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EXCHANGE RATE vs MONETARY TARGETS

In your memo of 15 May, you do not draw a crucial distinction and describe precisely what you specify as an exchange rate regime. You talk of "linking" (para 3). But the nature of the link and the institutional structure in domestic markets is the crucial issue. I would define a truly fixed (hereafter fixxed) exchange rate regime as one in which there are no bands (other than the commercial commission deviations) and no realignments.

There are great advantages of a fixxed rates system. From the history of the Currency Boards, we know that price and exchange rate stability can be delivered if (a) the metropolitan country has a stable monetary policy, (b) the institutional structure of the member country is made consistent with the fixxed requirement, and (c) the member country is willing to bear the consequences of sharp adjustments in response to monetary and real changes.

(I did some research on such fixxed systems and published a summary in my article on Currency Boards in New Palgrave 1988.)

As you know, I was a moving spirit in fixing the Hong Kong dollar with respect to the US dollar. I was rather nervous about (a) since it looked likely that US would inflate somewhat but could see no alternative. The institutional structure (b) of a Currency Board was put in place and operated quite well just as we knew it could. As for (c), it is difficult to imagine a country with more flexible and open markets.

Of course in all but name, and allowing for seigniorage,

a fixxed system operates like a currency union, and in the EC framework, it would be dominated by the Dmark as the metropolitan currency. This is very different from the ultimate union envisaged in the Delors Report where policy will be set not by the Bundesbank but by some European board of appointees.

A CB Dmark dominated system is technically viable and would have many advantages in reducing transactions cost. Whether it would give price stability (point (a)), compared to a monetary control system, is more dubious [See **Vaubel** attached]. We all thought that the United States would not inflate in the 1950s and 1960s, as we tied ourselves to the dollar - how wrong we were. I suspect that the political changes in Germany will eventually have their effects on monetary policy. Similarly, on point (c), I do not think European countries have flexible enough labour and other markets to take the full force of the adjustments required without unacceptable levels of unemployment and disruption, or more ominously, trade barriers and capital controls. As for (b), it is clear that the Banque de France is not willing to relinquish monetary sovereignty to the Bundesbank (hence the demand for symmetry, etc).

I adduce that we are not (yet?) ready for anything like a viable fixxed system. But what about a "little fixity" as in the ERM. Here, I will not repeat my usual arguments about capital mobility and their perverse effects on the adjustment process. (My forecasts in 1987-8 turned out to be correct). I would assert again that the ERM, as at present constituted, is not viable except with controlled credit and exchange markets. (You will recall that capital flows shattered Bretton Woods in the 1960s.)

Now consider the rationale for my "time is ripe" definition. If there are free markets, the ERM will have to change radically. The two possibilities (excluding re-imposition of controls) are:

- ( i) movement to fixxed rates based on the Dmark;
- (ii) a widening of the bands so that they become reference zones - or eventually a free float.

The middle ground is untenable.

I conjecture that (ii) is far more likely than (i). Fixxity requires institutional change whereas floating or "reference bands" do not.

We can live with all the forms of reference band systems that are likely to emerge. Essentially, our exchange rate would be free to move as much as we wished. Thus we have been good Europeans and achieved our preferred monetary arrangements.

If, in the most unlikely event the Rest of Europe goes to (i), there are a number of options. Of course we could also become fixxed and we know the consequences of that. Perhaps the most interesting and likely, but least researched, is if we play the role of Canada to the US of Europe. I suspect that it will do us little harm.

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*cc Professor B. Griffiths  
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Sir Alan  
with best regards

Roland Vaubel

Roland Vaubel

Manfred Wegner's description and appraisal of the European Monetary System (EMS) shows only one side of the coin: its success in reducing exchange rate fluctuations among the member currencies participating in the exchange rate mechanism (ERM). What is the other side of the coin? Let us compare the years before and after the establishment of the EMS.

1. *Nominal and real exchange rate variations vis-à-vis (eight) other major OECD currencies have on average increased more for the ERM currencies than for the other OECD currencies or the other European OECD currencies (Ungerer et al., 1986, Tables 22 and 25).*
2. *Nominal effective exchange rate variations have on average decreased less for the ERM currencies than for the other European OECD currencies (Ungerer et al., 1986, Table 28).<sup>1</sup>*
3. *The average annual rate of depreciation vis-à-vis the Deutschmark has on average decreased less for the ERM currencies than for other major European OECD currencies (calculated from Lehment, 1987, Table 2a).*
4. *Expected exchange rate changes as proxied by the standard deviation of long or short-term interest rates have increased among the ERM currencies; they have grown a little less, but since 1979 have been larger than among the other major OECD countries (Ungerer et al., 1986, Tables 43 and 44; Harbrecht, Schmid, 1987, Figures 12 and 15).*

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<sup>1</sup> This cannot be explained by the fact noted by Wegner that "a number of European countries such as Austria and Switzerland are quasi-members of the EMS, and others such as the United Kingdom have tacitly accepted exchange rate targeting in recent years." (III, 2nd paragraph).

5. *The weighted average of the inflation rates decreased much more slowly, and in 1986 was still a little higher, in the ERM countries than in the rest of the OECD (Scheide, Sinn, 1987, Table 1; de Grauwe, 1987, Table 1; 1985, Figure 4; Collins, 1987, Table 2; Harbrecht, Schmid, 1987, Figure 3). It also decreased more slowly in the EMS than in the other European OECD countries although it is still lower in the former than in the latter group (Scheide, Sinn, 1987, Table 1; de Grauwe, 1987, Table 1).*
6. *If the seven years before and after the establishment of the EMS are compared, the standard deviation of inflation rates shows an increase among the ERM currencies but a decrease among the other major OECD currencies (Collins, 1987, Table 2). Over the whole life of the EMS, the dispersion of inflation rates has also been much larger among the ERM currencies than among the major OECD currencies (Collins, 1987, Table 2; Harbrecht, Schmid, 1987, Figure 5; de Grauwe, 1985, Figure 3). For the more recent past, this is not true any longer (Collins; Harbrecht, Schmid, *ibid.*) but there remains the fact that inflation convergence took longer in the EMS than in the rest of the OECD.*
7. *From December 1978, bid-ask spreads vis-à-vis the Deutschmark increased for the average of ERM currencies, and they increased more for the ERM currencies than for an average of other major European OECD currencies (Lehment, 1987, Tables 4a and 4b).*
8. *Since the establishment of the EMS, all old members of the EEC<sup>2</sup> have experienced larger growth rates in their trade with non-ERM countries than with other ERM countries (de Grauwe, 1985, Table 2).*
9. *Real growth of investment and GDP was much slower in the ERM countries than in the other OECD countries; compared with 1973-78, it declined more in the ERM countries than in the other major OECD countries; in the other*

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<sup>2</sup> As de Grauwe points out, this is not true for Denmark and Ireland which joined the EC customs union at a later stage and may still have been benefiting from entry-induced trade creation.

*European* OECD countries, investment has even increased (de Grauwe, 1987, Table 1).<sup>3</sup>

To sum up: the exchange rate mechanism of the EMS does not seem to have contributed to reducing nominal effective exchange rate variations, inflation and inflation differences of the member currencies, or to increasing intra-ERM trade, investment and growth in the member countries.

The EMS exchange rate arrangement is a cartel of national money producers with a price leader. Cartels are inherently unstable; *ceteris paribus*, they raise prices (here: the price of holding money) and reduce the output (here: real money balances). The EMS money supply cartel is neither a necessary nor an efficient step on the way to a common European currency.

Whether such a single European currency should be "the final objective of the Community", as Wegner suggests, is an open question to which politicians and economists cannot know the answer. It depends on the trade-off between price level stability and transaction costs. As I have argued elsewhere (Vaubel 1987), only individual money users possess the knowledge and incentive required to make that choice. The optimal way of finding out whether currency union is efficient and, if so, of bringing it about is unrestricted currency competition or "choice in currency" (Hayek 1976). The European Currency Unit (ECU) can be instrumental in this process, especially if its weights are permitted to respond to revealed currency preferences (Vaubel 1987).

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<sup>3</sup> "The disinflationary stance and the high real interest rates of the 1980s" emphasized by Wegner do not explain this difference, since disinflation was faster in the other OECD countries.

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