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PATRICK MINFORD'S VIEWS ON THE EMS

Patrick Minford argued strongly against joining the EMS at a seminar on Tuesday. His objections were:

i. The risk of capital and trade controls to help sustain exchange rate parity.

ii. Speculators could bet against the currency without any risk of losing, but with considerable potential gains. This encouraged speculative pressures on currencies.

iii. These speculative pressures caused dramatic changes in interest rates unwarranted by domestic monetary conditions. Financial volatility was therefore increased.

I attach a press notice summarising his lecture.

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EMS MEMBERSHIP DISASTROUS FOR BRITAIN
MINFORD ARGUES

It would be a disaster for Britain to join the European Monetary System (EMS), argued economist Professor **Patrick Minford** today. There were few clear benefits and important disadvantages to membership. In the past the EMS has encouraged the growth of distortionary barriers to capital mobility and of restrictions on free trade. It has also led to increased monetary volatility in member countries. Minford argued that present UK monetary policy is performing reasonably well. Why then embark upon an unknown sea of troubles?

Patrick Minford is Professor of Economics at the University of Liverpool and a Research Fellow in the International Macroeconomics programme of the Centre for Economic Policy Research (CEPR) in London. He spoke at a lunchtime meeting organised by the Centre, one of a regular series of meetings at which Research Fellows discuss policy-relevant research. They may also advance specific views on policy, but these views are their own and not those of CEPR, which takes no institutional policy positions.

Minford observed that the EMS is a system of "fixed-but-adjustable" parities between a number of European countries, each pursuing independent monetary policies. The key currency in the EMS is the Deutschmark (DM), and the monetary policy of the Bundesbank plays a key role in the behaviour of the EMS. There have inevitably been shifts of member currency parities against the DM, notably the Belgian and the French francs and the Italian lira. These parity shifts are generally foreseen well in advance, even if their timing is uncertain. They create a "one-way option" in the devaluing currency, of the kind familiar in the later years of the Bretton Woods agreement. The exchange market becomes unstable, and during these crises capital flows must be stemmed by means of exchange controls and abrupt shifts in monetary policy. A period of quiescence usually follows the devaluation, but in the absence of monetary policy alignment with the Bundesbank, the initial instability recurs. Hence, Minford argued, exchange controls become institutionalized, either through two-tier markets or physical controls. Controls on trade in services such as tourism and insurance also become necessary, because these are a potential route for avoiding capital controls; even barriers to trade in goods may be encouraged for the same reason. Monetary policy also becomes more volatile.

It is often claimed in defence of the EMS that it has reduced fluctuations in intra-European price competitiveness, but evidence for this is weak and

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informal, Minford argued. The earlier pattern of random fluctuations has been replaced under the EMS by occasional sharp swings, resulting in possibly less volatility (lower variance) but a more skewed distribution. It was not clear that this was preferable, Minford observed.

Minford drew attention to **the disadvantages of EMS.** One cost is the tendency of the EMS to encourage **barriers to capital mobility and to free trade.** The distortions caused by these barriers are well-known and likely to be important, driving a wedge between investment returns in the world and in the protected markets.

A second cost of the EMS is **the increased monetary volatility it causes in member countries.** Such volatility leads markets to add a risk premium to bond yields. Interest rates increase, thus creating another market distortion. Monetary volatility also contributes to greater volatility in the real economy, Minford added.

These problems are compounded for Britain, because she is an oil exporter and one of the major world financial centres. One object of the government's Medium Term Financial Strategy (MTFS) was to create monetary stability. Minford argued that Sterling M3 had been rightly abandoned (informally) as a major indicator some four and a half years ago, because it yielded a distorted picture in the more competitive financial environment which has arisen since 1979. Since 1981 M0 has assumed an informal role as an indicator of monetary conditions and has performed relatively well. **The correct policy for the UK, according to Minford, involves continued emphasis on M0, preferably in a slow evolution towards Monetary Base Control. Policy should respond to the exchange rate only if it displays sharp and sustained movements, which threaten to destabilise monetary conditions. Such a policy has worked well hitherto, and Minford viewed this as perhaps the most decisive argument against the EMS. Why embark upon a sea of troubles when present policies serve us reasonably well?**

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The Centre for Economic Policy Research is a private educational charity which promotes independent analysis of open economies and the relations between them. The research work which it disseminates may lead to or may include views on policy, but CEPR itself takes no institutional policy positions. Patrick Minford is a Research Fellow of the Centre's research programme in International Macroeconomics. The opinions he expresses are his own and not those of the Centre. Financial support for this meeting has been provided by a grant from the German Marshall Fund of the United States, which does not necessarily endorse the views expressed by Professor Minford.