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PRIME MINISTER

AN OBJECTIVE STANDARD AND EMU

I have been reflecting on the idea which we discussed at our meeting on 31 May of the linking of currencies to some objective reference standard, for instance a commodity index which would work automatically, with the possibility of extending such a system to the dollar and the yen.

... I attach a short note on the proposal and a more detailed analysis by our economists. It shows that, while it has some attractions, it seems a very mixed blessing.

In particular, such a system would involve the loss of national monetary discretion. There would be no need for a central institution in the purer forms of these rule based systems. But, equally, national governments would retain no control over their interest rates which would rise automatically to whatever rate was needed to bring inflation down. Interest rates could rise very sharply and to high levels if there were shocks to the system. The effect on interest rates would be immediate so long as there was inflation in the system whereas the effect of interest rates on inflation would remain subject to long and uncertain lags. There would thus be a prospect of interest rates overshooting in a big way. To abate these effects would require an arrangement for overriding the rules which would undermine the whole purpose of the scheme.

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In the case of gold and commodity standards, price stability could not be guaranteed and there would be storage costs in operating them. A commodity indexed reserve asset system might avoid the latter but it exists at present only in theory and to establish such a system would require an immense amount of work. There is no certainty that an operational scheme could be devised or, if it could, that governments would find it acceptable and the public find it credible.

Turning to tactics, I very much doubt whether launching such a proposal would succeed in leading the Community's current EMU endeavour off in a different direction for a number of reasons.

To the extent that the approach has merits there is no reason why we or others should not adopt it now. Yet no major country (nor any minor one so far as I know) has shown interest in such an initiative as a practical proposition. That is not to say that they could not be persuaded to look at it. But even getting them to address the issue could take quite some time, almost certainly beyond the beginning of the IGC.

Secondly, there is no inconsistency between a single European currency and an objective reference standard. Indeed, there would be those who would argue that the most certain route towards linking the major currencies to an objective reference standard would be through the creation of a single European currency managed by a European central bank which was required to minimise inflation. This would create a tripolar currency world of the dollar, yen and ecu which could then be linked through an objective reference standard. That is certainly not the route forward that we would have in mind.

More important, the attachment in other EC Members - for political and economic reasons - to the ultimate goal of EMU as now

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conceived is very strong. An initiative for a commodity index would be seen either as irrelevant to that or, more probably, as a deliberate wrecking tactic.

All this leads me back to the difficult conclusions described in my minute of 24 May. Short of circumstances that are difficult to conceive, eleven Member States are intent on agreeing Treaty amendments for a single monetary policy and monetary authority. To let a Treaty of Eleven be signed would, I think, have grave economic and political consequences for our country as well as causing difficulties with many of our supporters at a crucially sensitive electoral time. Yet to sign a Treaty committing the UK to a single monetary policy and all that went with it is impossible. So I continue to believe that the course I proposed in my minute of 24 May is the least bad way forward.

We agreed on 31 May that we could make public our detailed ideas for Stage 2 at a suitable time. The Bank are proposing to put them forward for discussion in the Central Bank Governors' Committee and I am working on a speech which I will send you shortly.

I am sending a copy of this minute to the Secretary of State for Foreign and Commonwealth Affairs and to the Secretary of State for Trade and Industry.

[J. M.]
14 June 1990

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EMU: OBJECTIVE REFERENCE STANDARDS

The attached paper discusses possible objective reference standards to which European currencies and perhaps the dollar and the yen could be linked so as to provide an alternative monetary system to Delors Stage 3. The main features of such systems and their advantages and disadvantages are summarised below. The discussion is at a simplified level: the details are potentially very complicated and, given the lack of experience of such systems, would take a lot of work to develop.

What are objective reference standards?

2. The paper considers three broad possibilities: the gold standard, the commodity standard and a standard based on an index-linked reserve asset (ILRA). In each case the basic idea is that currency is issued to the extent of the value of assets in the hands of the monetary authority.

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3. In such systems the value of money moves in the long term inversely with the availability of the asset which backs the currency. More gold (or commodities, or ILRAs) will devalue money, that is raise prices. Thus the general price level will depend on the amount of the reserve asset in existence. Although history suggests that the supply of gold and commodities can be sufficiently stable over long periods of time to produce a reasonable degree of price stability, there is no guarantee of this. Moreover, prices could fluctuate in the shorter term in response to fluctuations in the gold or commodity markets. ILRAs can be created by governments, but the real value of the reserve asset is constant by definition.

How do objective reference standards work?

4. Price stability is not instantaneous. The mechanism by which it comes about in the long term is the same in most respects as with conventional monetary policy. In both cases a price rise,

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for example because of an increase in the oil price, means that the real amount of money in circulation is reduced, and interest rates rise as people seek to obtain money to maintain their transactions. Higher interest rates reduce activity in the economy and eventually bring prices back into line.

5. Objective reference standards produce a more automatic response of interest rates than conventional monetary policy as people seek to exchange money for the reserve asset. Thus the initial rise in interest rates under an objective reference standard could be immediate and sharper, leading to a more severe recession. There might be overshooting of interest rates initially. Because monetary authorities in a conventional system have discretion over the speed and scale of any interest rate response, they are likely to choose a more gradualist route than would be automatically imposed by a system based on an objective reference standard. This point is closely related to that which arises in the monetary base control debate: the more automatic nature of this system of monetary control is similarly likely to lead to faster and sharper interest rate changes than conventional monetary control.

6. Discretionary behaviour by the monetary authorities could be grafted onto an otherwise automatic objective reference standard system. But some of the benefits would thereby be lost: the chances of achieving price stability in the long term would be weakened, and inflationary expectations in the private sector consequently less favourable. Moreover, if discretion is to be allowed anyway, there seems little point in introducing novel and untried objective reference standards only in order to override their mechanisms in practice. In practice, there would sometimes be very strong pressures on governments to override them.

Economic advantages and disadvantages

7. The essential choice between an objective reference standard and conventional monetary policy is therefore one between on the one hand the greater counter inflation certainty which,

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subject to deviations caused by fluctuations in the supply of gold and commodities, they offer, and on the other hand the loss of the ability to react in a discretionary way to shocks, so that the monetary authorities just have to accept whatever movements in interest rates and the real economy the system throws up. Some might see this loss as an advantage because it removes governments' ability to pursue policies which could be inflationary. The debate about automaticity versus discretion in monetary policy is not a new one. Despite the short lived flirtation with monetary rules in the 1970s and 1980s by some monetary authorities, all major countries including the UK have clearly chosen discretion. It would be a major shift of direction to opt now for automaticity.

8. As between the three alternative versions of objective reference standards, the gold and commodity standards suffer from:

- their inability to guarantee price stability in the long term;
- their exposure in the short term to fluctuations in the supply and demand of gold and commodities;
- the costs of storing gold or commodities to act as backing to the currency.

On the other hand, an ILRA system has never been tried. An enormous amount of further analysis would be necessary before we could be sure that we could design an operational system which was both efficient and non-inflationary. And it would need to establish credibility before it could be expected to work well.

Objective reference standards in EMU and wider contexts

9. There are three main ways in which an objective reference standard could be introduced:

- (a) the UK (or another country) could introduce it unilaterally;

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- (b) it could be introduced by a new institution as a parallel currency alongside all existing currencies;
- (c) a new Community institution could introduce it as a new single Community currency to replace the existing 12.

10. The UK's evolutionary approach to EMU suggests that we should be arguing for going through all three stages in turn, or perhaps starting in the second stage with a view to moving onto the third stage. If we argued for starting in the second stage, we would be exposed to the challenge that, if we think objective reference standards are so good, why do we not introduce them in the UK first. Although there is a response to this (we are content with monetary policy as conducted by national monetary authorities now but Community systems need a new approach), it may not convince others. Another disadvantage of starting in the second stage is that there would be a serious risk that the new parallel currency based on an objective reference standard would never achieve critical mass and so not act as an effective competing currency.

11. Thus there are difficulties about moving gradually towards a European or wider system (ie embracing the dollar and the yen) based on an objective reference standard. On the other hand the UK would not find it easy, in view of our known scepticism about EMU, to argue credibly for moving straight to a new single currency. This third stage would involve a complete loss of monetary sovereignty, albeit to market forces operating through a set of rules rather than to a new institution.

12. More importantly, our Community partners have no interest at all in systems of this type. With one or two rare exceptions, Community governments and central banks have consistently and clearly favoured discretionary monetary policy over automaticity. They are also likely to be extremely wary of systems which are completely untried in modern circumstances. And they are anyway strongly committed to a conventional approach to monetary policy as embodied in the Delors proposals.

Conclusions

13. An objective reference standard could produce more counter inflation certainty than conventional monetary policies at either national or Community level. But it would be largely automatic and so would impose movements in interest rates and the real economy which governments and monetary authorities would have to accept. As with monetary base control, these movements could be sharp. In the case of gold and commodity standards, price stability could not be guaranteed and there would be storage costs associated with operating them. An index-linked reserve asset system would be entirely new and would require time to establish the details and, more importantly, credibility. Without much more study we cannot be at all certain that it would work.

14. Other Community countries are unlikely to have any interest in this approach. They would have doubts about its desirability in principle, and would not be prepared to invest time and effort in working out operational arrangements given their commitment to conventional monetary policies within a Delors Stage 3 framework. Any UK initiative along these lines could well be regarded as a wrecking tactic and could damage our negotiating position in the IGC.

CONFIDENTIAL**EMU: OBJECTIVE REFERENCE STANDARDS**Introduction

1. The purpose of this paper is to consider possible schemes of monetary reform which involve the use of some objective reference standard, for example gold, to which the value of money would be linked. The main types of objective reference standard that might be considered are:

- gold;
- basket of commodities;
- index-linked reserve asset (ILRA);

2. Clearly there are a number of possible variants for each of these, both in terms of the standard itself and the way in which the schemes might work. What they have in common is that the unit of account is defined in terms of something - the objective reference standard - other than the medium of exchange itself.

3. There are two main reasons for seriously considering such schemes. Firstly, they may provide a better way of achieving price stability and preserving the value of money. Secondly, and for present purposes more importantly, they may provide a viable alternative to Delors stages 2 and 3 without the need either for a new monetary policy institution at Community level or for a single currency. A simple European standard could be envisaged in which all 12 currencies would be defined in relation to the chosen commodity. More complex schemes could also be accommodated within this framework. For example one of the schemes examined below involves setting up a new currency based on an index-linked reserve asset alongside national currencies.

4. This paper discusses alternative models as though they apply to the EC alone. But all could be extended to the dollar and yen without significant difficulties of principle. Indeed, if a scheme were working well with a high degree of credibility then it is possible that non-EC countries would wish to join. It therefore has an obvious advantage over Delors stage 3 where

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participation in the currency scheme also implies full institutional integration.

5. The paper starts with a consideration of traditional gold and commodity standards, primarily to show the principles of how such schemes work. It then considers more modern versions based on index-linked reserve assets (ILRA) which in principle overcome some of the shortcomings of traditional commodity standards. A final section compares possible schemes with the single currency and European Central Bank of Delors stage 3.

Gold Standard

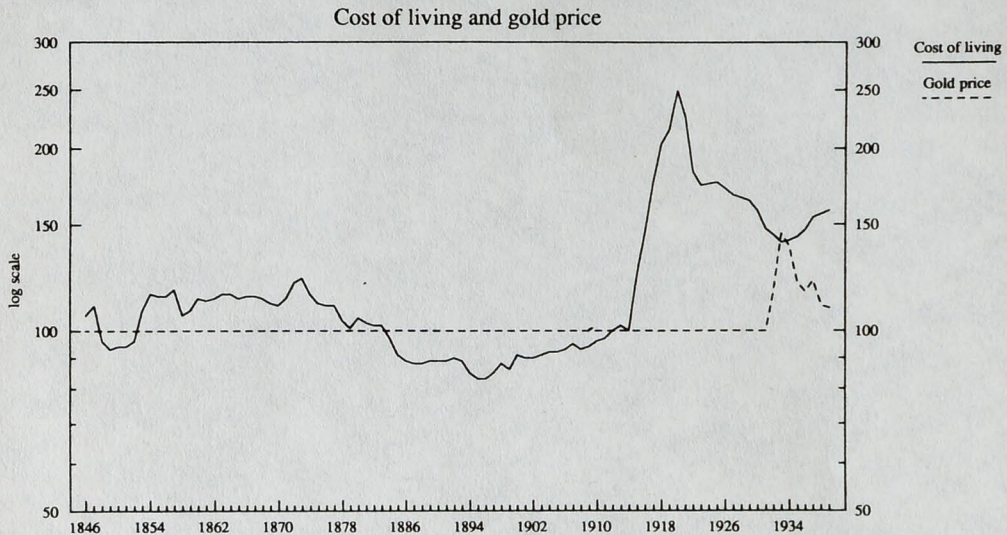
6. There is a range of possible gold and commodity standards. Common to all is the fixing of the unit of account, e.g. a pound sterling, in terms of a fixed volume of gold or of a basket of commodities. Under the international gold standard system which operated between 1870 and 1914 Britain and most other countries operated a fully convertible system, with gold itself playing a vital role. Private individuals generally had the unrestricted right to buy gold from and sell it to the central bank, and to export and import gold. Thus there was full convertibility of sterling, and free movement of capital between countries. Each country fixed, de facto, the value of its own currency against gold. As a consequence exchange rates between currencies were fixed.

7. Under a pure gold standard there is a link between the aggregate supply of gold and the global inflation. With constant velocities of circulation, an expansion of gold supply leads to a fall in the price of gold relative to all other commodities, and hence a fall in the value of money. In other words the general price level rises. At the individual country level any tendency for prices to rise faster than elsewhere would lead to an outflow of gold as individuals found that a given quantity of gold bought more goods elsewhere. This in turn would reduce the money supply in the more inflationary country, and this process would continue until prices had been brought back into line.

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8. Whether the pre 1914 gold standard actually worked in this way is still debated. In practice central banks exercised some discretion and changed interest rates so as to influence flows of gold. Credit conditions therefore changed both because of the automatic gold flow mechanism and also as a result of discretionary policy. But there is no doubt that price stability was quite good, as chart 1 illustrates.

CHART 1

9. Under the gold exchange standard system used during World War 1, and, in the UK, from 1925 to 1931, it was no longer possible to convert currency for gold, although its value remained fixed in terms of a quantity of gold. Also, reserves of dollars or other foreign currencies were held alongside gold, enabling countries to avoid the feed-through from changes in their reserves onto the domestic money supply. Similarly, gold inflows could be sterilized by open market operations. Thus much greater reliance was placed on discretionary action. The failure of both surplus and deficit countries to take appropriate action is sometimes cited as a reason for the breakdown of the system.

10. This brief description brings out some of the pros and cons of gold standard systems. In principle, in its pure form, it offers a system which could be fairly automatic in operation and give a high degree of price stability. In practice, a pure gold

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standard would almost certainly be unworkable, either for a single country or group of countries, in present day conditions:

- The tightness of monetary conditions, and hence prices generally, would depend on the supply of gold. Producing countries such as South Africa and the USSR would have undue influence. The price of gold has fluctuated much more in recent years than it did pre-1914.
- There would be significant transactions costs, as gold was stored by and moved between central banks.
- Under difficult conditions, for example the oil price shocks of the 1970s, governments would find it hard to resist calls to override the system, either by changing exchange rate parities or interest rates.

11. It would therefore make little sense nowadays to revert to a purely gold based standard on an EC wide basis. Changes in the supply of gold, either newly-mined or from non-EC countries' existing stocks, would affect the value of the nominal anchor and hence prices in Europe in a way which bore no relationship to underlying fundamentals.

A modern day commodity standard

12. In the light of evidence that the real price of groups of commodities have been less volatile than those of gold or any single commodity, a better standard might be one based on a bundle of commodities. The goods chosen would need to be transportable and storable since it would be an important feature of the system that money could be redeemed for the commodity bundle, by governments and central banks if not individuals. Thus metals such as copper, and wheat and oil might be included, but not manufactured goods. For reasons of price stability the composition of the commodity bundle should ideally be such that the individual prices varied together as little as possible, and no single commodity had a dominant weight. It might in practice

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be difficult to make this choice, there has been a tendency for most commodity prices to move together quite closely.

13. The advantages and disadvantages of a commodity standard compared with present day monetary systems are very similar to those of gold. However, compared with a gold standard it might give better price stability since supply factors might have less influence on monetary conditions than under gold. But there would be a price to pay for this advantage. Transactions and storage costs would be much higher. This would be especially so if perishable or bulky commodities, such as wheat or oil, were included. This is probably the main reason why in practice the idea of a commodity standard has found little favour. To our knowledge it has never been tried in modern times.

Index-Linked Reserve Asset (ILRA) system

14. An important shortcoming of traditional commodity standards is the requirement for money to be redeemed for the commodities which back the currency. As we have seen this would impose heavy transactions and storage costs. And it means that not all goods and services can be included in the commodity basket, so that the value of money will fluctuate. Some recent authors have proposed systems in which currency is defined in terms of some broadly based commodity basket, so that its value simply varies inversely with the price level. But there would be no redemption of currency for these goods. Such a system, it is argued, would have all the attractive features of a commodity system - especially stable prices and automaticity - without the disadvantages - high transactions and storage costs and sensitivity to choice and weights of the goods in commodity basket.

15. At the centre of this system would be a reserve asset (ILRA), issued by the central bank. Its market value would be index-linked to the price of a broadly based commodity basket while its par value would be fixed, as with a conventional Treasury Bill, in terms of currency. The index-linking ensures that the real value of the ILRA is constant. The currency itself, call it new pounds, would, analogously with the gold system, be

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backed by ILRAs: it would always be possible to redeem currency for ILRAs of equal par value at the central bank. Although currency may be redeemed for ILRAs it is an important feature of the system that the latter cannot be used for transactions purposes, so they are not money. The final element of the system is the commodity basket whose price is used to index the market value of the ILRA. This should be as widely defined as possible, so a generalized basket of goods and services consumed in the economy might be chosen.

16. The central bank would be responsible for redeeming ILRAs for currency, and issuing notes and coins. So as to prevent too ready redemption it might do so at slightly below par, or do so only in very large multiples, thus effectively confining the redemption process mainly to commercial banks and other financial institutions rather than private individuals. It would not, for reasons explained below, be responsible for interest rate policy.

17. Under this system equilibrium would hold when 'new pounds' and the ILRA were equal in value, i.e. the ILRA was trading at par. To see how the system might work we can consider the case of a rise in the general price level of, say, 10 per cent, caused, say, by a rise in world oil prices. The market price of the ILRA also rises by 10 per cent, by virtue of its being index-linked. An opportunity for profitable arbitrage has now opened up. By redeeming one new pound at the central bank for one ILRA whose value has risen to 1.1 new pounds and then selling the ILRA, holders of cash can make a risk free capital gain of 0.1 new pounds. The opportunity for this arbitrage continues as long as the market value of the ILRA remains above the nominal value of the new pound. This will be so as long as prices in general remain above their initial, pre-disturbance, level. But it will not be in the arbitrageurs' interests to exploit this to the maximum possible extent, as explained later.

18. In practical terms, as already suggested, most of the arbitrage would probably be done by commercial banks. It is this fact which would cause interest rates in general to rise as cash is redeemed. This causes a change in the asset composition of

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their portfolios, which are now less liquid because ILRAs have been substituted for cash. In order to rebuild their liquidity the commercial banks raise interest rates to attract more deposits, some of which will be in the form of cash. This rise in interest rates also reduces bank lending to the private sector. The commercial banks would therefore raise their interest rates to the point where the non-bank private sector had reduced its cash holdings by the same amount as the banks had redeemed at the central bank.

19. Interest rates would rise to the level at which the extra cost to the banks of attracting more cash from the non-bank private sector was exactly equal to the risk-free capital gain obtained from redeeming cash at the central bank. The rise in interest rates is therefore directly related to the size of the initial price increase. In practice interest rates would rise very quickly to their new level following any price rise.

20. In this light, the monetary policy transmission mechanism might in practice not be fundamentally different from that in place today. Higher interest rates would reduce expenditures, and holdings and hence inflationary pressures. The greater automaticity of the ILRA system might lead to favourable effects on expectations by enhancing the anti-inflation credibility of monetary policy. This in turn might reduce the lags between interest rates and inflation, and hence the real costs of disinflation.

21. There could be a danger that behaviour of the economy might be unstable under this system. Experience shows that the lags between interest rates, expenditure and prices are long, and that they differ among the various areas of the economy. This might mean, in the example above, that the rise in interest rates was so large that at some later date the deflationary impact would cause prices to undershoot their equilibrium level. This would initiate a rise in the money supply, as the original arbitrage process was reversed. Such instability would undoubtedly encourage the authorities to modify the system, perhaps by seeking a way to

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restore to the central bank some of its influence over interest rates.

22. The system has close parallels with that of monetary base control. Under the ILRA system the demand for new pounds would be closely limited by arbitrage through changes in interest rates. Under monetary base control the central bank varies interest rates in order to keep the growth of the monetary base in line with the target. In both cases interest rate changes would from time to time be much sharper than under conventional monetary policies. But an ILRA system has a number of essentially untried features, and it would therefore be a more risky innovation than monetary base control. Because in principle the system is automatic and depends on the behaviour of financial markets unfettered by the action of a central bank, adjustment might be more rapid and unstable than under monetary base control, where the rule for the monetary base is at the discretion of the central bank.

The ILRA system as an alternative to Delors 3

23. A number of alternative ways of introducing an ILRA system at an EC level can be envisaged.

(i) A single country could undertake a currency reform introducing an ILRA based system in place of its own currency. This would then become a competing currency, which might gradually displace other currencies with inferior price performance.

(ii) The ILRA system might be introduced as a parallel currency to be used as an alternative to national currencies anywhere in the EC. In this case there would need to be some central body to fulfil the role that the central bank would play in a domestic ILRA system. (This seems to be the idea favoured by Professor Walters.)

(iii) A single EC currency could be based on an ILRA using a Community wide commodity basket. A central EC institution would be required as in (ii).

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Each of these would have significantly different properties, and pros and cons compared with Delors stage 3. In order to keep discussion manageable we discuss (ii) and (iii), with (ii) perhaps as a first step towards (iii) brought about by competition.

ILRA as a parallel currency

24. Probably the easiest way to establish this would be for national central banks to provide assets, which would be converted into ILRAs, in exchange for shares in the ILRA issuing authority. At the same time the new ILRA currency would be issued, redeemable for ILRAs and treated as legal tender throughout the Community. In this respect the ILRA currency would be another competing currency within Europe.

25. The ILRA currency would gain acceptability within the EC as and when it showed itself better able to hold its value than other currencies. Acceptability could not be guaranteed, and much would depend on whether the ILRA itself was a useful addition to private sector portfolios. There are existing financial assets with near certain real value, for example indexed gilts, and it might therefore be difficult for the ILRA to establish a niche.

26. Initially at least, it would seem unlikely that the market for ILRAs would be sufficiently large that the interest rate on them would have an influence on interest rates in general. So the macroeconomic effect of a 'competing currency' ILRA might be small, especially if its value proved to be volatile and its acceptability for international transactions limited. It is therefore unlikely that policy credibility, inflation expectations or price stability would be favourably influenced. The decisions of national central banks would still be the main influence on monetary policies. The main merit compared with Delors stage 3 of this form of ILRA would be the avoidance of the loss of sovereignty to the ESCB.

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ILRA based single currency

27. In principle, under the parallel currency model, the ILRA might gradually displace other currencies. This is perhaps far fetched, and a single currency ILRA system is more likely to come about as the result of agreement between EC governments. Its virtues and drawbacks compared with Delors stage 3 would in many ways be similar to those of a modern day gold standard as described in paragraphs 6-11 above.

28. Arguments for the ILRA based system might include:

(i) greater price stability, essentially because of the link between the ILRA and the price level. This might be even greater than under a commodity standard, where there is always the possibility of a change in the price of the commodity bundle;

(ii) helpful effects on inflation expectations. This advantage would be stronger if the greater automaticity of the system led to greater credibility of policy. There would be diminished scope for political interference compared with the ESCB, provided of course that countries agreed that the ILRA issuing authority should stick to the rules, even under difficult conditions;

(iii) little or no loss of monetary sovereignty to the ESCB - the ILRA issuing authority would be confined to the task of redemption of currency and issuance. Of course, the loss of freedom of manoeuvre of monetary policy for individual countries is similar to that under Delors 3, but the loss could be to a set of rules rather than to the ESCB.

29. Arguments against an ILRA based version of Delors 3 might include:

(i) much tougher anti-inflation adjustment, with greater volatility of interest rates and/or monetary base, and hence greater instability of the real economy;

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(ii) the automaticity of the ILRA would present a strong temptation to national governments, either individually or at the Community level, to override the system. Even if they did this only infrequently at times of major difficulties it would tend to undermine any possible credibility advantage;

(iii) much greater uncertainty as to how the system would work in practice. Without much more study, we cannot even be sure that it could be set up to produce guaranteed price stability in the long term. It has no close parallel in modern times. Its closest parallel, monetary base control, was adopted by the US between 1979 and 1981. The experiment was short lived mainly because of the greater volatility of interest rates that resulted. This suggests that countries are reluctant to pursue rigid rule based systems;

(iv) it would be difficult to devise and agree on a Community wide price index. Consumption patterns vary considerably between countries. It is difficult to know what implications this might have for the stability of the system.

30. Although an ILRA system might be the front runner amongst objective reference standards there are a number of powerful arguments against it as a serious alternative to Delors stage 3. It avoids the loss of monetary sovereignty inherent in the ESCB, although in terms of freedom of manoeuvre for the UK the gain might be small. It might also lead to greater price stability. But there would be no certainty in this. Governments have shown a willingness to interfere and mitigate the effects of very high or volatile interest rates. But the main argument against the system is that its macroeconomic consequences, for example for inflation and the stability of the economy, are very uncertain.

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