987b). One would think that the "pitfalls of international fine-tuning" (Horne, Masson) would be generally accepted as a classic example of how not to do things.

## International Cooperation at the World Level: 1. Managed Exchange Rates

The EMS has presented Europe with a stable exchange rate system but global exchange rates have in contrast fluctuated to an excessive degree. In order to lessen the difficulties a number of proposals have been put forward with a view to establishing a system of "managed" exchange rates. Both monetary and fiscal policy would be geared to assist exchange rate stabilisation within a quite generous fluctuation limit. To this extent exchange rates are not to remain exclusively subject to the whims and vicissitudes of the foreign exchange market and general economic policy. Exchange rate stabilisation is now to rank as an intermediate target in its own right within the framework of the government's economic policy.

Capital movements inspired by economic and political speculation have contributed to the enormous fluctuations in exchange rates which have occurred in recent years. This deplorable state of affairs is to be remedied by the system of "managed" exchange rates designed to reduce the gains that can be obtained from opportunist international speculation. Within the framework of the new system, fiscal and monetary policies are to be organised so that they will be binding and readily comprehensible, thereby guaranteeing a higher degree of predictability to market operators.

The advocates of this newfangled system are again evoking rosy prospects for the fine-tuning of monetary and fiscal policies via concerted international action.

The proposals threaten to undermine the principles which have guided German economic policy since 1963. Our counterinflation strategy has depended on the selection of monetary growth rates and consequent D Mark exchange rates which are compatible with a zero inflation rate in Germany. Any modification to this monetary and exchange rate policy would not only damage Germany: it would also undermine the counterinflation strategy of the EMS economies.

In its latest report (Annual Report 1986/87, paras. 245-259) the German Council of Economic Experts has expressed strong reservations about "managed" exchange rates. These reservations are based upon the following considerations:

- In its initial phase the system would have to function with exchange rates negotiated on the basis of political compromises of a kind that could hardly be arrived at on a worldwide scale.

- If such a system were to be established there would be a great danger that all the countries concerned would end up with an averaged inflation rate roughly equivalent to the average of their original inflation rates. In the worldwide coordination process it would be virtually impossible to maintain on a longer-term basis a policy of stabilisation such as exists within the framework of the European Monetary System, which has depended upon one major country achieving price stability while the others gradually adjust their inflation rates to the zero rate achieved by that key country.

Under the the new scheme the margins of exchange rate fluctuation are to be widened. If this system actually materialised, the probability is that each country's exchange rate would be close to the upper or lower limits of the permitted margins. Two way movements by individual countries are likely to be exceptional since each state would have a preference for either currency appreciation or depreciation and would allow its exchange rate to drift in that direction to take advantage of the scope for action offered by the widened fluctuation margins. This in turn would trigger constantly renewed speculative flows of capital until the next corrective exchange rate adjustment.

The German Council of Economic Experts believes that there is a direct way of ensuring that the goal of exchange rate stability is attained: consistent and predictable monetary and fiscal policies must be pursued by the leading countries that belong to the world's flexible exchange rate system.

Summing up its conclusions, the Council stresses the following points:

Fixed exchange rates can only be established if all the countries concerned adhere to the same stabilisation policy. This is particularly true in cases where there are no restrictions on foreign trade or capital transactions. At present, however, it is impossible to bring the various national policies into line with each other.

Managed exchange rates can only be established if coordinated national stabilisation measures are undertaken on the basis of constantly renegotiated international agreements. Official foreign exchange market interventions will also be necessary and these need to be negotiated between the central banks concerned. But as has been shown above, such conditions cannot be fulfilled at present.

A working system of flexible exchange rates involves a great many presuppositions with regard to the consistency and predictability of national stabilisation policies. The countries concerned need to observe strict disciplinary rules in order to hold to the stabilisation policies they have set out. At the same time - and in this respect a system of flexible exchange rates is quite different from a system of fixed rates - the member states can go their own ways, by for instance pursuing different national inflation targets because the economic goals of the various countries will not be the same. It is essential however that each country pursues its own individual targets consistently because it is well known that exchange rates will fluctuate wildly if the inflation prospects of the various countries keep changing.

**International Cooperation at the World Level: 2. Coordination of Fiscal Policy**

There is something tragicomical about the way in which America's tax-cut-based supply-side economic policy of the early eighties actually became a classic case of demand boosting policies through its creation of enormous budget deficits. The total government deficit which reached 7% of GNP in 1982 has fallen to 4% in 1987, but it will be years before the American deficit can be reduced to easily financible proportions. The United States government hoped to persuade Congress to agree to cut total public expenditure by limiting the tax revenues available, but these efforts have so far failed to produce significant results.

The American example, like many others, inevitably leads to scepticism about the scope for international economic cooperation to coordinate fiscal policies. It would be irresponsible to attempt to remedy national failures through internationally concerted action.

In comparison with monetary policy, fiscal policy is far more deeply rooted in the political process. The internationalisation of fiscal policy can only increase the extent to which it becomes politicised. It is moreover becoming increasingly difficult to achieve the best timing for countercyclical fiscal measures. This timing problem can only become more difficult if there has to be international consultation about any fiscal action.

The current problem is posed by a widespread belief that there should be a concerted international approach to monetary and fiscal policy in an effort to reduce America's trade deficit. Rather than to achieve this by the direct means of reducing America's budget deficit, it is proposed to achieve this indirectly by means of a reduction in the exchange rate of the dollar and through expansionary monetary and fiscal policies by Germany and Japan.

It is most unlikely that this approach to the reduction of the American balance of payments deficit will be successful. The devaluation of the dollar should have some effect, but its impact on the trade balance is likely to be insufficient. Despite some recent improvement, the deficit is still running at an annual rate of about $150 billion. America's $264 billion foreign debt is now two and a half times as high as the debt of Brazil, the world's second largest debtor.

The further easing effect on the American deficit of prolonged monetary and fiscal expansion by the German Federal Republic (which would undermine our own medium term economic strategy where fiscal policy is meant to strengthen the supply side of the economy) would in fact be minimal: 1% extra growth by Germany and Japan for three years would cut it by only $5-$10 billion in view of their quite small fraction of world output. In the opinion of the German Council of Economic Experts, such policies can in any case be ruled out because they would create an immediate risk of a new wave of inflation in Germany where the money supply is already abundant, interest rates are low and the budget deficit is in any case rising. These considerations indicate that the German economy has already made full use of such scope as might have been available for monetary and fiscal expansion. A new wave of inflation in West Germany would be detrimental to the world economy, not least within the framework of the European Monetary System, and it would moreover introduce a further element of exchange rate instability.

__What can actually be done?__

It does not appear that present day employment problems can be resolved by means of international Keynesianism, Mark I or II. There have already been enough postwar experiments to bear witness to the fact that Keynesianism does not really have the sustained impact on unemployment that its advocates expect. These advocates tend to forget that, "classical unemployment, if fought by Keynesian policies, will merely be transformed into much worse diseases, ie capital shortage, unemployment and, eventually, technological unemployment" (Giersch, p. 272); which explains why these policies so often raise unemployment (the worst cases because they have budget deficits of more than 10% of GNP are Italy and Ireland which also have unemployment rates of well over 10%) instead of reducing it. This means that we can learn little from Keynes in the 1980s.

The unemployment problem with which we are now confronted has little to do with cyclical fluctuations, and cyclical swings in economic activity no longer assume the dimensions for which Keynes and the Keynesians designed their economic and fiscal policies. Our concern today is with sustainable growth rather than with short term measures designed to foster expansion. Strictly speaking, we are concerned with reinforcing the process of economic evolution, we are interested in innovation and in continuous structural change. Over the past 15 years a number of economists have been unduly preoccupied with the problems raised by exogenous shocks: but the problem facing us today is not how to adapt to exogenous shocks. Our real problem resides in the need to infuse our economies with a series of endogenous shocks on an ascending evolutionary path. The appropriate model for this was built not by Keynes, but by Joseph Schumpeter. It is Schumpeter therefore who is most appropriate to the domain of economic policy which is most relevant to us.

His model tells us that we must create new products, firms and industries to ensure that there is an increasing degree of competition in our advanced economies. We must offer sufficient opportunities to pioneers in the business world. We must offer more training opportunities for our workers. This is the path that we must follow in order to find a solution to our employment problems. Our need today is not primarily to boost demand or to boost supply. What we have to do is to improve the quality of what we supply so as to create the kind of supply that will open up new prospects for expansion and carry demand along with it. It is not sufficient merely to adapt to existing situations. What we need to do is to evolve so as to transform those situations continually in favour of new products and industries.

It is doubtless true that an economic policy geared to this objective can only claim a comparatively limited degree of feasibility. It must rely on the power of the free market competitive process in the hope that this will itself be able to create the necessary impetus. But such a policy offers more than a reiteration of previous attempts to make Keynesian solutions work. We have decades of Keynesian experimentation behind us and the patient is becoming unfit in consequence. "The elixir of the economy is dynamic competition" (Annual Report 1984/85, para. 314). Economic policy should be guided by this insight. The principal and indeed sole contribution that stabilisation-oriented monetary and fiscal policies can offer reside in their predictability. Providing those objectives can be fulfilled monetary and fiscal policies can provide a medium term framework within which firms in individual countries can achieve the development of new products and processes on which the growth of employment in the world economy truly depends.

(1038/730/411)

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ps4/30H

SECRET

FROM: A P HUDSON
DATE: 27 October 1987

1. Jonathan
To see
2. PWP

MR H P EVANS

cc Economic Secretary
Sir P Middleton
Sir G Littler (o/r)
Sir T Burns
Mr Cassell
Mr Peretz
Mr C W Kelly

**WORLD ECONOMY: NEXT STEPS**

The Chancellor discussed with you and others the 22 October letter from M. Balladur, and other issues being discussed between members of the G5.

2. The Chancellor decided to write to Secretary Baker in the near future, and would be grateful if you could supply a draft. He decided to invite Balladur to London in the week beginning 9 November; he asked you to pass that on Sir Ewan Fergusson, who was due to see Balladur this evening.

APH

A P HUDSON

CHANCELLOR OF THE EXCHEQUER

Ch,

Sorry to bother you with these ppB. again. But I am unclear about whether you think there should be an early meeting of Deputies or not.

AF

2/11

MPE to Spk 2 GL tomorrow re B/dw, Stat. etc.

Meanwhile, we will draft a letter to Wilson.

N

29.10/2/sh

SECRET

PSG: Get a letter drafted to Wilson, at once, ASAP. No need to write to Baker just yet, but ought to write to Balladur to say I look forward to seeing him in (Paris) to discuss these matters with him.

Ch
Content to write as suggested? Agree to a meeting of Deputies? ('X' below)? Re Wilson ('Y' below) you wanted to write to him about BP, and to thank him for Canadian support for SSA at CHOGM. Do you still wish to write?

FROM: H P EVANS
DATE: 29 OCTOBER 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler (o/r)
Sir T Burns
Mr Cassell
Mr Peretz
Mr C W Kelly
Mr Matthews

**WORLD ECONOMY: NEXT STEPS**

AT 30/10

I attach a draft letter to Secretary Baker, proposing a package of measures involving G3 which could form the basis of a G5/7 agreement. The final paragraph suggests a meeting of Deputies. If you agree, we should tell Sir Geoffrey Littler in Madrid tomorrow today so that he can consult Tietmeyer and Trichet about possible dates.

2. You have had letters from Balladur (copied to G5) and from Wilson (with, we think, similar letters to G7).

3. The Wilson letter is particularly thin and does not call for a reply. The only point worth noting is the penultimate paragraph where he suggests that non G3 countries must implement policy changes - but I have not been able to get any guidance from the Canadians on what is envisaged.

You still have the Wilson letter. AT 31/10

4. The only substantive point in the Balladur letter is a proposal for an analysis by deputies of recent developments in financial markets. Now is not the time to launch a major study, but the draft letter to Baker suggests that this is wrapped up in the preparatory work by deputies for a ministerial meeting.

5. Balladur's message to you (reported in Telno 1041 from Paris) had three elements, apart from the references to EC finance: US action on the deficit; lower German interest rates; and reaffirmation of Louvre, with the dollar kept "at more or less its present level". On the last element, Balladur may shift his position in the face of market pressures. But you may like to talk or write to Balladur setting out the case for a lower dollar now

that circumstances have changed since the reaffirmation of the Louvre accord last month. Otherwise there is no need to reply to Balladur's letter and messege before you see him.

6. We have just heard that Balladur has now, in an interview in Friday's issue of Le Monde, proposed a permanent system of policy coordination with a secretariat to administer the Louvre Accord. Our Embassy in Paris is attempting to get more details.

HPE

H P EVANS

29.10/1/sh

**DRAFT LETTER FROM CHANCELLOR TO SECRETARY BAKER**

I have been giving some further thought to the problem of economic policy co-ordination that we have discussed several times on the 'phone recently.

It is now clear that the sharp falls in share prices throughout the world will have the effect of tightening monetary conditions and are likely to have a dampening effect on world demand - though the consequences are needless to say extremely uncertain. I am obliged to publish an economic forecast (next Tuesday) which attempts to take some account of these changes. We must expect trade and output both to be lower in 1988, not just in the industrialised countries but throughout the world.

3. Understandably, the Fed has moved to inject liquidity. Interest rates have fallen and I am sure this is the right approach. It was important to act quickly: if it proves necessary, these changes in interest rates can be reversed in due course. We too have reduced our interest rates.

4. I think it important for everybody to realise that these falls in the stock markets have shifted the balance of risks somewhat in the world economy. I do not think this has as yet been sufficiently appreciated. In particular it seems to me that the Germans need to recognise that the changes which have occurred reinforce the need for lower interest rates in Germany. If German interest rates were correct before the equity market fall - and there was a good deal of doubt about that - they can hardly be right now. Because they have not acted, there has been a substantial cut in the interest rate differential between the US and Germany, a major factor in the current weakness in the dollar.

5. When we met in Washington last month, I agreed with you that we needed a further period of stability in the dollar. But the sharp fall in equity

prices in recent weeks is also relevant to this judgement. We must all now feel greater concern about a possible recession, or at least a period of slow growth, in your country. At the same time, worries about inflation must be less. Against this background a lower dollar must carry less risk for inflation; and at the same time, with domestic demand less buoyant in the US next year, it might have a larger impact on the trade balance than we thought likely a month or so ago.

6. These arguments, and the intense pressures now being felt in the markets, suggest that it may be right to consider some further step down in the dollar. That is not to argue for any substantial fall: as usual many of the numbers being tossed about are much too large. But the economic analysis suggests that it might be right to consider a modest dollar realignment as part of an overall package.

7. The other important elements of a package are clearly:-

a. agreement between the US Administration and Congress on a new budget. To impress the markets it would be immensely helpful if cuts in the deficit were larger than the $23 billion provided in Gramm Rudman II. Other helpful elements would include: an element of increased taxes, an agreement covering more than one year and a high proportion of lasting and solid policy changes in the deficit reduction.

b. lower interest rates in Japan and Germany. I have already reduced interest rates in the UK, but would be prepared to consider a further cut, above all if the Germans and Japanese were prepared to move also.

8. Once such a package were announced, we would of course all need to be

prepared to intervene in the exchange markets, and set interest rates, as necessary to maintain currency stability at the new levels.

9. When we spoke on the telephone, we agreed it would be a great mistake to rush into a meeting of Ministers, until we have established a clear understanding <u>and</u> agreed on a package that would act to reassure and not alarm markets. Let us try to work towards such an agreement as quickly as we can. I am keeping in close touch with my European colleagues, so as to keep up the pressure on Germany. If time allows, the next step could be a meeting of our Deputies, to prepare the ground for an agreement, against the background of an analysis of recent stock market movements of the kind suggested by Edouard Balladur.