SECRET

PRIME MINISTER

STERLING AND THE EUROPEAN EXCHANGE RATE MECHANISM

Joining the ERM could turn out to be the most important economic decision of this Parliament and quite possibly of your administration.

2. The meeting to discuss this is on Monday at 1600 for two hours. The proposed cast is

Chancellor	Governor	Nigel Wicks
Economic Secretary	Kit McMahon	Brian Griffiths
Sir Peter Middleton	Eddie George	John Redwood
Sir Terence Burns	Anthony Loehnis	Myself
Frank Cassell		

And the Foreign and Commonwealth Secretary.

3. The papers are:

Annotated Agenda	(Flag A)	— the other participants do not have this.
Treasury/Bank paper	(Flag B)	
Record of February's meeting	(Flag C)	
Note by John Redwood	(Flag D)	
Note by David Willetts	(Flag E)	
Telegram from Sir Alan Walters	(Flag F)	
Note on presentation by Nigel Wicks	(Flag G)	
Hansard extract of your comments to the House	(Flag H)	

The main paper from February's meeting is also enclosed.

4. You might like to invite the Chancellor to introduce the discussion, and then to ask the Foreign and Commonwealth Secretary and Governor for their views.

/Approach

Approach

5. Your discussions with the Chancellor have moved this question to the point where it may look to the Treasury that it is a foregone conclusion that we shall join.

6. I would urge you to make the proponents argue their case, even if you privately agree with them. David Willetts' note (Flag E) sets out some of the difficult questions.

7. The Treasury/Bank paper seems to start from a view that economic decision takers do not recognise the force of the Government's economic policies. The problem is to show them that the Government's policies will produce a fully competitive economy, where costs have to be properly controlled. Joining the ERM would be designed to give them a signal which they can understand.

8. On that basis, the proposal to join the ERM should be seen as an evolution of the policy framework, a more convincing explanation of it, not a tightening of the policy stance.

9. But the Chancellor's reference at your meeting to "raising the stakes" is an admission that the policy stance may not be tight enough. Under the existing regime if markets think the policy stance is too lax, the exchange rate takes the strain (i.e. falls). In the medium term this is a delusion because it simply takes the pressure off management and unions to get their costs right. But in the short term it does give some room for manoeuvre - room for manoeuvre which will be lost if we join the ERM. In the ERM loss of market confidence feeds back very quickly through the exchange rate into interest rates (unless we devalue).

10. In the ERM we tie ourselves to Germany. The figures show the pressures that may be placed on the exchange rate.

/ Germany

	Germany	UK
Inflation	2	6 (though falling)
Manufacturing earnings	2½	9
Manufacturing unit wage costs	-2	5

11. Sir Alan Walters and, to a lesser extent, the Chancellor tend to see joining the ERM as a question of the framework. John Redwood sees it more as a question of the stance, risking tighter policies, higher unemployment and damage to the Government's electoral prospects.

12. One further point. The past behaviour of the ERM is no guide to how it would behave with sterling in it. Among other things, the other members may find the ERM even more difficult to manage with us than it was without us. The kudos from joining the ERM could be short-lived. (This is implied in one of David Willetts' questions and mentioned in the Annex to the Treasury/Bank paper).

Next steps and procedure

13. As the Chancellor has asked, you will want to avoid taking a final decision even if the clear outcome is in favour of joining. You could point to the need to consult other colleagues.

14. Nigel Wicks' minute (Flag G) discusses the important question of presentation.

15. If that is the way the decision goes, you might further discuss dates for joining with the Chancellor at your bilateral on Wednesday. You will also want to discuss the presentation with the colleagues most closely concerned.

/16.

16. You may also want to talk further about Parliamentary aspects in view of Mr. Healey's statement (last page of the Treasury/Bank paper) and your remarks to the House (Flag C). Neither seems to tie the Government to consult in advance.

DRN

DAVID NORGROVE

27 September 1985

LO3AL Q

26th June 1979

Mr. Eldon Griffiths: Will my right hon. Friend undertake to keep the House informed of the progress in the Government's thinking on EMS before a final decision is taken by the Cabinet? Is my right hon. Friend satisfied that there is now a common European policy for the production as well as the conservation of energy? Will Europe be able to speak with one voice not only in Tokyo but to OPEC? Is the Prime Minister aware that there is a wide welcome in Europe, as there is in Britain, for the refreshing change in style and manner in which she has approached the European Community?

The Prime Minister: I shall endeavour to meet my hon. Friend's point about the EMS. The next meeting is in September when, unless anything unusual occurs, the House will not be sitting.

Mr. Shore: The Prime Minister spoke earlier about the timing of the possible main EMS decision in September. Will she think about this again, because it really would be intolerable, given the importance of the issue, if such a decision were made at a Council of Ministers meeting at a time when the House had no opportunity to debate it and was, in fact, in recess.

The Prime Minister: What I said about September was that we would be in a position then to make our first assessment. I did not say that we would be in a position then to decide whether we would join. We shall be in a position then to make our first assessment. I am determined that we shall not hurry this matter, and I shall take full account of what the right hon. Gentleman and my hon. Friend the Member for Bury St. Edmunds (Mr. Griffiths) said.

MS

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SECRET

JOINING THE ERM: AN ANNOTATED AGENDA

1. Reasons for considering now?

What are the difficulties in maintaining downward pressure on inflation by sticking to the existing strategy and targets?

2. Purpose of membership and implication for macro-economic policy

a It is agreed that the purpose would be to reinforce - not to relax - financial discipline - with the implication that our firm intention would be not to re-align against the DM?

b In principle, keeping up with DM would require more rapid progress against inflation than the present plans. Do we want/could we achieve this. What would be the implications for interest rates and fiscal policy, and would these be acceptable?

3. Exchange rate vs. monetary targets

a Could we continue to have monetary targets? If so, how would we resolve conflicts when they occurred? (Presumably in the short run we would have to give precedence to the exchange rate).

b To be consistent with parity with DM, should we reduce the target ranges for the monetary aggregates?

4. Presentation of policy

a There have undoubtedly been problems with market understanding of present policy - in particular the role of the exchange rate. How far would membership of the ERM help in providing a simpler framework?

/b And how far

And how far would it be damaging, given the difficulty of explaining the continuity of policy, and the presentational capital built into the strategy as set out in successive MTFS's.

5. Practicality of keeping the £ within the permitted bands

a How great a problem, in general, would it pose having two reserve currencies in the system, in neither case with exchange controls? And how difficult would the petro-currency factor be?

b How would we operate to withstand pressure, when it came (accepting particular importance of doing so successfully on the first occasion, for obvious market reasons)? Do we think we could hold the position, when the market had a possible weekend re-alignment conference in its sights, without very large scale intervention? If so, how high would short term interest rates have to go, and how far could base rates and mortgage rates be insulated?

c Could there be exceptional arrangements (automatic re-alignment, or temporary withdrawal) in the case of fluctuations caused by oil? (And could the conditions be defined closely enough to reassure markets there was no relaxation of financial discipline?)

6. Political Arguments

a Joining would be a symbol of our European commitment and welcomed by our partners. How much weight should we give that? Is there anything we could look for in return?

b Is there any difficulty about accepting, as a condition of joining, that our partners would have to agree to any re-alignment for sterling (and might on occasion seek to attach some form of policy conditions to that agreement)?

Timing

What is the case for and against waiting for:

i) a calmer oil market;

ii) a further fall in the $ against the DM?

LO3ALP

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PRIME MINISTER

IF WE JOIN THE ERM: PRESENTATION

If (and it is a big if) we decide to join the ERM, presentation will be vital. It certainly is too important to leave to the two departments mainly interested: Treasury will concentrate too much on the technicalities of £M3, MO et al, and the FCO will regard it as an exercise in Europhilia.

Presentation needs to go wider:

What it means for control of inflation?

What it means for British industry?

What it means for jobs?

What it means for future mortgage rates?

Why HMG's control over economic policy won't be diluted?

Why now is the right time to enter?

Our presentation must be positive, not reactive. So we need to have material ready for all those points (and no doubt others too), directly the decision is announced. We will only get the presentation right if it is planned in advance. This is difficult in view of the need to keep the decision to the "need-to-know" circle. (Just the sort of situation that we faced with GCHQ and TSRB.) Nevertheless, the following Ministers, besides the two principals, need to be ready to join the presentation campaign right at the beginning.

/Mr. Brittan

Mr Brittan

Lord Young/Mr Clarke

Mr Tebbit

Mr Walker (?)

and in the second wave, because there may be special opposition in Scotland and Wales to entry:-

Mr Younger

Mr Edwards

Treasury officials would, I think, have to provide the briefing material, not departmental officials in view of the sensitivity. Sir Peter Middleton ought to be put in charge of arrangements so that the material can be prepared. Bernard ought to be involved.

Monday's Meeting

If the meeting inclines towards joining, it would be worth

- emphasising again the importance of presentation especially the questions in paragraph 2 above.

- commissioning work from the Treasury on presentation

- considering whether the presentational ground can be prepared before any announcement (eg by stimulating helpful articles, speeches by non-Governmental figures). Probably too risky.

N.L.W.

MJ2BDS

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SHOULD THE UK JOIN THE EUROPEAN MONETARY SYSTEM?

Evidence to the Treasury and Civil Service Committee

Earlier this year I was invited to submit evidence on the pros and cons of full EMS membership to the Treasury and Civil Service Committee. The reply, recently printed in the Committee's collected memoranda on The Financial and Economic Consequences of UK Membership of the European Communities, is given in this paper.

1. Fundamental ideas

Basic questions here are "what is the economic rationale of drawing frontiers between currency areas?" and "why should the nation-state be a more accepted unit for defining a currency's usage than continents or the world?". A sophisticated branch of economic theory, on the determination of optimum currency areas, has developed to answer these questions. They are directly relevant to the issue of the UK's membership of the EMS. The key conclusions are that a nation is more likely to benefit from participation in a currency area if

i. Labour and capital mobility within the area is easy because of the lack of government restrictions (e.g. exchange controls) and for other reasons.

ii. Trade between member countries should be on a substantial scale, promoted by the absence of tariff and non-tariff barriers.

More generally, a currency area will produce better results if the existence of political frontiers does not imply the existence of economic frontiers.

2. Main conclusions on the EMS

Contrary to widespread comment, the EMS has not been a great success. Exchange rates have been stable since early 1983, but exchange rate stability is not in itself an ultimate economic objective. The disappointments have been in the following areas:

i. Growth rates, of both output and trade, in member countries have been slower since the formation of the EMS than they were before.

ii. Economic policy, as measured by the budget deficit g.d.p. ratio, has become more divergent since the establishment of the EMS. There has been an associated increase in the divergence of inflation and external payments performances. (See pages 6 to 8.)

iii. Exchange controls, and other barriers to trade and capital flows within the EEC, are as widespread now as in 1978. (See pages 8 and 9.)

3. Main conclusions on the UK as a potential EMS member

The UK is the least appropriate member of the EMS because, for geographical reasons, labour movement and trade flows are more difficult between it and other EMS members among themselves. Three further major objections are that the UK is a significant oil exporter (see pages 3 and 4), that a fixed exchange rate cannot be easily reconciled with money supply targets (page 11) and that the UK financial system should not be forced into an over-regulated European mould (pages 10 and 11).

Growth in intra-EEC trade of the UK, Germany and France since the EMS's creation

	% change, 1978-84	
	Exports	Imports
UK	+55.8	+47.8
West Germany	+25.4	+25.5
France	+13.4	+23.9

Source: OECD Monthly Statistics of Foreign Trade

18th September 1985

Tim Congdon

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Reply to the Inquiry on the European Monetary System by the Sub-Committee of the Treasury and Civil Service Committee - July 1985

The Sub-Committee's inquiry takes the form of a short statement of its scope and a questionnaire. In this reply the questions will be answered after a preliminary discussion of certain theoretical issues which would arise for any country joining a currency bloc. The advantage of the approach is that it enables the subject to be seen in a coherent analytical framework, making the reasoning behind the answers more transparent.

I The Economic Theory of Optimum Currency Areas and Other Considerations.

i. Optimum currency areas

Most of the evidence received by the Expenditure Committee inquiry in 1978 was concerned about the adjustment costs the UK economy would face if it joined a European fixed-exchange-rate system. At that time the underlying inflation rate in this country, at above 10 per cent, was at least twice as high as in West Germany. It was widely thought that the UK would be able to maintain a fixed sterling/deutschemark rate only if an attempt was made to reduce inflation to West Germany's level. It was also believed that such an attempt would result in more output and employment losses than if the UK retained the option to vary the exchange rate. As the inquiry demonstrated, this concern was common to observers on all points of the political spectrum. (In the author's memorandum emphasis was placed on the danger that the loss of monetary sovereignty might entail a more severe recession to curb inflation than if the UK geared a medium-term financial strategy to its own inflation expectations.) In the event inflation in the UK has been brought down virtually to the average EMS level. This has, as was predicted, involved heavy output and employment losses which have not been mitigated in any obvious way by the retention of monetary sovereignty. Perhaps not surprisingly, there is now a common view that full membership of the EMS would have minor adjustment costs and is therefore more appropriate than seven years ago.

Since the transitional problems no longer appear too awkward, it may be interesting to discuss some considerations relevant to determining the size of optimum currency areas in the long run. In economic theory, currency areas have either a common currency issued by a single central bank or complete convertibility between several currencies at a fixed exchange rate. Territory is divided into optimum currency areas when the resulting "frontiers" are most favourable to the simultaneous pursuit of high employment and price stability. The EMS is not yet a currency area in the sense understood here, since its members change the relative values of their currencies from time to time and exchange controls in France, Italy, Belgium and Ireland prevent complete convertibility. However, the ambition expressed by political leaders is that the EMS should eventually become a currency area. The UK can join such an area or remain independent. Is the UK by itself a closer approximation to an optimal currency area than the UK combined with the existing full EMS membership?

The two most influential contributions to the literature on optimum currency areas date from the early 1960s, although the subject was foreshadowed by Meade in a 1957 paper which included a section on the "integration approach" to intra-European payments imbalances. (R. A. Mundell 'A theory of optimum currency areas' American Economic Review 1961, R. I. McKinnon 'Optimum currency areas' American Economic Review 1983 and J. E. Meade 'The balance of payments problems of a European free trade area' Economic Journal 1957.) Both contributions recognised that participation in a currency area confers large benefits to economic agents in terms of simplicity of the payments mechanism and ease of financial flows. But Mundell pointed out that such gains might be offset by a loss of price and wage flexibility between regions with limited factor mobility. If such regions suffered from an adverse demand shift which caused unemployment and they were members of a currency area, they would be precluded from varying the exchange rate to promote the demand for their exports and so for their labour; if they were autonomous currency areas, exchange rate depreciation could counteract the demand shift and help restore the original level of employment. In other words, the damage from barriers to factor mobility should be neutralised by the establishment of separate currency areas. An optimum currency area is characterised by factor mobility within itself and factor immobility with other currency areas.

McKinnon emphasised the importance of the size of the traded sector in the economy. In an economy with a high ratio of traded to non-traded goods, demand management policy should be effective in curing payments imbalances because a small change in demand impacts powerfully on the large traded goods sector. By contrast, demand management is not so suitable an instrument in an economy with a low ratio of traded to non-traded goods since much of any change in demand hits the non-traded sector with only limited effect on the balance of payments. For such an economy variations in the exchange rate are a more attractive means of restoring payments equilibrium. An implication of McKinnon's argument is that large countries, which typically have low ratios of traded to non-traded goods, are more likely to be optimum currency areas than small. This agrees with the real world, in which small countries often have a fixed exchange rate with large neighbours, but to some extent conflicts with Mundell. The Mundell idea would on occasion justify the Balkanization of large countries to create new wage and price flexibility between regions suffering from factor immobility. However, the work of Mundell and McKinnon suggests two conditions for the success of a country's accession to a currency area. These two conditions are:

1. The country should enjoy considerable factor mobility with other participant countries. Capital and labour should be able to move easily across political frontiers, not only because of geographical proximity but also because of the absence of politically-imposed restrictions such as exchange controls. It should be noted that some factors of production, notably natural resources (e.g. oil reserves), are intrinsically immobile.

2. The country should trade a substantial proportion of its output with other participant countries. Free movement of goods, facilitiated by the complete removal of tariff and non-tariff barriers to trade, would obviously promote this end.

ii. Capital market integration and the relevant notion of policy convergence

A few further remarks are in order. Exchange rate misalignments, and the associated payments imbalances, can be eliminated in two ways. Relative domestic price levels of the countries concerned can adjust to inappropriate exchange rates; or exchange rates can adjust to inappropriate relative domestic price levels. It is true, as a general statement, that economists prefer exchange rate adjustments because they are painless in themselves, while changes in domestic price levels can require underemployment of resources. However, there are differences of emphasis. Those who believe that the domestic price level responds quickly to resource underemployment should be - and usually are - more sympathetic to exchange rate fixity than those who believe that prices suffer from inertia in the face of changing market conditions. There is a wider message here. If the UK economy was flexible and adaptable, with resources moving with little friction from declining to expanding industries, anxieties about full EMS membership would be less. The 1978 majority view against membership may therefore be interpreted as symptomising widespread scepticism about the degree of resource mobility in the UK economy.

The discussion about optimum currency areas is undoubtedly helpful in assessing the merits of the UK's full participation in the EMS. In particular, the Mundell/McKinnon work highlights the role of factor mobility in enhancing the viability of a currency area. But there is an important extension which their approaches overlook. Free movement of capital between European countries would be beneficial not only because it would be associated with easier rectification of exchange rate misalignments than currently prevails, but also because it would create an integrated capital market. One of the advantages enjoyed by American companies in international competition is the size of their domestic capital market. This enables them to have larger capital issues than their European counterparts, facilitating investments which exploit more fully economies of scale. While European capital markets remain fragmented on a national basis, European countries will constantly be struggling against bigger and more flexible American rivals. Of course, a key precondition for the emergence of an integrated capital market is the removal of exchange controls in all European countries. If this were combined with fixed exchange rates fixity between currencies, European companies would have access to a more substantial savings pool. Moreover, the equalisation of marginal rates of return on investments throughout the EEC - which would clearly be promoted by capital market integration - is desirable on the usual optimality criteria recognised by economists.

Indeed, it has been argued that the absence of balance-of-payments problems between the regions of the USA is a consequence of the integrated capital market. On this view, the same result would be achieved in Europe if capital markets were integrated and exchange controls removed. In that event, "The entire stock of securities held by a nation's banking system (or other financial institutions) becomes a potential source of foreign exchange to settle a deficit". (J. C. Ingram 'State and regional payments mechanisms' Quarterly Journal of Economics 1959.) Although this argument has force, an important caveat has to be noted. A country can have a payments deficit because its public sector and/or its private sector are incurring debts abroad. In the case of private sector cross-frontier debts, the failure of borrowers to repay is a matter for settlement between the parties. This may create work for bankruptcy lawyers, but should not concern policy-makers. The position is the same as with bad debts between agents in one country. Public sector borrowing is, however, rather different because the failure of one European government to honour its debts to the citizens of another European country would be unacceptable. While several independent European governments exist the possibility of intra-European payments disequilibria and the associated need for policy adjustment remain. In the USA no such possibility arises because there is only one government. One implication deserves emphasis: it is that payments disequilibria in an European currency area could not be a serious cause for concern if all the governments involved either balanced their budgets or ran budget deficits so small that their national debts were growing more slowly than Europe's money gross domestic product. This suggests that the most important aspect of policy convergence is the equalisation, at a low level, of budget deficit/g.d.p. ratios in EMS countries.

Two conclusions emerge.

1. Abolition of exchange controls in all EMS countries would ease the solution of intra-European payments imbalance, contribute to the creation of an integrated capital market and so strengthen the currency area.

2. Harmonisation of fiscal policies would be the most valuable form of policy convergence within the EEC. There is no need for anxiety about payments defícts between the private sectors of the various countries.

Their relevance to the UK is straightforward. The benefits of full EMS membership will be greater the more exchange controls are relaxed within the system and the more fiscal policies are conducted with uniform responsibility throughout the EEC.

II Answers to Questions asked by the Committee

1. In general do you favour British full membership of the EMS or not?

As the transitional problems of full EMS membership are less now than they would have been in the late 1970s, adjustment costs on entry are not such a serious difficulty. However, the theory of optimum currency areas suggests that the UK remains the least suitable member. Factor mobility between the UK and other EMS countries is less than that between the other EMS countries; the ratio of European trade to total trade is also lower for Britain than for other EMS members.

There is a further issue. Oil is an immobile natural resource, of considerable importance to our international trade. If it had not been for the miners' strike, the surplus on oil trade last year would have been almost £10b., equivalent to about 3% of g.d.p. Future changes in the oil price will require, if a satisfactory balance-of-payment position is to be maintained, offsetting changes in the value of non-oil imports and exports. This will necessitate some shifting of resources from non-tradeable goods production to non-oil tradeable goods production. Given the degree of factor immobility within the UK, the option to vary the exchange rate would be helpful. Exchange rate variations cause changes in the relative prices of tradeables and non-tradeables, and so ease resource movement and the process of balance-of-payments adjustment.

Since 1978 the interaction between oil and the structure of the economy has been an important subject, with highly charged political undertones. The appreciation of the exchange rate until early 1981 was damaging to non-oil tradeables (i.e., manufacturing industry) and beneficial to non-tradeables (i.e. services, some parts of construction); its depreciation since then has reversed the pattern to some extent. So there has been undesired economic disturbance even when the exchange rate has been allowed to perform its signalling function. (The debates about de-industrialisation and the North/South divide reflect this.) The problem of moving, say, 2% of g.d.p. into improving the non-oil trade balance would be intensified if the exchange rate against major trading partners could not be altered. The conclusion must be that Britain's oil dependence could make full EMS membership, without the opportunity to change the exchange rate, highly uncomfortable.

Of course, the UK could participate in the EMS with either a wide permitted band for exchange rate fluctuation (similar to Italy's arrangement) or occasional large exchange rate realignments, due to oil price or other changes. (Six major realignments of central rates have occurred since 1979, with the last in March 1983.) But, if the EMS is to be merely a method for effecting exchange rate changes through infrequent, large and officially-managed steps instead of frequent, small and market-determined steps, it is hard to see that full membership for the UK would represent significant progress on the current position. The position might, nevertheless, be changed radically for the better if full membership was accompanied by major advances within the EMS itself. Exchange control abolition and harmonisation of financial regulations are the key areas here.

The UK is quite clearly the least appropriate member of the EMS. The UK combined with the existing EMS countries is less obviously an optimum currency area than the existing EMS group by themselves. This is, however, not a decisive case against full membership since political considerations also need to be remembered. Perhaps the most important point here is that the EMS imposes a constraint on financially irresponsible governments because devaluation against the deutschemark is regarded as symptomatic of policy failure. For historical reasons, this would be particularly so in the UK if it joined. If financial control appears to be breaking down because the Cabinet is in open rebellion against the medium-term financial strategy, Treasury ministers might sensibly advocate full participation in the EMS. Rightly or wrongly, spending ministers are more likely to be intimidated by the threat of sterling devaluation against the deutschemark than they are by news of another sterling M3 overshoot.

In essence, then, full membership of the EMS still seems to have no obvious substantial advantages on economic grounds. Given the strength of opposition to sound financial policies in this country, it might nevertheless be a good idea on political grounds. It should be emphasised that the economic case for full participation in the EMS would be transformed - and transformed very favourably - if this were to be part of a larger attempt to establish an integrated European capital market. (See answer to questions 10 and 15.)

A The EMS 1979-85.

2. What do you see as the major role of the EMS?

It is not clear that the limited degree of exchange rate stability achieved within the EMS has given worthwhile advantages to the member countries. The main original motivation of the West German authorities was to spread the supposed strain from a depreciating dollar to other European countries. This may sound curious today, but it is nevertheless true. In 1978 Emminger, the then president of the Bundesbank, saw the first "driving force" behind a European currency zone as "an attempt to shield the EC area against the untoward effects of the vagaries of the dollar". (Quoted in S.A.B. Page 1 'The Development of the EMS', National Institute Economic Review November 1982, p. 55.) Whether the West German authorities believe that the vagaries of the dollar have diminished since 1979 seems doubtful. The Bundesbank intervened in the deutschemark/dollar market in 1984, selling dollars to the value of 23,158m. deutschemarks, and in the first quarter of 1985 to the value of 13,400m. deutschemarks. (See Report of the Deutsche Bundesbank for the year 1984, p.67.)

There seems to have been no evident benefit to trade or financial flows. The average annual growth of intra-European trade was slower in the five years after 1979 than in the decade before it. Because of the persistence of exchange controls in four EMS participants (among other reasons), no worthwhile progress has been made towards an integrated capital market. It should be emphasised that exchange controls interfere with trade. The expectation of exchange rate changes undoubtedly continues within the EMS, as evidenced by the wide dispersion of Eurodollar interest rates (see Table 1 below), and companies must want to hedge future commitments in forward exchange markets. But exchange controls hinder the development of such markets. (Some observers have praised the Banque de Frances tactics in overwhelming speculators "against" the franc by, on occasions, driving up Euro-franc rates to 2,000 per cent or more. They do not seem to understand that behaviour of this kind makes the Euro-franc market useless for significant commercial transactions since banks are not prepared to take positions against a powerful, artbitrary and spiteful operator.)

Table 1 Euro-currency interest rates for the main EMS members

Market closing rates in % on 24th May, 1985

	D-mark	Dutch guilder	Belgian franc (financial)	Danish krone	French franc	Italian lira
7 days	$5\frac{5}{8} - 5\frac{3}{4}$	$7\frac{1}{16} - 7\frac{5}{16}$	$9\frac{1}{8} - 9\frac{1}{4}$	$9\frac{1}{4} - 9\frac{3}{4}$	$10\frac{1}{16} - 10\frac{3}{16}$	$11\frac{1}{2} - 13$
3 months	$5\frac{5}{8} - 5\frac{3}{4}$	$6\frac{15}{16} - 7\frac{1}{16}$	$9 - 9\frac{1}{4}$	$8\frac{7}{8} - 9\frac{3}{8}$	$10\frac{3}{16} - 10\frac{5}{16}$	$13 - 13\frac{1}{2}$
1 year	$5\frac{3}{4} - 5\frac{7}{8}$	$6\frac{7}{8} - 7\frac{1}{8}$	$9\frac{3}{8} - 9\frac{5}{8}$	$9\frac{3}{8} - 9\frac{7}{8}$	$10\frac{11}{16} - 10\frac{13}{16}$	$14 - 14\frac{3}{8}$

Source: The Financial Times

The interest rate differentials indicate that the foreign exchanges expect the guilder to depreciate, over the next year, by 1.1% against the deutschemark; the financial Belgium franc by 3.4%; the Danish krone by 3.5%; the French franc by 4.5%; and the Italian lira by 7.3%.

The main benefits of the EMS for its existing membership seem to have been twofold:

1. Fluctuations in real exchange rates may have been lower than would otherwise have been the case. This statement is not demonstrated rigorously here, but seems plausible. As a result, production and investment decisions (e.g. the location of new factories and warehouses) may have been more rational.

2. The need to watch their exchange rates with the deutschemark may have caused macroeconomic policy in France, Italy and some of the smaller countries to be more responsible. Again the statement cannot be proved rigorously, but concern about currency weakness within the EMS is often mentioned in the various countries as justification for measures to reduce the budget deficit or raise interest rates.

The first of these benefits is not easy to quantify; the second is of no relevance to the UK at present since it has its own domestically-imposed financial guidelines (i.e., the money supply and PSBR targets in the medium-term financial strategy).

3. How successful has the EMS been in reducing fluctuations in European exchange rates either within the Exchange Rate Mechanism or between member currencies and the US dollar?

The Bank of England has given the answer to this question for the period April 1979 - December 1982 in its article 'The variability of exchange rates: measurement and effects' in its September 1984 Quarterly Bulletin and can presumably update the exercise to early 1985.

A surprising result of the September 1984 study is that exchange rate variability between both Exchange Rate Mechanism currencies and the three major non-ERM currencies (i.e., dollar, yen, sterling) declined after the establishment of the EMS. It is not immediately obvious why there should have been diminished variability in the three cross-rates between the dollar, yen and sterling.

4. What evidence is there to suggest that currency instability has impeded trade and capital flows?

This is a difficult question which can only be handled by sophisticated statistical techniques. The September 1984 Bank of England study is obviously relevant. The International Monetary Fund also published a reseach paper on the subject last year.

Nevertheless, a crude exercise - comparing the growth of intra-EEC trade by the UK, West Germany and France since the formation of the EMS - is interesting. It shows that Britain's trade with other EEC countries grew faster than West Germany's or France's between 1978 and 1984, despite the UK's abstention from the ERM.

Table 2 Trade with other EEC countries by three members with the largest economies

all figs. in $m., monthly averages

	UK		West Germany		France	
	Exports	Imports	Exports	Imports	Exports	Imports
1978	2,256	2,653	5,434	4,977	3,347	3,502
1979	3,162	3,694	6,899	6,423	4,313	4,461
1980	4,037	4,033	7,679	7,208	4,720	5,164
1981	3,569	3,628	6,848	6,461	4,066	4,531
1982	3,372	3,684	7,030	6,217	3,751	4,563
1983	3,352	3,805	6,767	6,247	3,736	4,353
1984	3,515	3,920	6,812	6,102	3,795	4,339
% change 1978-84	+55.8	+47.8	+25.4	+25.5	+13.4	+23.9

Source: OECD Monthly Statistics of Foreign Trade

5. To what extent have member states' economies shown signs of convergence?

Participants in the EMS's exchange rate mechanism have had widely divergent inflation and balance-of-payments performances since 1979. Table 3 below, using a simple measure of the dispersion of these two variables among the ERM countries (excluding Luxembourg), suggests increased divergence after the establishment of the EMS. The standard deviation of inflation rates and current account imbalance/g.d.p. ratios in the ERM countries was higher in the five years, 1979-1983, than in the five years, 1974-78.

In the preliminary discussion it was argued that harmonisation of fiscal policy - measured by the narrowing of differences in the budget deficit/g.d.p. ratios in the ERM countries - is the key aspect of policy convergence. Once again a simple measurement of fiscal policy, the standard deviation of budget deficit/g.d.p. ratios in six of the ERM's eight members, indicates increased divergence. Indeed, the heightened contrast between the fiscal responsibility of West Germany, the relative responsibility of France and the Netherlands and the irresponsibility of Italy, Belgium and Denmark may help to explain the widening disparity in inflation and balance-of-payments performance. (Figures on the general government financial balance are not given for Ireland and Luxembourg in the OECD's Economic Outlook.)

Table 3 Dispersion of inflation and balance-of-payments performances in ERM countries

1. Current account position as percentage of g.d.p.

	Average of ERM countries	Standard deviation of ERM countries
Before EMS		
1974	-2.0	4.2
1975	0.0	1.2
1976	-1.3	2.8
1977	-1.3	2.4
1978	-1.1	2.9
After EMS		
1979	-3.0	4.7
1980	-3.9	3.5
1981	-3.7	5.0
1982	-2.8	4.0
1983	-1.1	2.7

Average value of standard deviations before EMS 2.7
" " " " after " 3.6

2. Increase in consumer prices (%)

	Average of ERM countries	Standard deviation of ERM countries
Before EMS		
1974	13.5	3.9
1975	12.6	4.6
1976	10.8	4.5
1977	9.8	4.2
1978	7.2	3.2
After EMS		
1979	8.8	4.2
1980	12.0	5.7
1981	12.0	5.2
1982	10.8	4.4
1983	7.9	3.8

Average value of standard deviations before EMS 4.1
" " " " after " 4.7

Sources for data: OECD Economic Outlook December 1984, Tables R5 and R10, and L. Messel & Co. estimates.

Luxembourg has been excluded from the countries in the calculation because it consistently runs a large current account surplus (of 20% or more of g.d.p.), which would distort the first part of the table, and its inflation rate is virtually identical to Belgium's, which would distort the second part.

Table 4 General government financial balances as share of nominal GNP/GDP (%) in ERM countries

	1979	1980	1981	1982	1983	1984*
Germany	-2.7	-3.2	-3.8	-3.4	-2.7	-1.7
France	-0.7	+0.2	-1.8	-2.5	-3.4	-3.5
Italy	-9.5	-8.0	-11.9	-12.7	-11.8	-13.5
Belgium	-7.0	-8.6	-14.1	-12.7	-13.4	-11.2
Denmark	-1.9	-3.3	-6.9	-9.3	-7.7	-4.9
Netherlands	-4.0	-3.9	-5.3	-7.0	-6.4	-5.9
Average of 6 ERM countries	-4.3	-4.5	-7.3	-7.9	-7.6	-6.8
Standard deviation of 6 ERM countries	3.0	3.0	4.4	4.0	4.0	4.2

Source: OECD Economic Outlook December 1984, Table 2 and L. Messel & Co. estimates.

It follows that the ERM member countries must have been able, to a large extent, to pursue independent economic policies. But a qualification must be made. In the absence of the EMS, the divergence between policies in the various countries may have been even greater than it actually was. To suggest that increased divergence after March 1979 was caused by the EMS is obviously unjustified.

6. Have there been any significant changes in the way in which the EMS has operated, and what further changes are desirable?

No major changes in the method of operation have occurred in the EMS since 1979, although the absence of a major exchange rate realignment since March 1983 is notable.

Intervention tactics and the responsiveness of interest rates to exchange rate pressures are important subjects, but they cannot be dealt with effectively in a few paragraphs. As expected, the Bundesbank has become the lynchpin of the system and lends deutschemarks to other member central banks when their currencies are weak. Market awareness of the Bundesbank's preparedness to act in this way has discouraged speculation. In 1984 Bundesbank intervention to protect the existing EMS exchange rates amounted to only 3,637m. deutschemarks. (See Report of the Deutsche Bundesbank for the Year 1984, p.67. The 3,637m. deutschemark figure includes intervention by other central banks where they affect the external position of the Bundesbank.)

The big disappointment is that there have been no significant moves towards easing exchange controls. This disappointment is felt keenly by the Bundesbank. In its 1984 Report it refers specifically to the continuing two-tier exchange market system in Belgium and is critical of the lack of progress on exchange restrictions throughout the EMS. It says, "the liberalisation of financial transactions in the member countries of the system has made practically no progress. In recent years, indeed, new restrictions on foreign exchange and capital movements have been introduced and some of them are still in force." (p.68)

There is a possibility that the existence of the EMS has delayed exchange control relaxation and capital market integration. It arises because governments may have been tempted to buttress a weak exchange rate against the deutschemark by imposing new restrictions on foreign exchange and cross-frontier capital transactions. The potential loss of economic efficiency from such retrograde steps must be balanced against gains in other areas.

7. What has been the role of the ECU and how do you think the ECU's role will develop in the short- to medium-term future?

The ECU's prospects have been rather exaggerated, partly because the emergence of an ECU-denominated bond market suggests that the private sector has a genuine commercial interest in the unit. In fact, the purpose of issuing ECU-denominated bonds is largely to evade central bank restrictions on bond issuance in particular currencies. For example, the Bundesbank has until recently required that deutschemark bond issues be managed by German institutions and the Bank of England continues to operate a queuing system for sterling bond issues. Non-bank holdings of ECU deposits are trivial at about $1½b., with a considerable part of this sum accounted for by the balances of EEC institutions. (This contrasts with total non-bank Eurocurrency deposits of over $600b.)

The main function of the ECU is to act as a generally acceptable unit of account - and, to some extent, as a means of settling debts - within the EEC, without damaging the amour propre of particular countries. It should be emphasised that the retention of exchange controls reduces the tradeability of several ECU currencies. As the Bundesbank notes in its latest Report, "the ECU combines currencies of widely differing quality".

8. Are the obligations on debtors and creditors in the ERM symmetrical?

Under existing EMS rules creditor central banks are obliged to accept only up to 50 per cent of their net claims in ECUs in settlement operations with debtor central banks. The obligations on debtors are therefore not symmetrical. (This state of affairs has a simple rationale. The ECU contains lira, francs and sterling as well as deutschemarks. The Bundesbank is not prepared, since it is almost invariably the main creditor institution, to have deutschemark obligations covered - except to a limited extent - by payments in these other currencies. Its views on their "quality" have been made clear in the anwser to question 7.)

Trade surpluses and deficits are not necessarily indicative of macroeconomic imbalance. Indeed, a country with a high marginal rate of return on capital compared to neighbouring countries should be a capital importer. The counterpart to the capital account surplus will be a current account deficit, including almost certainly a deficit on trade. The current account deficit can be extremely large as a proportion of g.d.p., without any problems emerging, if the capital-importing country is content to see part of its capital stock in foreign hands and its growth rate is high enough to service the foreign-owned capital without difficulty. South Korea, Singapore and Hong Kong have all had substantial current account imbalances during their hyper-growth period. Within the USA it is likely that capital imports into the South-West and the West Coast have been substantial in the last twenty years. In view of the wide disparities in wage and profit levels in the EEC, there must be considerable scope for efficiency-improving capital flows. The abolition of exchange controls and capital market integration might encourage more such flows between the private sectors of member countries, causing larger trade and current account imbalances than at present observed.

However, the existing pattern of current account imbalances seems instead to reflect the contrasting fiscal positions of the various countries. Capital flows are not, therefore, motivated by private sector attempts to search out the most profitable opportunities within a unified currency area, but by judgements about the ability of taxpayers in countries with large budget deficits to honour commitments to savers in countries with low budget deficits. The answer to question 5 shows that the situation has not been significantly changed by the establishment of the EMS.

B The EMS and the UK

Several of the answers to the questions in this section are contained in the answer to question 1. Where there is little further to say, the question will be answered only briefly. Questions 10 and 15, and questions 13 and 14, will be answered together.

9. To what extent have the reasons given for not joining in 1978 been borne out by subsequent events?

The concern about transitional adjustment costs has been fully justified. Reducing inflation to 5 per cent has been very expensive in terms of lost output and employment. However, an important related issue - the impact of oil on the balance of payments and the UK's economic structure - was not properly recognised in late 1978. This was understandable as oil was less valuable before the second oil shock in 1979 and 1980 than it has subsequently been.

It is not possible to say whether the output and employment costs of inflation reduction would have been greater under the discipline (such as it might have been) imposed by the EMS than under the discipline (such as it is) imposed by the medium-term financial strategy.

10. What advantages have the UK gained from membership of the EMS and what advantages and disadvantages would arise from full membership of the ERM?

15. Can the ERM function with both the pound and the deutschemark as participants?

It will be assumed, in answering these two questions, that Britain's membership in the ERM is meaningful. In other words, the intention is to maintain a relatively stable exchange rate between the pound and the deutschemark. The maximum permitted fluctuation between the two currencies might be rather more than indicated by the divergence threshold between the existing ERM members, in recognition of the UK's oil-supported economic structure. It will also be assumed that both the UK and West Germany avoid exchange controls. (The discussion would be similar in character, but with more participants, if France, Italy and other countries scrapped their exchange restrictions. As the Netherlands and Denmark do not have exchange controls, "Germany" should be interpreted as West Germany, the Netherlands and Denmark combined.)

The promise of a stable exchange rate should cause the virtual elimination of an interest rate differential between the pound and the deutschemark; the absence of exchange controls should stimulate capital flows between the UK and Germany to take advantage of differences in the rate of interest paid to savers and in the rate of return on investment. The capital flows would pass through the banking system, stock markets and other channels (e.g. direct investment by companies). The efficiency gains from the amalgamation of the two nations' savings and investment mechanisms could be extremely large.

However, there are problems, most of them arising from differences in financial regulations, tax arrangements, and legal and accounting standards. In principle, the absence of exchange controls should make it easy for a bank in Britain to lend deutschemarks to a company in Germany and to take deutschemark deposits from German residents. In practice, it is unclear that the Bundesbank would like these developments. It imposes more onerous reserve requirements of deutschemark bank intermediation in West Germany than the Bank of England imposes on sterling bank intermediation in Britain. It is also less flexible about the provision of rediscounting facilities to new foreign entrants to banking than it ought to be. It interferes in the bond market, particularly when bonds are to be issued by foreign entities. The lack of a tradition of self-regulation, which is well-established in the City of London, may explain the contrast between the Bundesbank's approach and the Bank of England's. But the Bundesbank's probable hesitation about a harmonisation of regulatory systems is not the only obstacle to a fully integrated capital market. Also relevant are German restrictions on the operations of insurance companies and building societies.

There is much more to say, but the central thrust of the argument may already be obvious. Britain at present has the most liberal, flexible and efficient financial system in Europe. It would therefore have more to gain from capital market integration than Germany, although both countries could benefit enormously from easier cross-frontier flows of savings and investment. An implication is that, if the UK were to join the ERM, it should bargain for a relaxation of restrictions on its exports of financial services. In Germany the restrictions are mostly administrative and prudential in character; in the rest of the EMS

they take this form as well, but exchange controls are more important. It could be mentioned to other European governments and banking authorities that savers are already "voting with their feet". An increasing proportion of financial intermediation takes place in the offshore markets, free from many of the regulations applicable to onshore markets. Much of the legal, accounting and transactions work required for so-called "offshore intermediation" is actually conducted in London. This pattern will continue unless the existing EMS member governments ease the panoply of controls, restrictions and interferences they now regard - for reasons best known to themselves - as necessary.

One final point should be made. It is a logical development of the preceeding argument. If ERM membership for the UK would require our financial system to adjust to European standards (of over-regulation), rather than ERM countries' financial systems to liberalise in the British manner, the UK should stay out of the ERM.

11. What modifications, if any, would have to be made to the ERM, to make British entry feasible and economically and politically acceptable to the UK and to member states?

Because of the oil problem, the UK should have a wider permitted band for exchange rate fluctuation than other ERM countries. The Italian arrangement is the obvious precedent.

12. What would be the appropriate rate of exchange for the pound against the ECU and on what principles would it be determined?

Britain's bilateral trade position with the rest of the EMS is of no direct relevance to the correct setting of the exchange rate between the pound and other EMS currencies. A trade deficit with EMS partners may be offset by a surplus with other countries. Even if it is not so offset, it may not be symptomatic of the excess supply of sterling which alone can undermine the pound/deutschemark exchange rate. An excess supply of sterling is most likely to result from a mismatch between UK and European monetary policies.

13. How would the pound's rate within the ERM be fixed and how much influence would the UK and the other members have in determining it?

14. What constraints would full participation place on domestic monetary and fiscal policy?

If the UK joined the ERM and was determined to avoid a devaluation against the deutschemark, macroeconomic policy would have to be co-ordinated with that in Germany. An independent financial strategy, whether short-term, medium-term or long-term, could no longer be pursued. However, control of the PSBR and the monetary aggregates would certainly still be necessary. The government might quantify the targets it deemed appropriate for stability of the pound/deutschemark exchange rate and these targets might on occasion trigger short-run policy adjustments. (Both this and the previous answers have taken the pound/deutschemark exchange rate as the lynchpin of the ERM for the UK if we joined. Strictly speaking, the central rate against the ECU is supposed to determine intervention decisions and subsequent policy moves. But the deutschemark has the largest weight of any single component in the ECU and, in reality, it is the EMS's key currency.)

16. Does the UK have to become a member of the ERM to enable a European "dollar policy" to be formulated and implemented?

The notion of a European "dollar policy" is fantasy after the events of the last few years. In effect the markets and central banks (mostly the Bundesbank) decide what the deutschemark/dollar exchange rate should be and the EMS arrangements decide the associated franc/dollar, lira/dollar and other exchange rates.

Existing agreements about sharing the obligation to intervene to affect the dollar cross-rates could be extended. But - as was pointed out in the author's evidence to the 1978 inquiry - there is a lack of obvious criteria for deciding how much of its reserves each central bank should have to commit. This problem is more serious for the Bank of England than for other European central banks, apart from the Bundesbank, because the pound/dollar market is deep and active.

17. What are the arguments for setting targets on the exchange rate as opposed to sterling M3 or the PSBR?

In one member of a currency union macroeconomic policy is directed towards exchange rate stability; in an independent currency area it should be guided instead by targets for the money supply and the PSBR.

In other words, this question reduces to the issue discussed at the outset, "is Britain by itself a closer approximation to an optimum currency area than the UK and the existing full EMS membership in combination?". The conclusion, in broad terms, was that an enlarged ERM, with the UK as a full member of the EMS, would move closer to an optimum currency area if four conditions were more fully satisfied:

1. Increased mobility of labour and capital within the EMS, with complete exchange control abolition as the most important single step to achieve this.

2. Increased trade between EMS member countries leading to higher ratios of trade to national output.

3. Strengthened capital market integration.

4. Macroeconomic policy convergence, in particular the restoration of balanced budgets or the harmonisation of budget deficit/g.d.p. ratios at low levels throughout the EMS area.

12th June, 1985

Tim Congdon

Mr.Healey:

On the other hand, if the changes which I have described, and for which the Government are pressing, are made in the exchange rate regime in the next few days —and many other countries besides ourselves are pressing for these changes— if the Heads of Government were to agree next week on the necessary commitment to concerted action and resource transfers, and if, therefore, the Government decided that it would be in Britain's interest to join the exchange rate regime, then—I was asked this question at Question Time the other day—the Government would submit their view to Parliament for debate, and, if necessary, a vote, before the regime came into operation at the beginning of January.

I hope that that allays the anxieties which some of my hon. Friends, and indeed some of my right hon. Friends, have expressed.

Mr. J. Enoch Powell (Down, South): When the right hon. Gentleman says " before the regime came into operation ", does he mean before this country is committed to participate in it or after we are committed but before it begins to operate?

Mr. Healey: If the House were to take a view that was different from that of the Government, on a matter of this importance, it would indeed be a very serious matter. There is not the slightest question but that the Government would be guided by the views of the House. But I hope that the right hon. Gentleman, who is a stickler for constitutional precedent here, is not suggesting that the Head of the British Government should go to an international conference and enter into negotiations and reach conclusions *ad referendum* to votes in this House. I think that that would be a total breach of all historical precedent. If the right hon. Gentleman was suggesting it, he would have difficulty in reconciling it with his views on many other issues of a constitutional nature.

I have made it absolutely clear that the essence of democracy in this country is that the Government repeatedly have to take decisions on many matters and submit them to the view of the House. If the House rejects their views, they either resign or change their policies.