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ALAN WALTERS

PRIME MINISTER

EMS

Prime Minister

Alan Walters

Earlier date for a meeting on this is Nov 11.

MS 23/10

1. Pseudo-fixed versus fixed

The ~~real~~ underlying exchange rates are determined by fiscal and monetary policy, relative to those policies of our trading partners. Conversely, if we really fix exchange rates by some intervention system, we lose some sovereignty over monetary and fiscal policy. That policy will be determined by the behaviour of (much larger) aggregate of trading partners. The essential question therefore is whether this regime of fixed exchange rates with a monetary fiscal policy determined by the exigencies of the exchange markets, is a better regime for conducting economic policy than the one which operates at present, under which we determine our fiscal monetary policy and the exchange rate is left to market forces. (An additional complicating factor in the case of the UK is that the exchange rate is influenced to an unknown extent by the oil joker. But the objections on these grounds are well known and I will not deal with them further in this note.)

The EMS, however, is not a system of fixed exchange rates. First parities move within a band. And after bumping along against the ceiling or the floor they go through a process of periodic re-alignment. Then rates move in discreet jumps. The "exchange rate discipline", which many people think is desirable, is not one of a fixed rate but of a rate that is pseudo-fixed but periodically jumps. Ultimately, in a relatively free market, the extent of the movement in exchange rates must, of course, reflect the relative fiscal and monetary policy. The only difference is that the path may be determined by a free market or the administered EMS jumping bands.

2. The issue of stability

The argument that EMS would produce greater stability of exchange rates therefore can only apply in the short run. And such stability will be subject to the political uncertainties of the periodic jumps. It is also anticipated that the UK would enter initially with something like a 6% band which would imply the possibility of very short term instability in that band. With a free system any trader can

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buy stability by entering the forward market. (He can do this with EMS or non EMS currencies.) In short, if anyone wants a stable rate he can buy it.

3. Fiscal and Monetary Discipline

The only substantial argument for joining the EMS is that it will supply an exchange rate discipline which can be used to strengthen, politically, domestic fiscal and monetary policies. The EMS constraint could be prayed in aid in discussions of public expenditure, taxation, etc. It would be a European version of the IMF bogeyman.

The exchange rate discipline may point in the same direction as the domestic requirements. Assume for the present that that is the case. The next question is will it be effective, (say roughly to the same extent as the IMF under Bretton Woods)? There are good reasons for doubting this.

4. Evidence from History of EMS

Since 1979 the European countries have conducted their domestic policies with very much domestic objectives in mind. There is no convincing evidence that the movements in domestic policy have been motivated by external requirements of the EMS. The usual mechanism for domestic monetary control has been movements of interest rates. I think it is clear that movements in German interest rates since 1979 have been motivated by their domestic problems and in particular the need to contain inflation after the rise in oil prices. Similarly, the French have carried on a long tradition of pursuing a policy that they consider both politically and economically correct for their circumstances. (The French used the old Bretton Woods system far more skilfully than we did.) In the two-and-a-half years of its life there have been a large number of adjustments of the bands, far larger than under the Bretton Woods system. The general conclusion is then that the domestic economic policies have been not much influenced by the exigencies of the EMS bands. In case of difficulty the bands have been moved. Thus they cannot have acted as a crucial or important stimulus to the appropriate domestic policies.

5. The UK as a "Difficult Case" of
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Obviously in some circumstances domestic and international interests may pull in opposite directions. This would probably have happened with sterling had we have joined with the Irish punt. In order to contain the upward pressure on sterling during 1980, we would have required a very considerable expansion in the money supply and much lower interest rates in order to keep sterling down in the EMS band. Following form in the EMS, we would have given primacy to our domestic requirements to control the rate of inflation and let sterling appreciate in one or two re-alignments. But this policy would have been accompanied by great difficulties in stemming the inflow of funds in anticipation of further increases in sterling. There would undoubtedly have been a much greater expansion of the money supply in 1980 running through the first months of 1981 which would have spelled trouble for our anti-inflation policy in 1981/82/83. Because of our special position with oil and the fact that sterling is still a widely held, freely available international trading currency, it is likely that we shall have conflicting domestic and EMS objectives more frequently and more severely than the other countries of Europe.

6. Credit Controls, Exchange Controls and Import Surcharges

If the EMS discipline is effective, then it is very likely to lead to demands for exchange controls and probably also credit controls. Temporary import surcharges, such as have been employed by Italy in the EMS, would also be considered as possible means of defending the rate. It would be argued that we could only defend our parity if there were additional weapons, certainly credit controls. Realistically it would be argued that sterling is inherently at least as weak as the French franc, if not the Italian lira. And draconian measures would frequently be needed.

(Rumours in the City are strong that exchange rates are likely to be re-imposed. There is also an increasing belief that we shall enter the EMS now our currency has fallen to what are thought to be more realistic levels. These rumours, and particularly those about exchange controls, are causing very grave difficulties both in general funding and in financial markets.)

7. The Likely Stability

7. The Likely Stability of the Deutchemark and Franc

Going into the EMS would imply tying ourselves primarily to the Deutchemark. This would mean that domestic monetary policy would be settled largely by the behaviour of the German economy and German monetary policy. Although Germany has been a model of stability since 1950, there is no guarantee that this will persist. It is not only external events, such as Poland, but also considerable internal divisions are appearing in what was once thought to be a wide consensus on the conduct of German economic policy.

Although the influence of France is considerably less than that of Germany, there are very grave doubts about whether the French will pursue policies anything like consistent with stable parities. The network of controls grows apace. And the performance of French governments before 1958 does not bode well. I suspect that the French will use the EMS system for what its worth but will break it up if it interferes with their domestic political aspirations.

8. Exchange Rate Regime Outside the EMS

In principle we could adopt an exchange rate regime with respect to the EMS, yet not join the EMS itself. Successful defence of the parities would require the same policies whether we were in the EMS or out of it. The only argument for joining the EMS would be it would conceivably make the defence of the parities more credible and perhaps involve less intervention.

9. Politicisation of EMS

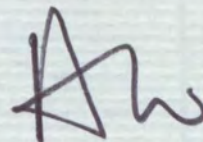
Lastly, there is the undesirability of being involved in the political process of fixing new parities or intervention bands. Movements in exchange rates bands, or re-alignments, are a matter for political horse trading. On some occasions such as the Italian devaluation, these have been done unilaterally. But the procedures of the EMS clearly require multilateral negotiation of re-alignments. This inevitably involves a great deal of political horse trading. Although the fundamental underlying economic reality has an influence on these arguments, there is no doubt that such a political process is not the best way of determining exchange rates. The market does a better job.

10. Conclusion

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If the EMS were a step on the road to a true central bank for a Europe which would have one currency and a unified fiscal monetary system, then one would have a very different view of the desirability of joining the EMS. In my discussion I have assumed that this is not the case. I do not believe we shall ever achieve monetary and fiscal union in Europe. I do not think there is any chance of the emergence of a proper central bank, depoliticised and independent of governments, running European monetary policy.

I remain convinced that the disadvantages of joining the EMS far outweigh the small advantages of joining. With its present constitution, heavily politicised, I doubt whether it will ever be a propitious time for us to join. At present, however, in view of the likely disparate policies to be followed by the Germans on the one hand and the French and Italians on the other, it seems to be a particularly bad time to envisage joining a club that seems likely to pull itself apart.



ALAN WALTERS

22 October 1981

cc Mr. Alexander
Mr. Scholar
Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Vereker