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Treasury Chambers, Parliament Street, SW1P 3AG
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PRIME MINISTER

ERM

... I promised you another paper on the ERM. This is now attached. It deals with three main issues:

- sterling's rate on entry;

- the width of the band sterling should join;

- the position of sterling within the band in relation to its central rate.

The covering note to the paper summarises the arguments and I will not repeat them here.

Sterling's Rate on Entry

2. On sterling's level on entry to the ERM, I take it as axiomatic that we want to enter at a rate which reinforces our objective of reducing inflation as quickly as possible. The paper attached argues that at its present levels sterling is, if anything, still a little on the low side for our inflation objective. But there has been some helpful strengthening of the rate in the last week or so, despite the publication of some decidedly mixed economic figures, partly as a result of market expectations of our entry into the ERM. I would not rule out some further modest strengthening on this and other grounds. But too

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large an increase in the rate would, I think, be unhelpful. To join at too high a rate, which is widely seen as unsustainable, and with the prospect of downward realignment, would be counterproductive in terms of its effect on policy credibility. On the other hand, joining at too low a rate and being faced with a rapid upward movement shortly after entry with consequent pressure for unwarranted reductions in interest rates to keep within the band would also be harmful to policy credibility.

Width of the Bands

3. There is considerable uncertainty in the economic and financial dynamics which will accompany sterling's entry. The exchange rate might rise, if entry is seen to help counter-inflationary policy, and interest rates might fall. But the size of these effects, or even whether they occur at all, is not clear. And we would not know immediately before entry whether and to what extent any such effect was already discounted in current exchange rates. In some circumstances the pressures could be in the opposite direction.

4. Nevertheless, if recent market behaviour of sterling is anything to go by, entry might be expected to be followed by upward pressure on the sterling exchange rate as foreign money moved heavily into sterling attracted by the 6¾ per cent interest rate differential over the deutschmark and 3½ per cent over the lira (currently the strongest currency in the narrow band). Clearly a rise in the exchange rate would not be unwelcome, provided the increase was not such as to push sterling up to the upper level of the band. The wider band would leave us with much more room for manoeuvre without having to contemplate either a revaluation or lower interest rates. It would thus give us much more flexibility over when we joined.

5. These arguments, I believe, point very firmly to joining the wide (±6 per cent) band rather than the narrow (±2¼ per cent) band. (For technical reasons explained in the note which my Private Office sent yours on 25 May the room for manoeuvre can be less than the total width of the bands.)

Sterling's Central Rate

6. If we were to join the wide band, I think we should probably join with a central exchange rate above, but not too far above, sterling's market rate immediately before entry. This would give sterling some latitude for depreciation, and thus some latitude against pressure for early upward movements of interest rates. But it would at the same time signal that we were not adopting broad bands to open the way to devaluation, since the asymmetry would give sterling a greater degree of latitude for coping with an appreciation of the rate; ie before the emergence of pressures, imposed by the upper limit of the band, for lower interest rates or a revaluation. In this way we would effectively bias our entry in an anti-inflationary direction by giving the signal, through the choice of central rate, that we judged that there was a greater prospect of appreciation than depreciation (while of course leaving some cautious scope for depreciation) and creating some new room for sterling to rise without generating pressure for a premature reduction of interest rates. We could reinforce this message by reaffirming our commitment in due course to move to narrower margins, as part of "Stage 1". I believe this is the right stance both for the markets and for our discussions with other Member States.

7. I have considered whether any of this analysis is affected by the beginning of GEMU on 1 July. There is a possibility that there could be an unsettled period in the markets in the weeks following GEMU, on 1 July. A successful start to GEMU could lead

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to a strong DM (and hence a lower exchange rate for sterling against the DM). At the same time, fears of extra inflationary pressures may cause the Bundesbank to tighten policy. If the DM did not rise spontaneously, or fell, there could be an increase in German interest rates, which could in turn put upward pressure on sterling interest rates, or downward pressure on sterling. But all this is somewhat speculative and does not, in my view, alter the essentials of the analysis above. Even so, we clearly need to keep the markets under daily review for any signs of problems here.

8. I think we can now provisionally conclude that we ought to join the wide band; and that, if the present disposition of exchange rates persists, we should contemplate joining with a central rate at or somewhat above that indicated by the present level of market rates. Final decisions would have to wait until immediately before we join.

9. I should like to discuss all this with you next week. In the meanwhile I will be thinking further about possible entry dates.

John M.

[J.M.]
8 June 1990

THE EXCHANGE RATE AT WHICH TO JOIN THE ERM AND THE WIDTH OF THE BAND

This note discusses the analytic considerations which bear on the exchange rate band at which it might be appropriate for sterling to enter the exchange rate mechanism (ERM) of the European Monetary System, if a decision was taken to join. It is based on four sets of evidence which are relevant to this issue:

a) the behaviour of the real sterling/deutschemark exchange rate over time (ie. movements of the exchange rate other than those that reflect differences in cumulative inflation in the two countries);

b) the level of the exchange rate which we have felt over the last year or so has been necessary to maintain monetary conditions appropriate to the Government's objectives;

c) the implications to be drawn from the outlook for the balance of payments;

d) French and Italian experience with realignments against the mark.

2. This evidence is reviewed in detail in the annex. On the basis of the conclusions to be drawn from it, this main note considers the characteristics of the band with which to join the ERM.

The Background Evidence

3. The conclusions from the evidence discussed in the annex can be summarised as follows :

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(i) both the real effective rate and the real sterling/deutschemark rate are currently reasonably close to their historical average levels. If anything, they are a little below the average levels of the 1980s alone;

(ii) given the recent state of monetary conditions, there is a presumption that sterling's effective exchange rate should not fall from present levels - and perhaps should rise;

(iii) the prospects for the next few years are for a sizeable and continuing current account deficit. The deficit has been caused, however, primarily by domestic demand growth in the UK exceeding that in trading partner countries and not by lack of competitiveness. Its future course is unlikely to be greatly influenced by movements of a few percent either way in the level of sterling.

(iv) on the other hand, there are constraints on joining at too high a level, if this would widely be regarded as unsustainable within the context of the UK's external position. A downward realignment of the pound, forced by foreign exchange pressures, shortly after its entry into the ERM would obviously be an unattractive prospect.

(v) before realignments, it has often been necessary for interest rates in France and Italy to be much higher than in Germany to maintain the ERM commitment. But after realignments capital flows to the devaluing currency have put upward pressure on its exchange rate and downward pressure on interest rates. These pressures have not always been helpful but their scale is dependent on the width of the band. They are liable to be much more intense with a narrow band than a wide one.

<u>Other Considerations</u>

4. Developing these conclusions into a recommendation about the right band for sterling involves three other considerations :-

(1) the behaviour and effect of interest rates when sterling joins;

(2) the interaction between the choice of band and the credibility of the Government's policies;

(3) the significance of the non-deutschemark currencies within the ERM and their exchange rates.

These are discussed in turn.

5. Interest Rates. Clearly, changes in short term interest rates would be one of the factors that could alter monetary conditions at whatever level sterling joined the ERM. There is a risk that the UK authorities would to be compelled to reduce interest rates and loosen monetary conditions in an effort to keep within an ERM band which with hindsight had been chosen at too low a level. (Some argue this was the Spanish experience; it is described in more detail in the attached Appendix).

6. In the long term, some fall in interest rates after entering might be consistent with the same downward pressure on inflation. That would happen, for example, if wage negotiations and price setters came to see ERM entry as bolstering or guaranteeing the Government's determination to defeat inflation. But it would take time for any such perception to grow. It would not be an effect of any significance at the time of joining or immediately afterwards.

7. Credibility and the Chosen Band. The effect of sterling's entry into the ERM will will be heavily influenced by the extent to which it alters the perceived credibility of the Government's policy.

- if the markets were sure that the Government would stick to it, a margin which allowed little room for sterling to fall would be preferable to one which gave wider scope. The narrower the scope for depreciation the more intense the

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favourable effect on inflationary expectations. But this conclusion would not apply, and could even be reversed, if the band was so narrow that the Government proved unable to keep sterling within it. If it proved necessary to devalue the pound quickly after joining, then the effect on expectations would be counterproductive;

- there is considerable uncertainty in the economic and financial dynamics which will accompany sterling's entry. The exchange rate might rise, if entry is seen to help counterinflationary policy, and interest rates might fall. But the size of these effects, or even whether they occur at all, is not clear. And we would not know immediately before entry whether and to what extent any such effect was already discounted in current exchange rates. In some circumstances, the pressures could be in the opposite direction. Spanish experience on entry sheds only limited light on this as the peseta is not used much as an investment currency. The fact that the original members had to iterate by a series of realignments in the early days of the ERM to a broadly satisfactory set of central rates underlines the uncertainties that are involved.

- there is a clear asymmetry for monetary conditions from different directions of sterling's movements after joining. An upwards movement in the pound - provided it was not so great as to force an unwarranted cut in interest rates - would be more beneficial in underlining the counterinflationary thrust of policy than a depreciation. A fall in the pound after entry would be less satisfactory altogether.

8. The Non-Deutschemark Currencies. There is a technical but vital point to be made about the role of non-Deutschemark currencies in the operation of the band against the deutschemark. In most circumstances, it would not be possible for sterling to utilise the full range of its band width against the deutschemark, whatever that was chosen to be. This can be illustrated by

noticing that the lira is currently around 2 per cent above the deutschemark. The bands on sterling's joining now would have to take that into account. But, over time, it is reasonable to suppose that the lira will fall against the deutschemark. With the lira in the bottom part of its band against the mark, the latitude that sterling would have to appreciate against the mark would be curtailed because appreciation to the full extent allowed by the sterling/mark band itself would force the lira out of its band against sterling. This extra constraint could be of considerable practical importance.

9. A different, but probably longer term issue, is the likelihood that at some point there will be a further general realignment in the ERM, with the deutschemark rising against currencies like the French franc and lira. Some Bundesbank officials have expressed a preference for this in the past, though the French are opposed. If it happened, we could then find ourselves embroiled in a general realignment of the ERM that was not of our making.

The Choice

10. Deciding the central rate for sterling to join the ERM and the width of its band involves balancing up the previous considerations. By no means do they all point in the same direction but perhaps two features stand out :

(a) the complexity of the forces that might or might not bear on sterling (and the UK economy) on entry;

(b) the asymmetry of the key considerations. Both in terms of maintaining downward pressure on inflation and in the context of deriving maximum benefit to credibility, an appreciation of sterling on joining would be strongly preferable to depreciation.

11. The complexity of the forces at work points up the advantages of joining with a wide band, and the greater flexibility that would bring, at least initially :

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- a wide band may not lead to a big jump in the exchange rate or unmanageable downward pressure on interest rates;

- a wide band is less likely to produce very high short term interest rates if markets fear a realignment: a narrow band runs the risk of excessively low or high interest rates at inconvenient moments;

12. Of course, there is an argument the other way:

- to obtain the full benefits of the effect of improved inflationary expectations on interest rates or the exchange rate a narrow band is preferable;

13. This suggests a strategy of joining the ERM with wide bands at the outset. We could announce at the outset, if we wished, that we would move to a standard 2¼ per cent margin when circumstances permitted. We could also consider some intermediate step - for example, a 4 per cent band.

14. The balance of considerations also point to joining at a central rate above the exchange rates against the deutschemark that have prevailed over recent months. That would err on the side of caution in terms of keeping downward pressure on inflation and leave more headroom for sterling to rise. It would also help secure the maximum benefit to credibility.

15. But these same considerations also suggest that it could be helpful for sterling's chosen central rate to be a little above the actual rate on entry. That would allow greater scope for sterling to rise if the pressure turned out to be that way. Some net tightening in the monetary stance might in any case not be unwelcome. But if the appreciation were sufficiently large, interest rates could be reduced to the extent appropriate. Such an asymmetric arrangement would also be helpful so far as credibility was concerned, underlining the counterinflationary

thrust of policy. At the same time, by not overdoing the asymmetry, some scope would remain for sterling to fall a little without forcing an interest rate rise regardless of all other considerations.

16. Joining at the sort of rates implied by such a band would mean a real exchange rate well within historic experience, indeed not far from the average. Such rates would not therefore be likely to cause major balance of payments problems. This would remain true even taking into account the inevitable deterioration in UK competitiveness which will stem from our inflation being higher than in other ERM countries over the next year or two.

Summary

17. Joining the ERM with a central deutschemark exchange rate at or a little above current levels would imply a real exchange rate close to its historical average - well within previous ranges of fluctuation both against the mark and in effective rate terms. But both maintaining satisfactory downward pressure on inflation and deriving maximum credibility from joining suggest that a further appreciation would be much preferable to a decline after joining. That suggests the desirability of a mildly asymmetric band, permitting more appreciation than depreciation. Nevertheless, the pressures to which the UK economy and the pound will be subject after entry are manifold and complex and cannot be quantified with any precision in advance. Prudence would therefore indicate joining with a wide band, perhaps 6 per cent, rather than a standard 2¼ per cent interval, only moving towards a narrower one in the light of further experience.

ANNEX : THE BACKGROUND FACTORS

This annex considers :-

a) the behaviour of the real sterling/deutschemark exchange rate over time;

b) the level of the exchange rate which we have felt over the last year or so has been necessary to maintain monetary conditions appropriate to the Government's objectives;

c) the implications to be drawn from the outlook for the balance of payments;

d) the dynamics of interest and exchange rate movements that existing ERM members have faced at realignments.

A. The Real Exchange Rate

2. The natural starting point for the analysis is the past behaviour of sterling against the deutschemark, the linchpin of the ERM. Chart 1 shows that sterling has fallen secularly against the mark over the last 20 years or so: rapidly until 1976, followed by a period of stability and then recovery in 1979 and 1980; and then a gentler decline subsequently. Much, though not all, of this experience can be explained by differences in inflation performance over time. As Chart 2 displays, UK prices have risen against German ones throughout the period but they did so particularly pronouncedly over the period 1974-82.

3. Chart 3 gives the "real" sterling/mark exchange rate, ie. the movement in sterling which cannot be attributed to the differentials in cumulative inflation over time. This provides two different kinds of information. On the one hand, it indicates the extent to which sterling's rate is acting as a restrictive or permissive factor so far as domestic inflationary pressures are concerned. The lower the real exchange rate the greater the headroom for domestic producers to adjust their prices upwards to

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Chart 1 : Nominal £/DM exchange rate (1985=100)

Increase implies £ appreciation

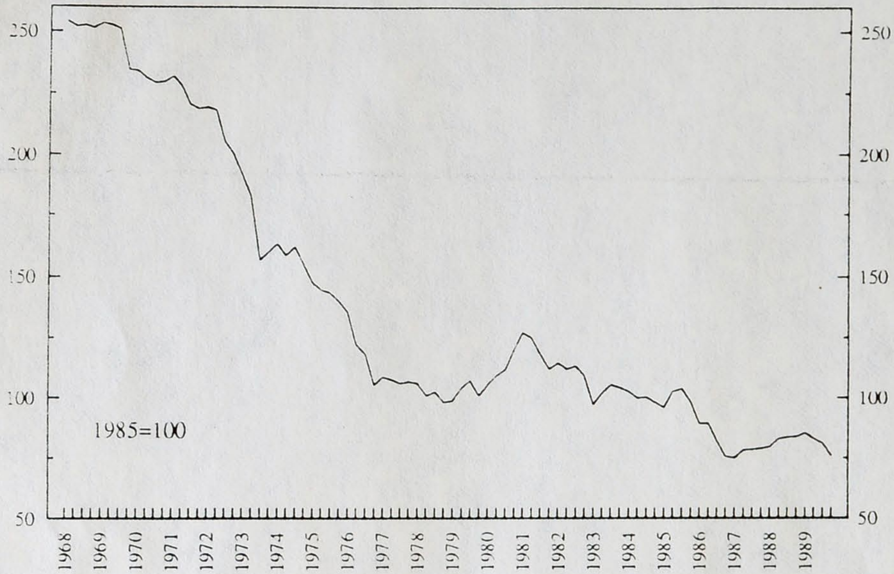

Chart 2 : Relative price levels in the UK and Germany

Increase implies higher UK inflation

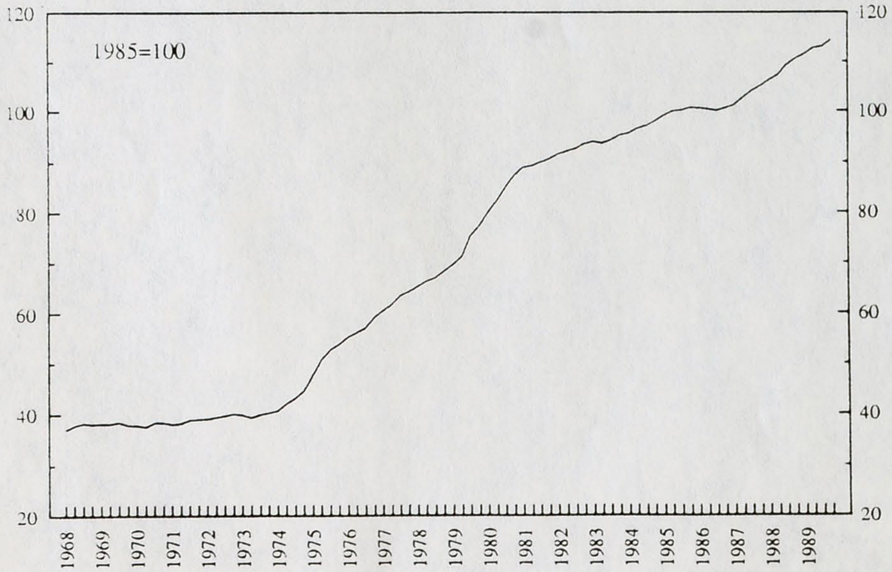

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Chart 3 : Real £/DM exchange rate

Increase implies £ appreciation

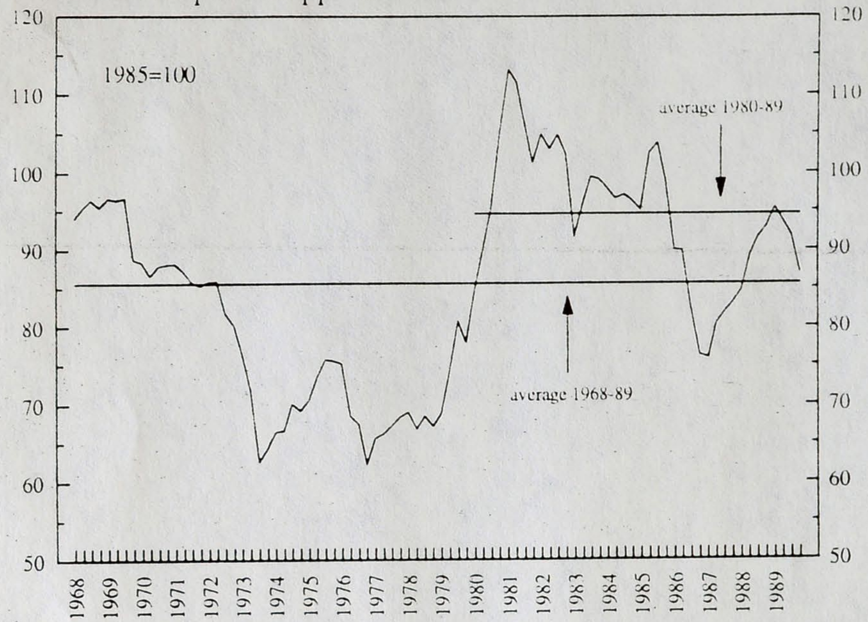
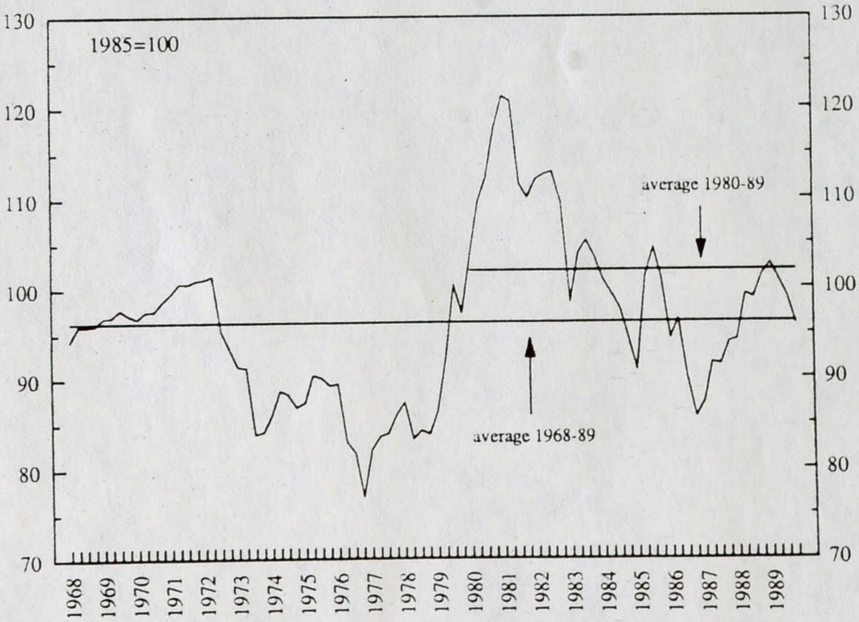


Chart 4 : Sterling's real effective exchange rate

Increase implies £ appreciation



world levels. Conversely, higher real exchange rates generate pressures to adjust domestic prices down to world levels. At the same time, the real exchange rate provides a measure of competitiveness. The higher the real rate the harder exporters will find it to compete in overseas markets and the easier it will be for importers to penetrate UK markets.

4. With this background, it is possible to make the following observations on the basis of chart 3:

i) the current real sterling/mark exchange rate is a little above the average observed over the last 20 years or so. However, the excess - 3 per cent or so - is small in relation to deviations which have occurred in the past;

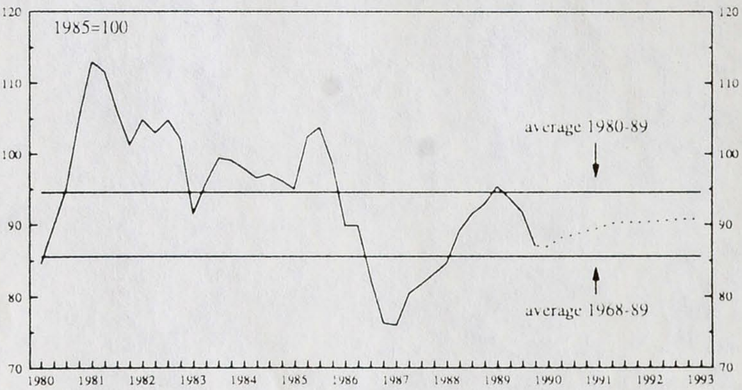
ii) the average level is itself very dependent on the period considered. In particular, it is affected by experience between 1972 and 1978 when, by any standards, the real exchange was extremely low and by 1980-85 when it was generally very high. By comparison with its average over the 1980s alone - when pressures on UK inflation were mainly but not exclusively downwards - the current real exchange rate is somewhat below that point;

iii) earlier exercises considering the appropriate rate for sterling to join the ERM (for example, in September 1985) concluded that sterling should be expected to be some way above its long run average because of the "petrocurrency status" that it enjoyed from the late 1970s onwards. Since then, however, the sharp decline in oil prices and the falling away in production has probably reduced the importance of any such factor to near insignificance;

iv) on the other hand, one new factor which has emerged since 1985 is the advent of a substantial current account deficit on the balance of payments at the same time as long term capital outflows from sterling continue, reflecting domestic portfolio diversification. This might argue for joining the ERM at a discount to the average real rate because this balance of payments disequilibrium will eventually need to be corrected. This is discussed further in section C below;

v) a further factor arguing for a low real rate on joining the ERM is the fact that UK inflation is currently significantly above German levels. German consumer prices have recently been rising at a 12 month rate of around 2¾ per cent. Underlying inflation in the UK is around 6¼ per cent on the same basis. This differential must be expected to persist for some time. Since joining the ERM represents a commitment to a fixed <u>nominal</u> exchange rate against the mark, the effect will be that sterling's <u>real</u> exchange rate will rise until either UK inflation falls to German levels or there is a realignment. The following chart shows the effect given current inflation projections and an unchanged nominal exchange rate;

Chart : The projected real £/DM exchange rate
assuming a fixed nominal exchange rate.



vi) that said, the UK inflation rate is not independent of the real sterling exchange rate. But it is one of the factors which will determine whether and when UK inflation falls to German levels. Increasing the likelihood of a rapid decline, therefore, argues for joining at a higher than average real exchange rate.

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5. Given the primacy that the Government attaches to defeating inflation, this last point is a crucial one. But it is not the real level of sterling against the mark which is directly relevant here, however, but the real effective rate more generally. To the extent that the deutschemark, for example, was itself misaligned against other international currencies, looking at the real sterling/deutschemark rate alone would give a misleading calibration of the extent to which the pound's level was permitting or constraining domestic inflation. This possibility can be checked upon by considering the real effective rate for sterling itself. This is shown in chart 4. Whilst the conclusions to be drawn are broadly the same as those from chart 3, it does suggest that the real exchange rate relevant for inflation is a little lower than the real sterling/mark rate. The real effective rate is very close to its average over the last twenty years and around 7-8 per cent below its average level in the 1980s alone.

6. This point is reinforced by noting the possibility, if not probability, that the yen is temporarily misaligned and must be expected to recover generally. Although the yen and associated currencies have a relatively small weight in sterling's effective rate index - around 9 per cent - this is non-negligible. If, in the medium term, the yen rises against all other currencies, then a constant real sterling/deutschemark exchange rate would imply a depreciating sterling effective rate. On the other hand, if as suggested in para 9 of the main paper, the French franc and lira were to be devalued within the ERM in the foreseeable future, this would be an offsetting factor.

B. Evidence from the Monetary Conditions needed to keep Downward Pressure on Inflation

7. Although sterling's real exchange rate is a key factor in determining future UK inflation, it is by no means the only influence at work. A range of other factors - the fiscal stance, the level of interest rates, the buoyancy or otherwise of domestic demand and so on - all have to be taken into account in appraising whether current monetary conditions are on track to defeat

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inflation. There is therefore likely to be no simple rule-of-thumb linking the level of sterling, real or nominal, to the extent of disinflationary pressure.

8. One way, however, to explore the matter further is to examine what exchange rates for sterling we have been happy with in recent months as being consistent with keeping downward pressure on inflation. The purpose of the ongoing Monthly Assessment, and the associated discussion at Sir Peter Middleton's regular meetings, is to conduct just the appraisal referred to in the previous paragraph. Looking back at these recent Assessments should therefore give some guidance.

9. To this end, table 1 shows the evolution of sterling's main exchange rates since the beginning of 1989, together with the behaviour of three-month interest rates and the attitudes towards the exchange rate as recorded by the various Monthly Assessments. Surprises in inflation have generally been on the up side over this period, so, if anything, the Assessments would probably have favoured rather firmer exchange rates, other things being equal, had they been made with the advantage of this hindsight.

10. On this basis, experience can be summarised as follows :

a. until the end of April 1989, sterling's ERI was around or a little over 95 and the rate against the mark steady at 3.18. Base rates were 13 per cent and three month rates close to that level. As judged by the Monthly Assessments, we were mainly content with the associated monetary conditions over this period, though with some flavour that tightening would be more welcome, should it occur, than a loosening;

b. during May 1989, sterling's ERI dropped quite sharply by over 3 per cent and then fluctuated within a band of about 91-91½ until the end of September. Base rates were increased by 1 per cent, to 14 per cent, on 24 May to compensate for this. By end-September, both the ERI and the sterling/mark rate had declined by around 4½ per cent compared with

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mid-April levels. On the evidence of the Monthly Assessments, we were again broadly happy with the monetary conditions obtaining over this period though with a rather sharper flavour of preferring tightening, from that position, to relaxation;

c. sterling took a further step downwards towards the end of October and into November. Base rates were raised to 15 per cent on 5 October in concert with the rises in other European interest rates on that day. But the Assessments were clear that the increase was, in any case, necessary to prevent the fall in the exchange rate from loosening monetary conditions inappropriately. Since then, the ERI has mainly remained in a range of 86-88 though it fell to below 86 briefly in November and in January rose temporarily to above 89. Monthly Assessments have displayed a slightly nervous acquiescence in the combination of interest and exchange rates that have prevailed since the end of September. Nevertheless, there has been some asymmetry in attitude. When the ERI fell below 86 in November, the Assessment concluded that monetary conditions were "precarious": when the pound displayed temporary strength in January, the Assessment was explicit that there was no case for a relaxation in the policy stance.

11. With this background, it would seem a reasonable starting point to suppose that entering the ERM at an effective rate some way above present levels would be desirable <u>if other factors bearing upon the tightness of monetary conditions remained unchanged</u>. More specifically if: (i) base rates remained at 15 per cent; (ii) joining the ERM has no effect, beneficial or otherwise; and (iii) there were no change in the fiscal stance, an ERI of 89-90 would probably be what was need to maintain downward pressure on inflation.

12. But the conditional clause in the previous paragraph is a key one. UK interest rates are currently well above the average in the major ERM countries - by a margin of some 5-7 per cent. After entry there may be pressures to reduce this margin. Joining at

too low a rate and being required, in consequence, to reduce interest rates to keep within the band, would be harmful to domestic monetary conditions. Equally, joining at too high a rate, widely seen to be unsustainable and with the prospect of an imminent downward realignment, could be counterproductive in terms of its effect on policy credibility. A central consideration in this respect will be the prospects for the balance of payments to which the next section now turns.

C. Prospects for the Balance of Payments

13. When the rate at which sterling might join the ERM was last assessed in May 1987, the prospect was of a small current account deficit, £2¾ billion, in 1987 improving steadily to a surplus of £1 billion by 1990. Current prospects are a large current account deficit of £15 billion this year and, despite some improvement, a deficit remaining in excess of £10 billion in 1993. The post-Budget forecast, from which these predictions are taken, also projects continuing sizeable "long term" net capital outflows - both on direct investment and portfolio investment accounts. Combined, these long-term net capital outflows might themselves exceed £10 billion a year.

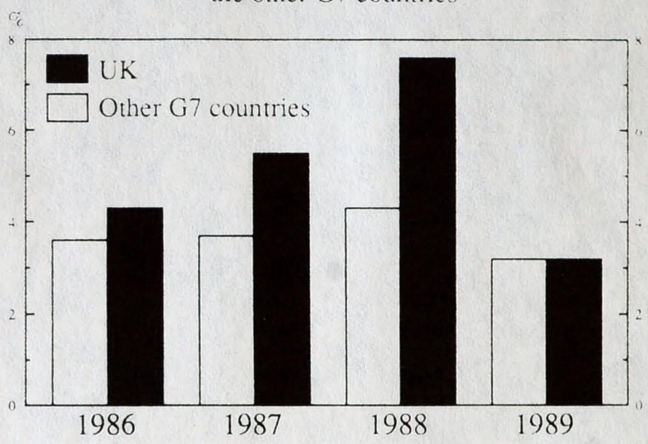
14. These predictions are made on the basis of an unchanged effective rate of 87.5 (very close to current rates) and an unchanged sterling/deutschemark rate. Clearly, on this basis substantial and cumulating short term capital inflows will be required to finance these continuing outflows.

15. In principle, in these circumstances, balance of payments difficulties, leading to downward pressure on the pound, could manifest themselves in several different ways. Eventually there could be a worsening in the current account itself if the real exchange rate were so high as to generate acute competitiveness problems. Similarly, there might be a greater outflow of long term capital than allowed for above, repelled by an exchange rate seen to be unsustainable in the medium run. Finally, there could be financing difficulties associated with insufficient short term

capital inflows to offset the long term outflows and current account deficit.

16. In practice, it is unlikely, however, that even a sizeable appreciation of sterling - say 5 per cent or so - would be sufficient to alter the current account prospect significantly in the absence of other policy changes (though no doubt it would affect exporters' profit margins to some extent). The important underlying point it that our current account deficit has not been caused by lack of competitiveness. The main factor has been growth in domestic demand at a faster pace than has happened in trading partner countries, as the following chart shows.

Chart: Real domestic demand growth in the UK and the other G7 countries



17. Again, the quantity of long term capital outflows would probably not be much affected by exchange rate changes of this order - being determined more strongly by slowly changing factors such as the pace of domestic portfolio diversification overseas. But where the level of sterling would be liable to have an effect is on the willingness, or otherwise, of short term investors to place funds in the UK. This could work in two different directions:

(a) if investors perceive that sterling has joined at too low a level then the prospect of sterling appreciation, coupled with its interest rate advantage, would make the pound very attractive. In consequence, it might be necessary to reduce interest rates to keep sterling in its band with the adverse domestic results mentioned earlier. That would not necessarily be disastrous since it would be possible for sterling to be realigned upwards with no great harm to credibility. But a realignment could not be arranged immediately and there could be a prolonged period of awkwardness;

(b) on the other hand, if investors fear a depreciation over time sufficient to outweigh the interest rate advantage that sterling enjoys, then their unwillingness to hold sterling will itself induce the depreciation that they anticipate. Even if short term investors were not positive sellers of sterling, merely not buyers, the current account deficit and long term capital outflows that we envisage occurring would themselves put downward pressure on the pound.

18. It is probably this last factor, therefore, which constitutes the major barrier, so far as the balance of payments is concerned, to joining the ERM at too high a level. With an interest rate differential of perhaps no more than 5 per cent to support it, investors would not be attracted by the prospect by sterling being realigned downwards by more than this amount in the next year or so. They would be inclined to take this view if they believed sterling had joined at too high an initial rate making it unsustainable.

D. The Interest Rate and Exchange Rate Dynamics on Entry

19. A further important set of considerations are the dynamics to be expected on entry : the pressures on sterling and the economy generally and the way that they manifest themselves in interest and exchange rate movements.

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20. These dynamics are inevitably uncertain. Some simplification is necessary in presenting the possible alternative developments. However our best guess of the underlying pressure are likely to be as follows:

- although membership of the ERM can be expected to help to narrow the inflation differential with other ERM countries this will take time. There is likely to be a period of adjustment with periodic realignments. Based upon the example of France and Italy we might expect that a gradual adjustment would mean progressively longer intervals between realignments and smaller realignments;

- over time there will be a tendency for currencies with faster inflation rates to depreciate in nominal terms relative to low inflation currencies;

- on average interest rates on the high inflation currency will exceed those on the low inflation currencies by an amount roughly equal to the expected rate of depreciation - although it can be argued that the differential might be bigger to reflect the additional risk in the high (and probably variable) inflation currencies;

- however the effect of ERM membership on exchange rate expectations is likely to be very different in the period immediately before and after realignments;

- immediately following a realignment market participants will put a low probability on a further realignment in the short term. Therefore the risk of a substantial depreciation is reduced. As a consequence investors may divert capital into the currency with high short term interest rates, putting upward pressure on the exchange rate and downward pressure on interest rates;

- as time goes on the persistence of higher inflation increases the likelihood of a realignment. At a point of the realignment holders of the depreciating currency incur a substantial loss. Because of this they require high interest rates to compensate the possible loss in holding a devaluing currency. If the risk of realignment increases sharply, interest rates will have to rise - possibly sharply - or large scale intervention will be needed.

21. The scale of these pressures will be affected by the width of the band. In particular they are likely to be much more intense with a narrow band than with a wide band.

22. This is partly because the size of the margins affects the behaviour of the exchange rate at the time of realignments and therefore the risk of holding a currency if a realignment seems to be imminent. With narrow margins, realignments tend to mean no overlap between the new and old band; ie the new higher limit will be below the previous lower limit. Therefore the spot rate tends to jump down at the time of realignments with the risk of a significant capital loss. With wider margins the pattern is different and more in the nature of a "crawling peg": the realignment is less than the width of the band so that at realignments the spot exchange rate has tended not to change significantly.

23. There is also a difference immediately following a realignment. With a narrow band the scope for downward movement within the band is less; so the pressure for lower interest rates immediately following the realignment will be greater. With wide margins there is more scope for downward movement and less pressure to close interest differentials.

4

24. These effects show up in the experience of both France (2¼ per cent margins) and Italy (6 per cent margins until recently):

- Charts A1 and A2 show the movement of the DM/FF and DM/ Lira in relation to their bands;

- of six realignments of the central DM/FF rate there was no overlap of the bands on four occasions

- on each of nine realignments of the central DM/lira rate there was some overlap and the new band included the rate existing before the realignment.

25. To examine the interaction between interest rates and exchange rates more closely, it is necessary to focus on daily observations for periods surrounding realignments (important effects are largely obscured in monthly data). Charts A3 and A4 show the movements in the DM/FF exchange rate and interest differential around a typical realignment (in April 1986). (Very similar movements are observed around other realignments) :

- the franc has shown a tendency to move to the top of the band after realignment and a strong tendency to depreciate below its lower band prior to the realignment;

- interest rate differentials have been high at the time of realignments and declined sharply afterwards.

However there has been no pressure to remove the interest differential entirely. Because the French franc has tended to settle at the top of its band following a realignment it has had room to depreciate by 4½ per cent before realignment is necessary. This leaves scope for an interest differential of 4½ per cent even if there is no further realignment for a year. The actual interest differential in the months following the realignment has averaged just a little less than 5 per cent.

X

CHART A1

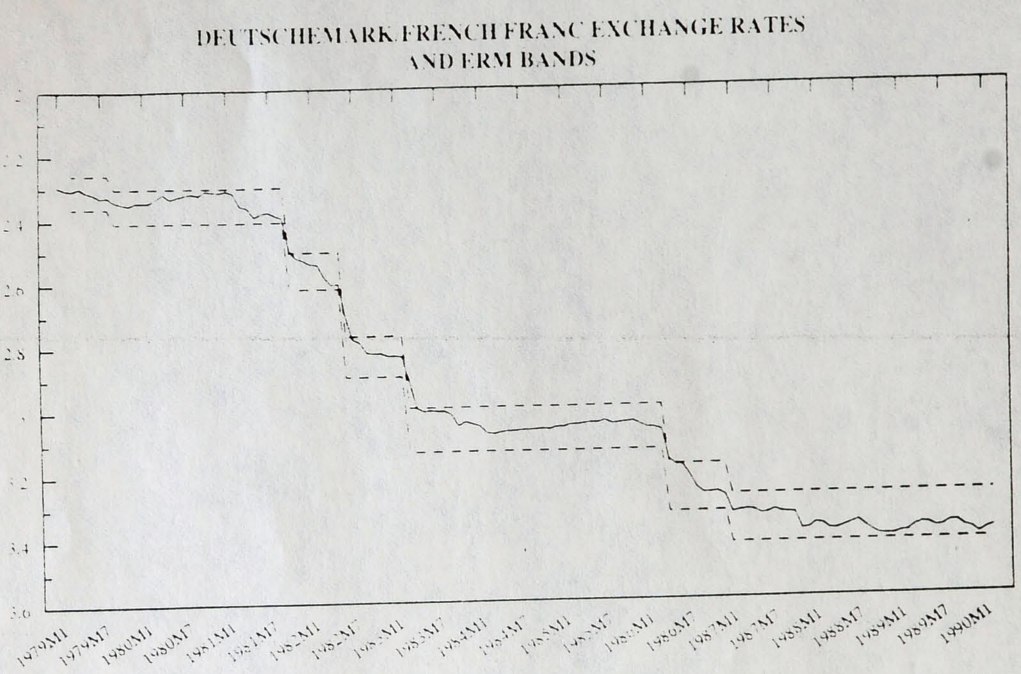
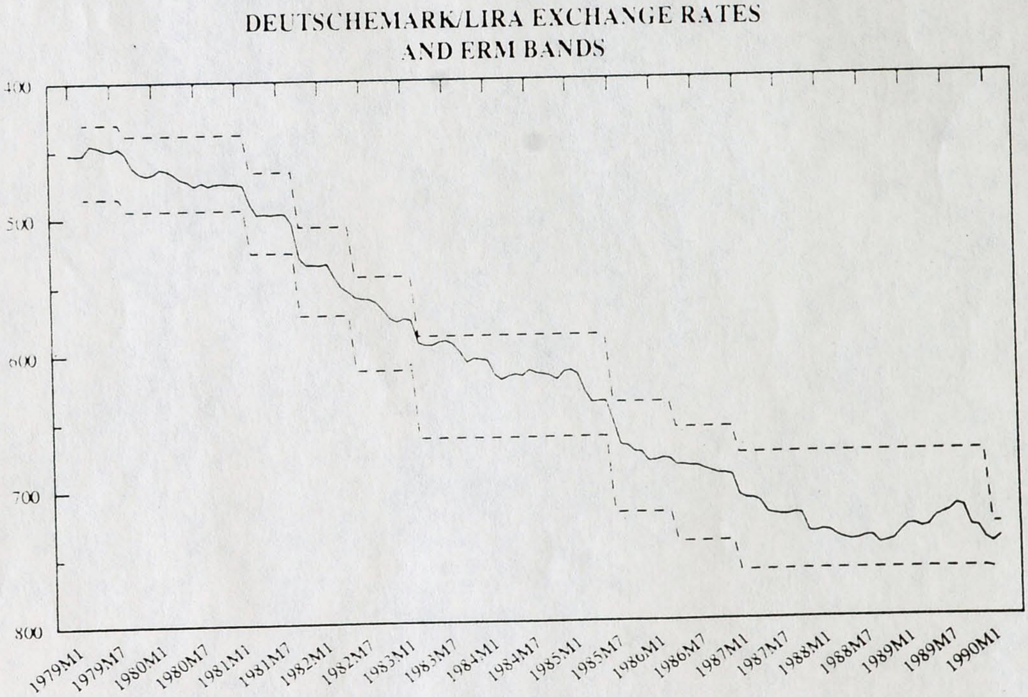


CHART A2



A i)

CHART A3

REALIGNMENT OF 7 APRIL 1986

DEUTSCHEMARK FRENCH FRANC EXCHANGE RATE

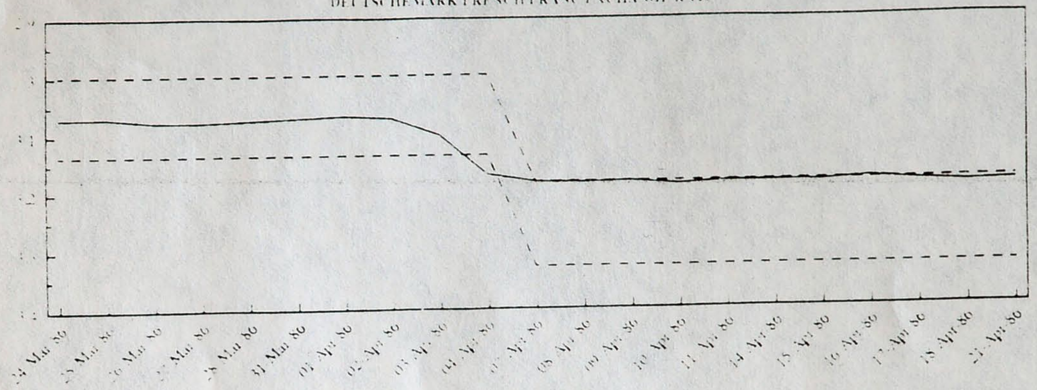
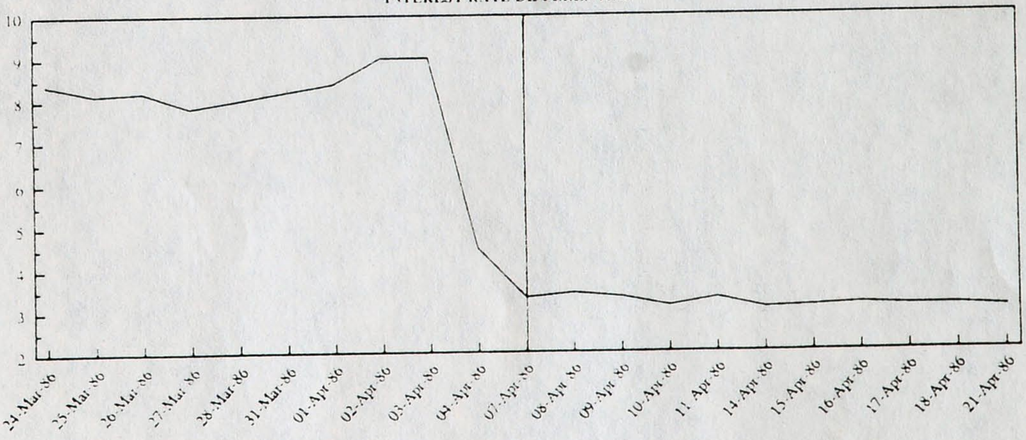


CHART A4

3 MONTH EURO FRENCH FRANC DEUTSCHEMARK
INTEREST RATE DIFFERENTIAL



B i)

CHART A5

REALIGNMENT OF 7 APRIL 1986

DEUTSCHEMARK LIRA EXCHANGE RATES

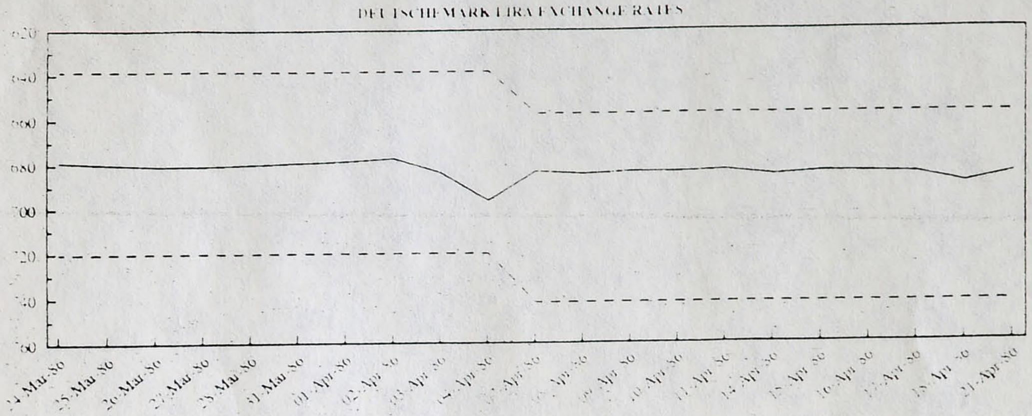
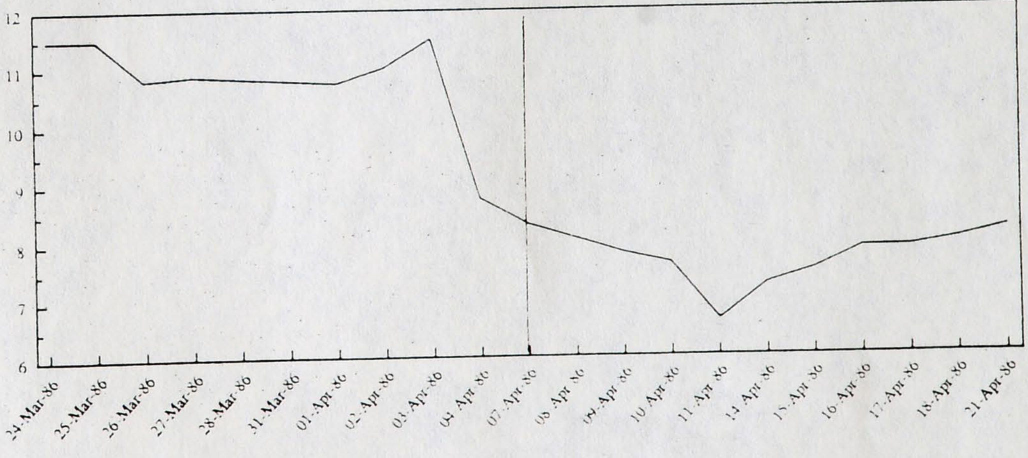


CHART A6

3 MONTH EURO LIRA DEUTSCHEMARK
INTEREST RATE DIFFERENTIAL



(i)

2[illegible]. Charts A5 and A6 show similar information for the DM/lira exchange rate and interest differential:

- the lira has shown less of a tendency than the franc to go to the top of the band against the DM following a realignment. As already noted, realignments have meant that the new band has included the old rate. Therefore for the spot rate to go to the top would have required the rate to depreciate at the same time as the central rate depreciates;

- the lira has tended not to reach the bottom of the existing band before realignment. The Italian authorities have not used the full range of flexibility and the bands have acted as less of a constraint. As a consequence therefore it is likely to have been less of an influence on market expectations of future exchange rate movements.

mg2.jw/jwg/2.17.5.tab

SECRET: ADSO

Table 1

Recent Monetary Conditions

	Exchange Rates: ERI	Exchange Rates: Sterling/ Dollar	Exchange Rates: Sterling/ DMark	Interest Rates: Base Rate	Interest Rates: 3 month I/B	Assessment
1989 Jan	98.0	1.75	3.27	13	12.9	Broadly satisfactory. No case for a reduction in interest rates but more confident of less need for further rise.
Feb	95.6	1.72	3.18	13	13.2	Need to defend the exchange rate at near to present levels.
Mar	95.5	1.70	3.18	13	13.1	Downward movement on the exchange rate would be unwelcome.
Apr	95.3	1.69	3.18	13	12.9	A policy response would be needed if the exchange rate came under downward pressure.
May	92.3	1.57	3.11	13/14	14.0	An appreciable further fall in the exchange rate would require a further rise in interest rates to maintain tight monetary conditions. (Base rate increased 24 May.)
Jun	91.9	1.62	3.06	14	14.0	If there was a further fall in the exchange rate, an increase in interest rates was recommended.
Jul	92.7	1.65	3.09	14	13.8	The rise in the exchange rate had been welcome, in tightening monetary conditions.
Aug	90.9	1.54	3.07	14	14.0	Policy should be tightened if the exchange rate fell sharply from these levels.
Sep	91.2	1.61	3.03	14	14.3	(No Assessment this month.)
Oct	88.0	1.57	2.89	14/15	15.4	Policy was on a tightrope. A further rise in interest rates was recommended if the exchange rate fell to ERI 85-86. (Base rates rose 5 October.)
Nov	86.5	1.58	2.79	15	15.2	Monetary conditions were precarious.
Dec	88.0	1.66	2.79	15	15.1	A further rise in the exchange rate would be welcome in the monetary conditions prevailing.

mg2.jw/jwg/2.17.5.tab

SECRET: ADSO

Table 1 (cont)

	Exchange Rates			Interest Rates		Assessment
	ERI	Sterling/ Dollar	Sterling/ DMark	Base Rate	3 month I/B	
1990 Jan	89.1	1.69	2.82	15	15.1	Need to wait on developments but no case for relaxing policy in these circumstances.
Feb	87.7	1.64	2.79	15	15.2	No case for a relaxation of policy.
Mar	87.9	1.64	2.79	15	15.2	The longer the ambiguity about the extent to which economic adjustment had occurred, the greater the case for tightening policy.
Apr	87.0	1.64	2.76	15	15.3	There was a case for and against raising interest rates in present circumstances.
May 22 (Latest figures)	88.8	1.69	2.82	15	14.9	-

(i)

Spanish Experience of Joining the ERM

This note discusses the Spanish experience of entering the Exchange Rate Mechanism (ERM) of the European Monetary System in the middle of 1989.

Background

2. For some months prior to Spain's joining the ERM on 19 June 1989, the Spanish authorities were concerned by the balance of their policy stance. Had it been attainable, they would have preferred to have higher interest rates than those which were actually obtained, accompanied by the same or a weaker exchange rate.

3. Table AP1 summarises macroeconomic conditions in Spain and demonstrates why the authorities would have wished for such a different balance:

(a) inflation in Spain has been at high levels in recent years and, until 1988, was clearly accelerating. Despite beginning to ease back in 1989, it remains in double figures. A continued tight policy stance overall was therefore essential if there was to be a significant move towards price stability;

(b) the rapid inflation was perceived to be associated with the brisk and probably excessive growth in money and credit. The authorities therefore favoured high interest rates to bring monetary growth under control; but

(c) they were also concerned by Spain's balance of payments deficit which by 1989 had grown to substantial proportions - over 3 per cent of GDP. The peseta's nominal trade-weighted index had appreciated a little since 1987 and by mid-1989 was back to the levels seen in 1983 and 1984. But because Spanish inflation had consistently outstripped that of its competitors, the real peseta exchange rate - ie. movements other than would reflect differences in cumulative

(ii)

inflation - had risen by around 20 per cent from mid-80s levels. The resulting lack of competitiveness worried the authorities.

4. Considerations (b) and (c) together define the dilemma that the Spanish authorities believed they faced. Whilst domestic monetary conditions warranted higher interest rates, external considerations acted as a constraint on the extent to which this was feasible. The fear was that ERM entry - with the need to prevent the peseta appreciating out of its band - would intensify the dilemma and precipitate a sharp and unwarranted fall in interest rates.

The Immediate Results of Spain's Entry into the ERM

5. The peseta joined the wide band of the ERM unexpectedly on 19 June 1989 at a central rate against the DM of 65 Ptas/DM, a rate below that on the previous working day (64.33 Ptas/DM), implying therefore a small devaluation. The immediate effect of entry was to put upward pressure on the exchange rate which rose to 63.20 Ptas/DM by 21 June 1989 (2.85 per cent above the central rate). The peseta has remained firm since joining the ERM and its current rate is 62.19 (4.3 per cent above the central rate against the DM, and about 5 per cent above its central rate against the French franc, the weakest ERM currency).

6. ERM entry had a small, but perceptible, effect on domestic interest rates with the three month rate falling from 14.97 per cent on the working day before entry to 14.37 per cent on the day after. However, by the 23 June the rate had returned to 14.90 per cent. Much larger effects were seen in the offshore markets with three month Euro-peseta rates falling from 14.60 per cent on the working day before entry to 12.00 per cent on the day after entry. However, these changes in both on-shore and off-shore rates were not sustained. The three month offshore rates rose from 13.8 per cent at the end of June to 14.6 per cent at the end of October, after being at 11.5 per cent at the beginning of the year. Similarly, the differential against deutschemark rates fell from 6.8 per cent at the end of June to 6.5 per cent at the end of

October, higher than the 5.6 per cent differential at the beginning of the year.

Appraisal

7. These considerations suggest that the fears about ERM entry, outlined above, proved largely groundless in the case of Spain. At most, it had only a limited impact in sharpening a real dilemma that the authorities faced. Indeed, the Spanish central bank are reported to believe that entry eased their difficulty to a degree. By its imposing a credible ceiling on the exchange rate, speculators were faced with a reduced possibility of capital gains from the peseta's appreciation. They were thus discouraged to that extent.

8. Nevertheless, it is important not to overstate this conclusion. It requires a number of caveats:

(i) ERM entry was accompanied by some upward pressure on the peseta, not sufficient to take it out of the ERM wide band it is in, but greater than would have been allowed had the peseta joined with a narrow band;

(ii) the underlying difficulty of external circumstances putting a constraint on interest rate increases desirable from a domestic viewpoint remains, notwithstanding the Bank of Spain's views noted in the previous paragraph. Monetary growth and inflation continue apace. ERM entry has not solved the dilemma even if it did not exacerbate it;

(iii) most importantly, it is not clear how far conclusions from Spanish experience can be generalised. Unlike sterling, for example, the peseta is not an investment currency and is not subject to capital flows of anything like the scale that sterling is. The pressures on the pound on entry could be much greater in either direction than those with which the Spanish authorities had to contend. On the other hand, some appreciation after joining would not be as unwelcome to us as it was to the Spanish.

51

Table AP1: Macroeconomic Conditions in Spain

	Exchange Rate(1) Nominal	Real	Interest Rate	Broad Money Growth (2)	Inflation Rate (3)	Current Account(4)
1983	104.4	102.5	19.4			- 2.7
1984	102.6	100.5	12.6			2.0
1985	100.0	100.0	11.6		13.7	2.9
1986	96.8	101.8	11.5	15.3	15.3	4.0
1987	96.2	106.9	16.1	14.4	14.4	- 0.2
1988	99.0	113.2	11.3	21.3	21.3	- 3.8
1989				16.9	16.9	-11.7
1989 J	103.3	120.9	12.4	19.4		
F	103.4	121.2	13.5	20.3		
M	103.8	121.9	13.9	20.5		
A	104.1	122.7	13.9	21.7		
M	102.9	121.7	14.0	16.7		
J	100.7	119.6	14.4	18.2		
J	103.4	120.8	15.1	15.5		
A	103.2	120.9	15.1	12.7		
S	103.3	121.1	15.0	16.9		
O	103.3	121.7	14.8	14.6		
N	104.1	123.1	15.2	13.1		
D	104.7	124.3	15.5	15.2		
1990 J	104.7	124.8	15.1	12.1		
F	105.0	125.4	15.1	13.0		

(1) Trade-weighted 1985 = 100

(2) 12 month growth rate, per cent

(3) Consumer prices

(4) Billions of dollars

2A-C

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PRIME MINISTER

mp

ERM

I attach a minute from the Chancellor covering a paper on ERM. This is intended for discussion at next week's bilateral on Wednesday. However, the Chancellor appreciates you are very busy next week: he would be content to postpone the discussion if you prefer.

It is a very useful paper on important policy/technical issues:

- exchange rate on entry to the ERM;
- the width of the band on entry;
- the position of sterling within the band.

The conclusions seem broadly sensible. If the UK is to enter the ERM, the aim must be to reinforce downward pressures on inflation. That means seeking a short term bonus on the exchange rate, providing that is consistent with underlying economic realities, ie. not putting too sharp a squeeze on industry. One might add that there is equally a need to avoid premature reductions in interest rates on entry - a point picked up in the background paper.

First, the paper indicates that the current DM/Sterling exchange rate is not much out of line with recent experience. The real exchange rate is within the broad range experienced over the 1980s, if a little on the low side.

The paper proposes that the UK should therefore aim to join at an exchange rate a little above the present: this is a sensible means of imparting an upward bias to the exchange rate - and a downward bias on inflation. But further consideration would have to be given to any proposed margin above the current rate (it would have to be fairly limited); and whether it should be done would depend on economic circumstances at the time.

Second, again in order to impart an upward bias to the rate, it is necessary to have a sufficiently wide band so that the exchange rate has scope to appreciate. Immediately after entry the expected bonus of membership - essentially the safeguard which financial markets have against a substantial depreciation of the currency - can either be taken as a higher exchange rate or lower interest rates. (To some unknown extent, this bonus may be discounted in advance in the exchange rate prior to entry).

Monetary policy and hence interest rates need to be determined by domestic circumstances. Accordingly, the Government might wish to avoid any reduction in interest rates. This points to leaving a sufficient margin of flexibility to allow the exchange rate to rise. Accordingly, the Chancellor proposes the wider bands of +/- 6 per cent: this seems sensible.

Thirdly, there is the question of where within that band the exchange rate should be set. Again, consistent with the theme of upward bias it is proposed that the entry rate would be set marginally below the central rate within the band. That would be an anti-inflationary signal.

Finally, the paper discusses the implications of GEMU. It concludes that it is very difficult to determine in advance what the implications might be for the ERM.

Next Steps

I will of course provide further guidance as required before Wednesday, in consultation with Andrew Turnbull and Brian Griffiths. The initial impression on reading the paper, however, is that it addresses the important but mechanical policy issues: the real question is the timing of entry. The Treasury is now ready to move on to discuss that issue.

As you know, the timing of entry involves complex calculations about the possible timing of a general election; the expected short term financial impact on the exchange rate and inflation (itself of uncertain strength and timing); the dangers of a later backlash, with money flowing out of the UK at an unfortunate stage.

Moreover, even putative entry to the ERM at various times over the next year may put constraints on the operation of economic policy. For example, any cut in interest rates in advance of joining the ERM will have implications for the entry rate and positioning within the band.

BHP

BARRY H. POTTER

8 June 1990

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(slh)