Memorandum by Mr Tim Congdon, economist at L Messel & Co, stockbrokers

The following memorandum argues that British participation in the proposed European Monetary System is undesirable because it would prevent Britain following independently chosen monetary targets. Such targets can be focussed on Britain's inflation and unemployment objectives; they allow monetary policy to be related to Britain's own economic needs. In the EMS, on the other hand, monetary policy would have to be geared to a fixed exchange rate with the European currencies; it would be influenced by foreign central bankers and politicians. In addition to the heavy cost involved in this permanent surrender of monetary sovereignty, there would be transitional costs in unnecessary deflation in the early years of EMS membership.

In any case, the conditions that have to be satisfied if the EMS is to survive are very exacting. It may not last long and, if it broke up after 1 or 2 years, Britain would have gained nothing by joining.

THE PROPOSED NEW EEC MONETARY SYSTEM—ITS CONFLICT WITH MONEY SUPPLY TARGETS

The details of the proposed European monetary system are still the subject of negotiation and, for that reason, analysis of its likely consequences lacks a well-defined focus. But the central objective of the EMS is clear—to establish (more or less) fixed exchange rates between the European currencies. This may be considered by the system's advocates as preliminary to more ambitious monetary co-operation, including the removal of exchange controls and the institution of a European currency. However, this paper will address itself mainly to the fixed exchange rate aspects. It will also be necessary to refer to the other substantive element in the proposals—the pooling of member countries' reserves in a European Monetary Fund.[1] The argument will be that Britain's membership of a currency union would make it impossible to follow its own independently chosen money supply targets. As such targets allow monetary policy to be geared to Britain's own economic needs, participation in the EMS would be a retrograde step and is undesirable.

Press comment—and, apparently, much high-level financial diplomacy—has concentrated on the debate between a "parity grid" and "basket" formula to govern exchange rate relationships. The importance of this issue is that it determines which particular central bank or banks have to intervene on the foreign exchanges in response to currency movements. Indirectly, it affects how member countries have to adjust to each other's economic policies.[2] But it is a small problem in comparison to others which do not as yet seem to have received much attention and is not discussed here.

The underlying premise of the argument is that exchange rates are determined by, among other things, comparative money supply growth rates in different countries. It follows that monetary policy in the EEC economies would have to be consistent, in a sense to be defined below, if the EMS were to survive. The conditions for exchange rate stability are very exacting. The political unison and technical skill in monetary management required to satisfy these conditions are unlikely to be met. Moreover, there would be serious problems of adjustment in the initial stages of the EMS, which would be both costly to the British economy and unnecessary.

CONDITIONS FOR THE SUCCESSFUL OPERATION OF THE EMS—THE SPECIFICATION OF MONEY SUPPLY AND DCE TARGETS TO ACHIEVE EXCHANGE RATE STABILITY BETWEEN EMS COUNTRIES

In this section, the question "what factors determine the relative money supply growth rates compatible with stable European exchange rates?" will be considered. It is assumed throughout that the economies are in balance, domestically and externally, and the policy question is how to maintain this state of affairs.

The first and most basic condition for the survival of the EMS is that the prices of traded goods be the same in the member countries. If there is inflation, all countries' traded goods must increase in price at the same rate. The reason is straightforward: if traded goods in one country have a continuous tendency to become cheaper (or dearer) relative to those in another, it will develop a current account surplus (or deficit) and its currency will have to be revalued (or devalued).

But a common rate of inflation for traded goods does not entail a common rate of overall inflation. There is a persistent trend for the price of traded goods, which are mostly manufactured, to rise more slowly than the price of non-traded goods, which include labour-intensive services. This divergence reflects the faster rate of productivity growth in industry than services. But the size of the differential between productivity growth in industry and services varies between countries; where the differential is large, services become expensive relative to manufactured goods more rapidly than where it is small. It follows that, if equality of traded goods prices is to be maintained, those countries in the EMS where industrial productivity is growing particularly rapidly must have higher inflation rates than the EMS average. Such countries would have to accept this as a condition for participation in the system.

There are two determinants of the required inflation differences between the EEC economies: the variation in productivity growth differentials between industry and services; and the relative importance of the traded and non-traded goods sectors. In the past, West Germany has had a bigger productivity growth differential than France or Britain. One estimate is that the differential in Germany was 2¼ per cent more than in Britain and 1¼ per cent more than in France over the 1959–76 period.[3] If this were to continue, Germany must have higher inflation than Britain or France as a condition for the success of the EMS. It is difficult to imagine the German public or financial community acquiescing in such an unfamiliar disparity. The variation in productivity growth differentials may, of course, be less now than in the 1960s or early 1970s. But some countries would unquestionably have to tolerate higher-than-average inflation as the price of EMS membership. (Ireland is an obvious example, since it can expect rapid industrial productivity growth for several years ahead.)

The need to keep traded goods prices rising at the same rate would impose other obligations on EMS members. The rate of increase in traded goods prices depends on two main factors—the improvement in labour productivity; and nominal wage growth. In those countries where productivity change is slow, wages growth will have to be lower than elsewhere.[4]

Money supply growth would have to be geared in each country to its inflation requirements, as described above, and the rise in its output. Real output growth is determined by productivity advance and the expansion of the labour force. However, in addition to these "real side" determinants of the monetary targets, reflecting the contrast in economies' underlying technological characteristics, there are others which are specifically financial. Two need to be mentioned.

The first is differences in "the income elasticity of the demand for money". The idea here is that, as their incomes grow, economic agents' demand for money balances may not necessarily rise in the same proportion. If it rises more quickly (ie the income elasticity of the demand for money is greater than one), the money supply can go up faster than income without inflationary results. The point is relevant for the EMS since recent experience suggests that the income elasticity of the demand for money in West Germany is more than one, whereas in Britain it may be beneath one. German's money supply target would have to be correspondingly higher.

The second financial influence is technical progress in the banking system which enables the same volume of transactions to be handled with smaller money balances (eg credit cards, medium-term acceptance facilities). If such technical progress is quicker in some EMS countries than others, its monetary target would have to be adjusted accordingly. In practice, it is difficult to isolate this influence from the effects of the income elasticity of money demand.

Clearly, there are many determinants of the pattern of European monetary targets consistent with exchange rate stability. However, a money supply target would not in itself be a complete specification of monetary policy. In a currency union, it would also be crucial that domestic credit expansion be aligned with the permitted growth in the money supply. If DCE consistently exceeded money supply growth by a substantial amount in any EMS country, it would experience steady depletion of its foreign currency reserves.[5] That could not last long without calling into question its exchange rate. Moreover, the excess credit of one EMS country would spill over into its neighbours and require them to run DCE beneath an agreed money supply growth target if these targets were to be achieved. They might object to this as an infringement on their desired monetary policies.

The Co-ordination of Monetary Policy in the EMS—an Annual Meeting of the European Monetary Fund

If EMS countries were mandated to follow money supply and DCE targets according to the economic logic outlined in the previous section, exchange rate stability could be durable. The target number for each country would depend on a formula which incorporated all the relevant conditions.[6] Finance Ministers might meet every year and bind themselves to monetary targets determined by their economies' characteristics (ie its productivity growth differential between industry and services, income elasticity of the demand for money, etc). If they co-ordinated monetary policy in this way, an important prerequisite for the successful operation of the EMS would have been met.

However, the enforcement procedures would still have to be decided. The European Monetary Fund could be given responsibility for monitoring progress towards the targets. There might be difficulties. European countries have markedly dissimilar financial structures and at present the monetary aggregates chosen for control purposes differ between them. The target is expressed in terms of M3 (ie notes and coin in circulation, bank deposits and certificates of deposit) in Britain, central bank money (ie notes and coin in issue, and banks' reserve assets) in Germany and M2 (ie excluding certificates of deposit) in France, while in Italy the meaningful constraint has for some time been a DCE limit imposed by the International Monetary Fund. The techniques of monetary policy have also been traditionally quite different—with Germany relying heavily on variations in the banks' reserve requirements ratio, and France and Italy on direct quantitative credit restrictions.

And what sanctions would the EMF apply if member countries transgressed their monetary targets? Sanctions would probably be used only when a member had had to borrow from it heavily—and, by that stage, the country's policies might be so delinquent that devaluation would be a preferable solution. It is unlikely that finance Ministers would treat the monetary targets laid down at the annual EMF meeting with much respect. To some politicians the targets might seem part of a weird numerical ritual concocted by international financial bureaucrats. Of course, implicit in the monetary targets would be an inhibition on fiscal room for manoeuvre. That might be politically unpalatable.[7]

Conditions for the Successful Operation of the EMS—Agreement on the Combined Direction of European Monetary Policy and the EMS's Monetary Relationships with the Rest of the World

The discussion so far may have encouraged a little scepticism about the feasibility of the EMS. But some of the biggest debating areas have not yet been touched. The framework for establishing comparative monetary targets given above indicates in what direction and by how much each EMS member's monetary target would have to differ from the EMS average if exchange rate stability were to be preserved. But it does not answer two equally important and closely related questions, "What should be the average rate of European money supply growth?" and "What should determine the exchange rate between the European Currency Unit (the proposed *numéraire* for the EMS) and non-European currencies?"

Clearly, agreement on the average rate of European money supply growth would be the major and perhaps the most controversial item on the agenda for the EMF's annual meeting. It would determine whether economic policy in the EEC was to be inflationary, neutral or deflationary for the following 12 month period. If the EMS economies were at roughly the same point in the economic cycle and had attained a degree of balance between themselves, this issue might not be too awkward. The long-established preferences of West Germany for low inflation and of Britain for full employment would no doubt be ventilated, but a compromise might be reached given sufficient political will. However, if the EMS economies were not moving forward in tandem, the depressed members would pressurise their better-placed partners into accepting a high European money supply growth rate. It should be emphasised that, within the fixed exchange rate straitjacket, a depressed economy would have little autonomy in fiscal or monetary policy and the annual European monetary concordat would be the key decision affecting its recovery prospects.

The problem of defining an "average European money supply growth rate" would be straightforward. As long as monetary systems remained separate, there would be no need to devise a European monetary aggregate, weighted accordingly to the size of rather heterogeneous deposits in different currencies in EMS member countries. It would be necessary only to specify a representative monetary aggregate in each country which would have to grow by the agreed average, plus or minus the adjustment to protect EMS exchange rate stability.

But the EMS's relationship with the rest of the world would be extremely complicated—and it is on this point that relationships between European central banks would probably come under impossible strains. The natural assumption from our earlier discussion is that the exchange rate between the ECU and a weighted average of non-European countries would be determined by the comparative money supply growth rates of Europe and the rest of the world—and, of course, other considerations of the kind (productivity growth differentials, income elasticity of money demand, etc) already outlined. The pivotal exchange rate would be that between the ECU and the dollar.

If member countries decided at the annual EMF meeting that there would be no net collective intervention on the foreign exchanges, a special problem might not seem to arise. The EMS taken as a whole would not have a payments imbalance with the rest of the world and, while the policies of EMS countries remained appropriate in relation to each other, there would be no serious payments imbalances within the EMS either. However, this is too naïve. If the average European money supply growth rate differed markedly from that in the USA, the ECU/\$ rate would fluctuate—and so would the £/\$, franc/\$, lira/\$ rates, etc. These fluctuations would have different impacts on the various economies. A fall in the ECU/\$ rate could have a serious effect on the export competitiveness and payments position of a country whose trade pattern was less directed towards Europe than the EEC average. If, as a result, it ran a payments deficit with the non-EEC world, it would wish to compensate by having a payments surplus with other EEC countries—and this might immediately raise disputes with their central banks and EMF. This consideration is particularly relevant for Britain, a country whose commercial and financial links outside the EEC remain most important.

In practice, it is unlikely that the EMS would adopt an agnostic attitude towards the ECU/\$ rate. Finance Ministers at the annual EMF meeting might reach an understanding about tolerable ECU/\$ rate movements, their respective bargaining positions being determined by the extent to which the dollar affects their particular national interests. When the ECU/\$ rate showed signs of diverging from agreed limits, an intervention obligation would be incurred.

But by whom? The EMF might have a role, but none seems to have been envisaged so far. The present proposal is that member countries contribute to the Fund 20 per cent of their foreign currency reserves (they would retain unconditional access to these) and a similar amount of their own currencies. They could only make drawings on the latter half of the EMF's resources if they accepted certain conditions on internal economic policy. If this proposal describes the EMF's powers, it would have no responsibility for intervention to affect the ECU/\$ rate: it would not be a genuine European central bank, but an agency to formalize borrowing and lending between EMS members. Such borrowing and lending could, of course, be done without an institution like the EMF.

Moreover, if the EMF did not intervene on the foreign exchanges, the task would have to be performed by individual central banks—as at present. How would intervention duties be allocated between them? One approach would be to pin the responsibility on the central bank whose currency was at the top or bottom of the permitted EMS band of variation. Thus, if the ECU/\$ rate was falling and the deutschemark was the strongest currency within the EMS, the Bundesbank alone would have to intervene and prevent European currencies becoming more expensive; and if the ECU/\$ rate was rising and the pound was the weakest currency, the Bank of England would have to shoulder the whole burden of defending their value.

Clearly, this approach is not feasible. All the EMS central banks would have to be involved. But there are no obvious criteria for deciding how much of its reserves each would have to commit. Furthermore, not only is there uncertainty about what these criteria should be in theory, but also there would be considerable practical difficulties in meeting them. Minute-by-minute consultation between central banks on deutschemark/$, £/$, franc/$ and other rates would be needed, in addition to co-operation on the amounts of currency being bought and sold. These complications would be superimposed on those arising from intra-EMS intervention to preserve exchange rate stability in Europe.[8]

The relationship of the EMS to the rest of the world, and the problems created for intra-EMS central bank co-ordination, deserve heavy emphasis. The political initiative for the EMS has come largely from Germany, because the Germans are said to dislike the special vulnerability of the deutschemark to dollar weakness and the resulting interference with domestic monetary policy when the Bundesbank intervenes to keep the dollar up. But this problem would not go away were the EMS set up—and might even be far worse.

There would inevitably be implications for monetary control. The analytical approach adopted in this paper suggests that, if the European central banks decided to uphold a particular ECU/$ rate, they would be successful only if the average European money supply growth rate bore the appropriate relationship to money supply growth in the USA. But it would be most unlikely that the relative stance of monetary policy in Europe and the USA was just right. A conflict might arise between the agreed ECU/$ exchange rate and the European monetary target. The job of resolving this conflict at the operational level—in the foreign exchange departments of central banks—would be extremely difficult, because it would have to be shared and co-ordinated between them. It could provoke endless squabbles between both the central bank technicians and the politicians.

THE EMS AS AN EXPANDED "DEUTSCHEMARK ZONE"

Enough has been said to show that the conditions for a successful EMS are unlikely to be met in the real world. In principle, monetary policies could be co-ordinated to make intra-European exchange rate stability viable. But technical problems would be formidable and member Governments would have to demonstrate exemplary political self-denial. Perhaps most difficult would be the co-ordination of the EMS's relationship with the rest of the world.

However, it could be argued that the portrait of the EMS given here is too idealistic. It has been described as an organization with concerted monetary objectives and an equal say for all its members. In the event, the EMS would be more likely to develop as an expanded version of the "snake". The Bundesbank would set the tone for European monetary policy, other European central banks would be its satellites and the guiding rule for economic policy in the EEC countries would be defence of established parities between the deutschemark and other currencies. Money supply targets would not be set. Instead, whenever a currency was weak relative to the deutschemark, its central bank would have to raise interest rates and, whenever it was strong, interest rates could be lowered. This simple framework for policy in the European economy would be comparable to that in the world economy under the pre-1971 Bretton Woods system, when the role of stage-managing central bank was played by the US Federal Reserve Board.

This could happen. But it would be anathema to many institutions in Britain, including almost certainly the Treasury and the Bank of England. It would also require a radical upheaval in attitudes in the City where the focus in the pre-1971 fixed rates era was on American interest rates and monetary policy. In the new fixed exchange rate regime, the focus would be on Germany. The City is unfamiliar with German monetary institutions and practices.

Moreover, doubts should be expressed about whether Germany has sufficient economic standing relative to Britain and France. Two conditions have been advanced as necessary for the formation of a currency bloc, "a dominant economy whose impact on the neighbouring economies is far greater than their impact on it; and the issuance of a currency by that dominant economy which is widely acceptable, as a store of value and medium of exchange".[9] These conditions are satisfied with Germany's relationships to the Netherlands, Belgium, Luxembourg, Denmark and Austria (countries which have been termed "the inner deutschemark area"). But it is not clear that they are satisfied as far as Britain and France are concerned. Britain, in particular, is not very closely integrated with the inner deutschemark area. In 1977, for example, only a fifth of its trade was with the area, compared to a third of France's. London remains the biggest international financial centre in Europe, as demonstrated by its role in 1974 and 1975 as a destination for oil producer revenues. The $/£ rate therefore continues to be the most carefully watched in the City because it influences the relative attractiveness of London and New York as homes for volatile financial flows. It could be argued that, in this context, to link the pound to the deutschemark would be incongruous.

BRITAIN AND THE EMS

Previous attempts to establish a European currency union have not worked. Their failure has been attributed to a "certain sloppiness in monetary and fiscal policies".[10] This paper has indicated how much less "sloppy" monetary policy would have to be if the EMS is to survive. Some of its answers look rather unhappy. Germany's position is particularly sensitive, since it would need to have a higher inflation rate than its European neighbours and might have to intervene on the foreign exchanges to sustain the dollar even more heavily that at present. There would be an arduous tug-of-war between Germany and the rest of Europe. In the end, the rope would snap and the EMS would break up. It could be argued that Britain should have nothing to do with such a fissile arrangement, since its membership would be temporary and prove an irrelevant interruption of its own economic policies.

But could the EMS be taken more seriously? Two workable frameworks have been identified—one in which money supply targets are co-ordinated; and a super-snake dominated by Germany. Would either of these be in Britain's interests?

In the first version, Britain would not determine its own money supply target. It would instead be related to the average European growth rate agreed at the annual EMF meeting. The implied abandonment of monetary sovereignty would end the British authorities' ability to pursue inflation or unemployment objectives. To some economists this might seem advantageous, since Britain's inflation record in recent years is poor and it can be argued that unemployment levels are determined in the long run by "natural" characteristics of the economy, not short-run demand management. Moreover, since British industry is not notably progressive in productivity terms, the inflation rate could be beneath the EEC average without endangering exchange rate stability.

However, the surrender of monetary sovereignty would be a serious step. The overall direction of macro-economic policy would no longer be determined by the British Government, but instead by the annual EMF meeting and the deliberations of EEC finance Ministers. The status of the Treasury and the Bank of England would also be downgraded, as they would have to collaborate with EMF staff when making assessments of Britain's economic prospects. Moreover, fiscal policy would have to be consistent with monetary policy. Britain's permitted money supply growth rate would be beneath the EMS average, because productivity in industry is not rising quickly and the income elasticity of the demand for money is lower than Germany's. This would require Britain to have a permanently small budget deficit (as a proportion of national income) than other countries. It would be the last nail in the coffin of Keynesian demand management.

Some of these consequences—or, rather, conditions—of Britain's membership of the EMS might be thought beneficial, particularly in comparison with what has happened to the economy in the 1970s with independently determined policies. However, the contrast with recent experience emphasises the implausibility of

British membership. Would the Government really accept a small budget deficit at the dictate of the EMF? Would the Bank of England agree to interest rate increases because the EMF put a pessimistic interpretation on recent sterling M3 statistics? And suppose that France and Germany, for their own reasons, expressed a preference for a markedly inflationary or deflationary money supply policy at the annual EMF meeting, why should Britain have to compromise its own position if it did not accept their views?

It goes without saying that if, in any particular year, Britain decided not to follow the same monetary path as its European partners, fixed exchange rates could not hold. For example, assume that British money supply growth needs to be 1 per cent beneath the EMS average, French ½ per cent above and German 1½ per cent above; and assume that the annual EMF meeting reached agreement on a 5 per cent average money supply growth rate for the whole system. Then, British money supply growth would have to be 4 per cent, French 5½ per cent and German 6½ per cent. If the British Government considered 4 per cent too low and allowed domestic credit to expand by an amount equivalent to 10 per cent of the money supply, either Britain would incur a payments deficit or the pound would have to be devalued. The payments deficit could be financed by EMF borrowing, but policies would have to be reversed at a later stage in order to achieve a payments surplus and repay the debt.

The second version of the EMS, linking the pound to the deutschemark in a super-snake, would make little sense to this country. Britain's trade and international finance is much more diversified geographically than those of existing members of the snake. West Germany takes only 7·6 per cent of its exports and is the origin of 9·8 per cent of its imports. Financial flows between London, New York and the former sterling area countries (connected with the residual " sterling balances ") are much larger than those between London and Frankfurt.

An equally fundamental objection is that the conduct of monetary policy would probably be far more erratic than at present. The international value of the deutschemark has been volatile in recent years. Other members of the snake have seen their currencies buffeted around on the foreign exchanges as they have followed the deutschemark's movements. They have had to raise and lower interest rates in big steps to preserve a fixed exchange rate with the deutschemark, interest rate flexibility being the unavoidable cost of exchange rate rigidity. If the pound was tied to the deutschemark, Britain's interest rate variations might not be so abrupt as they have had to be in Holland or Denmark, but they would certainly be greater than if the option of exchange rate changes was available to the Bank of England. The political presentation of sharp interest rate changes would be inconvenient since both the general public and the City would be unfamiliar with a monetary " discipline " imposed by the Bundesbank.[11]

The Transitional Problems on entry

The argument so far has been based on the perhaps rather ambitious premise that the EMS has established itself and that the economies within it are in a position of approximate balance, domestically and externally. It has considered how the EMS would function once these initial requirements have been met—or, to use the economists' term, when it is in a " steady state ".

But of course, the EMS has not been established and its prospective members are not in economic balance. Britain will have inflation in 1978 of 8 per cent, compared to 2½ per cent in Germany, 10 per cent in France and 12½ per cent in Italy. Its current account position on the balance of payments is in approximate balance, but Germany, France and Italy all have current account surpluses. Interestingly, money supply growth rates have over the last 2 years been closer together than inflation rates, but it is difficult to analyse the contrasting demand management policies of the 4 countries because of institutional differences.[12]

The universal assumption is that harmonisation of European inflation rates would be towards the low German figure, rather than the high French and Italian. (It is a pertinent question why this is the universal assumption, but the point will not be discussed here.) As the steady state EMS would be characterised by a lower inflation rate in Britain than Germany, Britain would have to aim at an inflation rate lower than is likely in Germany. The German economy is at present recovering quite strongly and price increases should be expected to accelerate in 1979 and 1980—perhaps to 4 or 5 per cent a year.[13] But that would still leave Britain with the task of reducing inflation to about 3 per cent in 2 years.

Fiscal and monetary policies could be designed with this end in view. Money supply growth would have to be reduced to at most 5 per cent a year, not an impossible objective as increases under 8 per cent have been registered in 3 of the last 4 financial years. To maintain a degree of equilibrium between the public and private sector contributors to monetary growth, the public sector borrowing requirement would also have to be cut.

It is a mistake to equate these policies with "deflation". The PSBR dropped from £8,600 million in 1976–77 to £5,500 million in 1977–78, but that has not prevented 1978 seeing a quite brisk recovery in domestic demand. The true deflationary consequences would arise because of the conflict between inflationary expectations, which are running at about 10 per cent a year, and the 3 per cent rate needed by late 1980 or 1981. Many financial and planning decisions in businesses are being made on the assumption of future 10 per cent inflation, while expectations in collective bargaining are still distorted by memories of the 1974–75 "wage explosion" when increases of 30 per cent were common. A policy of holding the pound stable against European currencies would undoubtedly involve a shock to industry and commerce—although, perhaps, a salutary one.

There are 3 possible ways of achieving more gentle adjustment. In the first exchange rates are altered at the beginning of the EMS to pre-empt probable inflation differentials: Britain, Italy and France would devalue, and Germany would revalue. The drawback to this approach is that devaluation would merely promote inflation, by raising import costs and easing competitive pressures on the tradable goods sector. It takes for granted and encourages a process which Governments are trying to stop. As inflationary expectations would be given added impetus, the ultimate adjustment might prove even more difficult.

The second method would be to allow occasional exchange rate changes in an induction period of, say, 2 or 3 years. But this is not worth serious consideration. Unless there were a pre-announced devaluation or revaluation schedule, finance Ministers would have to meet regularly and decide on what exchange rate changes were expedient.[14] Foreign exchange markets would be even more uncertain than they are now. Moreover, as Governments would know that fiscal and monetary misdemeanours could be offset by currency depreciation, they would not be under much compulsion to bring fiscal and monetary policies into line.

The third easing of the transitional problems would be through the explicit and forthright acceptance of payments imbalances between EMS members in the early years of the arrangement. The imbalances would be financed by inter-member borrowing and lending. In the current proposals, the EMF would only come into operation 2 years after member countries had agreed to fix their exchange rates in relation to each other, but credit facilities—perhaps of up to $25,000 million—would be available straightaway. The figure is being negotiated, with Germany wanting a low number and the other countries a high. However, Britain already has large international debts, with most coming due for repayment in 1981 and 1982, and it must be hoped that the Government does not except to increase them further.

Britain's difficulties on entry into the EMS would be serious. A "soft landing" could be attempted, but all 3 approaches examined here have their weaknesses. Quite apart from the surrender of monetary sovereignty, which would be a permanent result of EMS membership, Britain might have to accept high initial unemployment as a cost of participation in the system. Inflation would moderate, but it would surely be a preferable course to gear policy objectives to Britain's inflationary expectations, not Europe's.

THE EMS AND MEDIUM-TERM FINANCIAL PLANNING

In the author's memorandum "Some Comments on Cmnd 7049: *The Government's Expenditure Plans 1978–79 to 1980–81*" to the House of Commons Expenditure Committee in January this year, a medium-term financial plan was proposed for the 3 years to 1980-81.[15] The specific arithmetic in the proposal was illustrative, rather than closely reasoned. Nevertheless, the suggestion that money supply growth be lowered to 8 per cent in 1978–79, 6 per cent in 1979–80 and 4 per cent in 1980–81 was described by *The Daily Telegraph* (1 February) as "draconian". So far in the 1978–79 financial year sterling M3 has, in fact, increased at an annual rate of 6 per cent. The money supply numbers suggested in the memorandum were based on gradual reductions in the PSBR from £6,700 million in 1977–78 to £5,400 million in 1978–79, £4,800 million in 1978–80 and £3,800 million in 1980–81.

The interesting point as far as the EMS is concerned is that the numbers in the medium-term financial plan are similar to those which, it has been argued here, would be needed if Britain were to participate in the system. (It should be emphasized that the plan was not based on a properly specified econometric model and used approximate, not precise, figures.) But the similarity should not be taken to imply approval of Britain's membership of the EMS, for 4 reasons.

First, the medium-term financial plan was based on the assumption that the PSBR would be reduced from £6,700 million in 1977–78 to £5,400 million in 1978–79. In the event, the PSBR has been raised from £5,500 million in 1977–78 to an estimated £8,500 million in 1978–79. The required fiscal adjustment to bring the PSBR back on course would be large—of the £3,000 million to £5,000 million order over 2 years. Whatever the merits of this change, it is not regarded as "practical politics".[16]

Secondly, an objective of the medium-term financial plan was to accommodate a positive "external contribution" to money supply growth. This would allow Britain to begin repayment of its overseas debts. Implicit here was the assumption that the authorities would not be held to any fixed exchange rate, since that would make the external contribution to monetary growth susceptible to foreign influences. Quite possibly, the external contribution to monetary growth would be negative if Britain joined the EMS—and the debts would start to rise again.

Thirdly, one goal of the medium-term financial plan was to encourage economic recovery through allowing the industrial sector more financial leeway. But the disturbance to expectations from trying to bring inflation down very quickly, which has been shown to be a prerequisite for EMS membership, would not be friendly to an industrial revival.

Finally, and most fundamentally, the need to preserve a fixed exchange rate with the European currencies would introduce a new, complicated and unnecessary dimension to financial policy. It is difficult enough to bring fiscal, monetary and industrial policy together as an integrated whole at present. But to incorporate exchange rate management and continuous co-operation with other EEC countries as well would compound the problems.

CONCLUSION

The argument in this paper has been unsympathetic to the EMS. It is doubtful if the EMS could work, but, even if it could, Britain should not join. The acceptance of money supply targetry and the adjustment of fiscal policy in accordance with those targets have been the dominant themes of economic policy in this country over the last 3 years.[17] The benefits have already been considerable. Participation in the EMS would end Britain's monetary sovereignty and prevent the authorities choosing money supply targets focussed on domestically appropriate inflation and unemployment objectives. Apart from the large adjustment costs on entry, EMS membership would interrupt the recent favourable evolution of British monetary policy.

It has been said that, since sterling would suffer if it was alone in the world, no longer tied to the dollar and not associated with the European currencies, Britain has no political alternative to EMS membership. But there is no economic theory which says that a currency's international value depends on its loneliness.[18] By staying out of the EMS, Britain could continue to deal with its own economic problems in its own way ; by participating, it would surrender control of its economy to foreign central bankers and politicians.

27 *October* 1978

Notes

[1]. The idea for such a fund was put forward more than 20 years ago by J E Meade in "The balance of payments problems of a European Free Trade Area" *Economic Journal* vol 67, 1957 pp 379–96, reprinted in P Robson *International Economic Integration* Penguin: Harmondsworth, 1971, pp 219–41. The concluding paragraphs are particularly interesting.

[2]. Under a parity grid arrangement, one currency close to the top of the permitted band of fluctuation must be accompanied by another close to the bottom. Both the central banks responsible have to intervene and hold the currencies within the band. The adjustment burden (ie the change in domestic economic policies required to preserve exchange rate parities) is also symmetrical. The strong currency country has to reflate and the weak to deflate. With a basket formula, on the other hand, it would be possible to isolate a unique "deviant" currency—the currency of the black sheep country whose economic policies are either too financially strict or lax in comparison to its partners. The intervention and adjustment requirements would fall exclusively on that country. The role of the different countries in this is quite subtle. If the basket formula were used and, for example, West Germany adopted restrictive demand policies compared to the other countries, it would be identified as deviate and would therefore have to reflate *alone*. If there were a parity grid, a strong deutchemark would automatically be associated with (say) a weak lira, and Italy would have to accept deflation while Germany reflated. As it is universally assumed that Germany would like to be the dominant and most responsible financial power in the EMS, the grid *vs.* basket debate touches sensitively on the issue of how much suasion over other countries it could actually have.

[3]. London Business School *Economic Outlook* vol 2, October 1977, p 17.

[4]. The problem of wage control is sometimes viewed as political in nature, necessitating direct restriction through incomes policies. A corollary should be noted. It is that countries with low productivity growth in industry would have to police pay norms which explicitly envisage a decline in their living standards compared to other countries'. The author does not agree with incomes policies in any shape or form, but this point may interest those who do.

[5]. Domestic credit expansion exceeds money supply growth by two items, "external and foreign currency finance" and the increase in banks' non-deposit liabilities. The increase in banks' non-deposit liabilities corresponds to the growth in their capital reserves and is incidental to the present discussion. "External and foreign currency finance" has 3 components—the increase in foreigners' holdings of sterling deposits (if the UK is the country under consideration), the increase in the banks' net foreign currency position and "external finance of the public sector". It is external finance of the public sector which matters in the EMS context, since it is mostly intervention in the foreign exchanges to stabilise an exchange rate. External and foreign currency finance can be regarded as the balance of payments deficit (on both current and capital accounts) of the private sector. External finance of the public sector and the fall in the reserves are not

necessarily equal, but most transactions which provide external finance to the public sector do lead to a fall in the reserves.

[6]. For the derivation of such a formula, see M Parkin "World inflation, international relative prices and monetary equilibrium under fixed exchange rates" pp 220-42 in R Z Aliber *The Political Economy of Monetary Reform* Macmillan: London, 1977.

[7]. In his paper, "The adjustment problem" pp 159–84 in *European Monetary Unification and its Meaning for the United States* The Brookings Institution: Washington, 1973, M Corden draws a distinction between "a pseudo exchange rate union" (ie an agreement to maintain fixed exchange rates between central banks which remain independent) and "a complete exchange rate union" (ie an agreement to maintain fixed rates, accompanied by a pooling of reserves and a merger of central banks into one institution). It is doubtful if central banks could be merged in this way unless fiscal policy was also the result of one agency's actions. In other words, there would have to be a European Government. A complete exchange rate union and autonomous fiscal policy among EEC countries could not be combined. The reason for this is that a central bank owes its special status in any financial system to its role as banker to the Government.

[8]. A discussion of the problems which arise when small European countries try to "sterilize" reserve increases due to capital inflows is given in P de Grauwe "Monetary interdependence among major European economies" pp 179–201 in R Z Aliber (ed) *The Political Economy of Monetary Reform* Macmillan: London, 1977. Its concluding paragraph runs

> Attempts by national monetary authorities to insulate their money markets by sterilisation policies lead to explosive reserve flows. In addition, although joint floating insulates the total European monetary base from external (US) influences, it does not do so for individual European countries. Finally, although larger European countries do gain some degree of monetary independence by the device of joint floating, small countries (Belgium, Netherlands, Switzerland) do not increase their control over the monetary base in any significant way.

This pessimistic assessment is based on experience in the 1959–70 period. Capital flows today are much larger.

[9]. Amex Bank Research Paper *The European Currency Bloc—Deutsche Mark Sphere of Influence* July 1978.

[10]. L B Krause and W S Salant *European Monetary Unification and its Meaning for the United States* Brooking Institution: Washington, 1973 p 196.

[11]. The idea of an "optimum currency area" was advanced in 2 papers in the early 1960s, R A Mundell "A theory of optimum currency areas" *American Economic Review* vol 51, 1961 pp 657–64 and R I McKinnon "Optimum currency areas" *American Economic Review* vol 53, 1963 pp 717–25. Mundell's theory is that an optimum currency area is characterised by internal factor mobility: if factors are immobile between two regions, it is easier to correct demand pressure imbalance (eg over-full unemployment or unemployment) by an exchange rate change than by resource shifts, but if factors are mobile, they can have a common currency. The core of McKinnon's argument, on the other hand, is that, "if we move across the spectrum from closed to open economies, flexible exchange rates become both less effective as a control device for external balance and more damaging to internal price-level stability". In other words, the higher the ratio of traded to non-traded goods in an economy, the less powerful is the exchange rate as a policy instrument and the less worthwhile is it to have a separate currency.

Both these arguments provide a rationale for the snake. Labour and, to a lesser extent, capital move freely between Germany and the other snake countries; and the Netherlands, Belgium, Denmark, Luxembourg and Norway all have very high ratios of traded goods to non-traded goods. But Britain's economic characteristics do not justify membership in a super-snake. Labour movement between Britain and Europe is minimal, and Britain's ratio of exports to national income is one of the lowest in the EEC.

The concept of a "feasible currency area" (in which an exchange rate change can have real effects and, in particular, can change real wages) was advanced by W M Corden in *Monetary Integration* Essays in International Finance No. 93: Princeton, 1972. It is closely related to McKinnon's optimum currency area. In his paper, Corden was very critical of European monetary integration. For a partial recantation, see W M Corden *Inflation, Exchange Rates and the World Economy* Oxford University Press, 1977, pp 140–56.

The theory of optimum/feasible currency areas is of great relevance to the EMS. On almost all criteria proposed by the theory, Britain is the least suitable member.

[12]. Using the "MI plus quasi-money" aggregate monitored in the OECD *Main Economic Indicators,* money supply growth in the years to the fourth quarter of 1976 and 1977 were 6·7 and 11·2 per cent respectively in West Germany, 12·7 and 13·9 per cent in France and 10·7 and 9·8 per cent in the UK. Italy was rather aberrant, with rates of 22·3 and 20·3 per cent. In the last 12 months for which figures are available, the growth rates were 10·1 per cent in Germany (to May), 13·4 per cent in France (to March), 16·2 per cent in the UK (to May) and 20.0 per cent in Italy (to April). More recent data are available, but not in a comparable aggregate.

[13]. The author's guess is that, on recent trends, the Germans will be lucky to keep their inflation rate under 5 per cent in 1980.

[14]. If a pre-announced devaluation and revaluation schedule were announced, interest rates in EMS countries would have to be adjusted accordingly. Devaluing countries would need to have higher interest rates to keep their currency attractive. That would, of course, impinge on monetary policy.

[15]. Appendix 5, pp 81–87, in *The Government's Expenditure Plans 1978–79 to 1981–82* (Cmnd 7049) 2nd report from the Expenditure Committee, 1977–78 session, HMSO: London, 1978.

[16]. The author's personal view is that sharp increases in indirect taxes and the transfer of many public sector functions to the private sector are desirable, both to balance the budget and for their effects on incentives and economic structure. But this is generally categorised as "politically impossible" and should not be discussed here.

[17]. See Mr Healey's speech to the Lord Mayor's Banquet at the Mansion House, 19 October 1978 (Treasury press release). "The present Government is perhaps the first in Britain for very many years which has given monetary policy the importance it deserves" (p 6); "The essential instruments of monetary control are the appropriate stances on fiscal policy and interest rates." (p 7); and "The Government is . . . determined to control the growth of public expenditure so that its fiscal policy is consistent with its monetary stance." (p 8).

[18]. The Swiss franc is a very lonely currency—but not an unpopular one.