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From the Private Secretary 11 February 1985

I attach a note by Sir Alan Walters which raises some of the questions he feels need to be answered when considering Britain's possible membership of the EMS. This should be included in the papers for Wednesday's meeting.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and John Bartlett (Governor's Office, Bank of England).

ANDREW TURNBULL

Mrs. Rachel Lomax,
H.M. Treasury.

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LETTER FROM PROFESSOR SIR ALAN WALTERS TO MR. ANDREW TURNBULL

JOINING THE EMS - SOME ADDITIONAL QUESTIONS

1. Speculation against sterling is one of the main problems of the existing system. The EMS will not prevent such speculation - on the contrary, unless other undesirable measures are taken, it is likely to increase the profitability of shorting sterling. The authorities do not object to gradual movements in sterling - what they object to is sharp downward movements, arguing that it might be a "bottomless pit" which would destroy confidence. Yet the EMS re-alignments are all sudden changes. And, as French experience during 1982 shows, there is no guarantee that, in the EMS, the sudden shift halts the slide. Why is the plan unacceptable outside but good inside the EMS?

2. As is clear from the history of the French franc, joining the EMS is unlikely to reduce speculation against sterling and I would conjecture, because of the "step" movement on re-alignment, it would be made more profitable and so increase. In any case, the only way to deal with this is to make speculation against sterling unprofitable without, at the same time, making investment also unprofitable and depressing the economy. The present techniques and conventions of monetary control make this very difficult and chancy - essentially the need is sharply to raise overnight to seven-day rates without raising three-month (or more) rates. The French experience shows that, in the EMS structure, this is the only effective way of taking out the bears. Since we are a more open economy, the UK would be subject to much more pressure, so the need to tame the bigger bears is the greater.

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Do the proponents of EMS plan to change the monetary arrangements so that we can squeeze those shorting sterling? If so, could we know the institutional changes involved and how they are to be implemented?

3. It is not true that if we change the present system so that we can punish would-be bears, the difficulty of the bearish rush precipitating a fall of sterling would disappear. Joining the EMS would be likely to, at best, be irrelevant to the main issue.

4. Even if the UK joined, the DM would continue to dominate the EMS. Britain would have a role like France or Italy (the Netherlands is really part of the DM block). Both France and Italy have exchange controls and regulated credit rationing. In spite of the rigorous enforcement of exchange control in 1982-3 and the (3?) devaluations, the French Government had to intervene on a massive scale; indeed, there was much talk of the EMS having, in fact, broken down.

5. In view of our open capital and exchange markets and the continued role of sterling, the UK would come under much greater pressure than France, even if the latter had free credit and exchange markets. But with France and Italy regulated, it is very likely that Britain would have to bear much more speculative activity. Would the sponsors of Britain's entry envisage the introduction of credit rationing and exchange controls in Britain, at least as stringent as those in France as a concomitant of entry? Are we prepared to dismantle our open-market, free-exchange system in order to join the EMS grid?

6. Control of money and credit markets and insulation from the Euro market, a la France, would enable us to immitate the French in raising the overnight rate to tame the bears. However, it is worthwhile noting that this did not offset the need for massive and costly intervention, nor did it prevent the sequence of falls of the franc.

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7. To sum up:-

(i) EMS membership will not ease the stability problem and is likely to make it worse;

(ii) To deal with the stability of financial markets one needs either to:-

(a) not validate market expectations as the authorities reaction to a slide in sterling, or

(b) change institutional arrangements to enable the bears to be squeezed;

(iii) joining the EMS is likely to strengthen the argument for the reimposition of exchange controls like those of France and Italy with great disadvantages to a currency such as sterling;

(iv) one can understand the enthusiasm of the EMS members to include the UK since Britain would act as safety valve for much speculation in the System, and as the DM strengthens in the months ahead, sterling's position would continue to be precarious.

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Memo

From: ALAN WALTERS

To: Andrew Turnbull

Date: 8 Jan

Here is my addendum
to my longer piece on
the EMS

Hope you get it soon!

AW

Joining the EMS - Some Additional Questions

1. Speculation against sterling is one of the main problems of the existing system. The EMS will not prevent such speculation - on the contrary, unless other undesirable measures are taken, it is likely to increase the profitability of shorting sterling. Now the authorities do not object to gradual movements in sterling - what they object to is sharp downward movements, arguing that it might be a "bottomless pit" which would destroy confidence. Yet the EMS realignments are all sudden changes. And, as French experience during 1982 shows, there is no guarantee that, in the EMS, the sudden shift halts the slide. Why is a plunge unacceptable outside but good inside the EMS?

2. As is clear from the history of the French franc, joining the EMS is unlikely to reduce speculation against sterling and I would conjecture, because of the "step" movement at realignments, it would be made more profitable and so increase. In any case the only way to deal with this is to make speculation against sterling unprofitable without, at the same time, making investment also unprofitable and depressing the economy. The present techniques and conventions of monetary control make this very difficult and chancy - essentially the need is sharply to raise overnight to seven-day rates without raising three-month (or more) rates. The French experience shows that, in the EMS structure, this is the only effective way of taking out the bears. Since we are a more open economy, the U.K. would be subject to much more pressure, so the need to tame the bigger bears is the greater. Do the proponents of EMS plan to change the monetary arrangements so that we can squeeze those shorting sterling? If so, could we know the institutional changes involved and how they are to be implemented?

3. Is it not true that if we change the present system so that we can punish would-be bears, the difficulty of the bearish rush precipitating a fall of sterling would disappear? Joining the EMS would be likely to, at best, be irrelevant to the main issue.

4. Even if the U.K. joined, the D-mark would continue to dominate the EMS. Britain would have a role like France or Italy (the Netherlands is really part of the D-mark block). Both France and Italy have exchange controls and regulated credit rationing. In spite of the rigorous enforcement of French controls in 1982-3 and the (three?) devaluations, the Government had to intervene on a massive scale; indeed, there was much talk of the EMS having, in fact, broken down.

5. In view of our open capital and exchange markets and the continued role of sterling, the U.K. would cave under much greater pressure than France, even if the latter had freee credit and exchange markets. But with France and Italy regulated, it is very likely that Britain would have to bear much more speculative activity. Would the sponsors of Britain's entry envisage the introduction of credit rationing and exchange controls in Britain, at least as stringent as those in France, as a concomitant of entry? Are we prepared to dismantle our open-market, free-exchange system in order to join the EMS grid?

6. Control of money and credit markets and insulation from the Euro-markets, a la France, would enable us to imitate the French in raising the overnight rates to tame the bears. However, it is worthwhile noting that this did not offset the need for massive and costly intervention, nor did it prevent the sequence of falls of the franc.

To sum up:

(1) EMS membership will not ease the stability problem, and is likely to make it worse;

(2) To deal with the instability of financial markets one needs to either (a) not validate market expectations of the authorities reaction to a slide in sterling or (b) change institutional arrangements to enable the bears to be squeezed;

(3) Joining the EMS is likely to augment the arguments to reimpose exchange controls like France and Italy with great disadvantages to a currency such as sterling;

(4) One can understand the enthusiasm of the EMS members to include the UK since Britain would act as a safety valve for much speculation in the System, and as the Dimark strengthens in the months ahead, sterling's position would continue to be precarious.

Monetary Policy and the EMS

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

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

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

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

But if the exchange rate is fixed for an average of six months, then this will imply that the rates of interest on financial assets with those maturities will be roughly the same. If, after six months, I can exchange my lira for D marks at the same rate at which I bought them, I will find it proftable to switch into lira deposits if the interest rate in Italy is a tithe above that in Frankfurt. Thus nominal interest rates for those maturities must be approximately equal; portfolio arbitrage will ensure the outcome.[1] It follows that by joining the EMS, as in any fixed exchange rate system, Britain would have to forego a substantial degree of sovereignty over her monetary policy.[2]

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

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

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

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

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

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

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

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

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

have been frequent and sometimes quite sudden. The average percentage change (ignoring sign) from month to month (end) in the exchange rate of the French franc and the Italian lira from 1979 to 1983 was 0.8 percent.[1] If the movement is all one way, as it was substantially in the case of Italy, this represents about a 10 percent depreciation of the lira during a year. Although currencies outside the EMS exhibited greater month to month variability, on this measure, there were many more negatives cancelling out positives, rather than the more-or-less steady downward drift of Italy and France.

The forward markets reflect all these uncertainties about future rates of exchange. And it is noticeable that the forward discounts for France and Italy in the EMS group, with respect to the D mark, were and are usually larger than the ones pertaining to the United Kingdom.[2] Being inside the EMS did not seem to reduce the insurance premium one had to pay to avoid exchange rate risk. On the contrary, insuring against exchange risk cost more if you were in Italy, France or Eire than if you were outside in the

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

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

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

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

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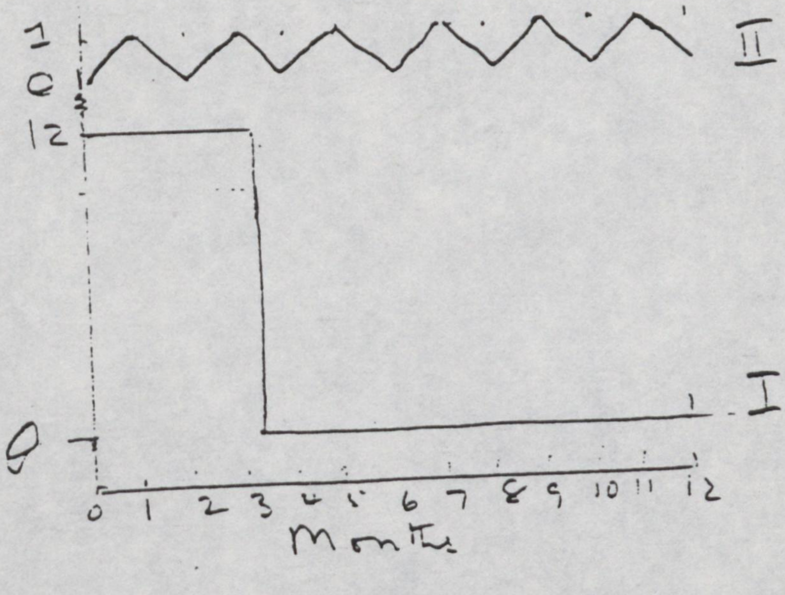

atypical of the EMS realignments), whereas in the other series II there is a plus one minus one pattern for each month. Additional unemployment in series I arises from the fact that no one known when the big fall will take place. Thus, the same measured result masks a very distinct and different reality.

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

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

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

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

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

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

trade.[1] On the other hand, those who seek eventual monetary union of Europe had best pursue it through quantitative convergence rather than exchange rate fixity. Britain will best serve monetary union in Europe by urging the right policies rather than embracing the wrong ones.

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

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

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

Exchange Rate Target

Of course it would have been possible for the government to pursue an exchange rate target without joining the EMS.[1] The set of possible exchange rate targets is virtually infinite. However, if one is seeking stability, not merely in terms of ~~the~~ foreign currency but also in terms of domestic monetary-fiscal policy, one should choose that currency, or a combination of currencies, together with an appropriate rules of reaction, which is thought likely to give rise to such stability. If we restrict our search, for the time being, to particular currencies -- suppose it is the U.S. dollar -- then the targetting is an act of faith in the greater likelihood of the United States pursuing suitable stable policies.[2]

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

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

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

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

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

Interpreting Exchange Rate Movements

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

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

The higher the likelihood of a Labour government being elected, and the greater the differences between the expected monetary and fiscal policies

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

of the two parties, the greater the depressing effect on the exchange rates in the year or months before the date of the election.

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

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

Clearly the exchange rate target for monetary policy is bad political economy.[1] But even if it were not, there are strong objections to a monetary policy that routinely reflects all the alarms and excursions that affect exchange rates. If, for example, the United States, in order to contain the inflationary impact of the large Federal deficit, induces a very tight monetary squeeze so that the dollar-sterling rate comes under great pressure, why should the United Kingdom respond in a like manner, in order to defend the parity? It may well be that the domestic monetary conditions in the United Kingdom are entirely satisfactory and do not call for any such squeeze. The exchange rate target will induce artificial oscillations and additional instability in monetary conditions in order to preserve stability of exchange rates.

Granted that it is undesirable to make monetary policy a consequence of the vagueries of exchange rate movements, it is worthwhile considering whether the movements in exchange rates can be used to interpret and get useful assessment of prevailing monetary conditions. If, for example, a high exchange rate meant that monetary conditions were "tight" and a low exchange rate implied that monetary conditions were "loose", then the

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

hange rate could rank along with interest rates, both nominal and real, as a measure worthy of close attention but not targetting. The exchange rate could provide corroborating evidence for our main targets, the monetary aggregates.

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

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

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

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

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

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

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

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

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

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

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

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

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COMPARISON OF INTERNATIONAL FOREIGN CURRENCY RESERVES

(ie EXCLUDING GOLD AND IMF ITEMS)

	End-November 1984 ($ billion)
UK	6.8
US	6.3
Japan	22.0
EMS countries	
W Germany	35.5
France(1)	20.4
Italy	20.0
Belgium	3.6
Netherlands	8.0
Denmark	4.1
Ireland(2)	1.9

(1) All figures valued at end-period rates and include holdings of ecus.

(2) End-October 1984.

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MOVEMENTS IN THE DOLLAR SINCE LOW POINT IN OCTOBER 1978

	% change to 7 February+ since	
	30 Oct 1978	3 May 1979
	($ low point)	(Election)
ERI*	+ 71½	+ 56¼
£/$	+ 87½	+ 86
DM/$	+ 87½	+ 70¼
Yen/$	+ 47	+ 16
F franc/$	+147	+126
Lira/$	+152¼	+134½
Sw franc/$	+ 86½	+ 60

* % change to 6 February.

+ 3pm rates.

Historic highs for the dollar

F franc	9.8740	in London on 7 February
Lira	1987.50	in London on 7 February
£	$1.1020	in the Far East on 14 January
DM	3.2365 (13 year high)	in London on 7 February
Sw franc	2.7530 (9 year high)	in London on 7 February