

Chapter 4

The ERM: incompatible with domestic policies

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The European exchange rate mechanism has had a troubled history. It is often described as a stepping-stone to European monetary union and a single European currency, and there is no doubt that this was one motive behind its creation in 1979. But the ERM in practice has been accompanied by so many devaluations, realignments and foreign exchange crises that it may have aggravated, rather than reduced, monetary tensions in Europe. The purpose of this paper is to argue that three conditions have to be met if a fixed-exchange rate zone like the ERM is to work, but that these conditions have proved impossible to reconcile, except intermittently, during the ERM's existence. The difficulties in reconciling the three conditions are so deep-seated that doubts have to be raised about the wisdom of trying to fix exchange rates in the manner prescribed by the ERM. The argument here has some affinities to the so-called 'Walters critique', although it covers aspects of the monetary situation which Sir Alan Walters has not discussed in much detail in Chapter 2.

Three conditions for the success of a fixed-exchange rate zone

The three conditions for the success of a fixed-exchange rate zone are that interest rates have to be roughly the same in all member countries (the interest parity theorem), that the prices, and inflation rates, of traded goods have also to be roughly the same in all member countries (purchasing power parity), and that the growth rates of credit and money have to be consistent with purchasing power parity (the monetary theory of exchange rates). Although the three conditions have been widely discussed, a few words of explanation may be helpful. As will emerge, the problem of inconsistency between the conditions is most interesting between the interest parity theorem and the monetary theory of exchange rates.

One: interest rate parity

The logic behind the interest parity theorem is straightforward. In the absence of exchange controls and significant transactions costs in the foreign exchange market, a simple relationship has to hold between the interest rates in two countries and the exchange rate between their currencies. This relationship is that the difference between the interest rates (for x months) in the two countries equals the forward discount (or premium) between exchange rate today and in x months' time. The forward discount (or premium) reflects, among other things, the foreign exchange markets' expectations about where the exchange rate ought to be. The thinking is that it should not be possible to make an effortless profit by borrowing in one currency, converting the proceeds into another currency on the spot market, leaving the money on deposit in that currency and simultaneously covering the exchange risk by a forward currency transaction. Any scope for profits from such a sequence of transactions ought to be eliminated by arbitrage activity between banks' foreign exchange departments and operators very close to them.

Two: purchasing power parity (PPP)

The rationale for purchasing power parity is also simple. In a free trade area (such as the European Community) the prices of standardized products have to be the same in all countries, after adjustment for transport costs and taxes. If they were not the same, it would be profitable for middlemen to purchase the products where they were cheap, to sell them where they were dear and to make a large return for little trouble. This is not to deny that inflation rates may differ for a considerable period between countries in a fixed-exchange rate system. Inflation can diverge for products and services which do not enter international trade, while it takes time for middlemen to eliminate price differences, even for highly standardized and internationally-traded products. However, the price differences are eliminated eventually. Over periods of several years, inflation rates in traded goods have to be similar in the member countries of a fixed-exchange rate zone. In practice, it is rare for the price levels of one country's manufactured goods (of the kind included in producer price indices) to be continuously over-valued, or under-valued, for more than three or four years.

Three: monetary growth consistent with PPP

The relevance of purchasing power parity to exchange rate levels is widely recognized. The extension of the idea to the monetary sphere further com-

plicates currency relationships and is perhaps a more controversial topic among economists. Clearly, international competition is a strong influence on prices in all countries, particularly in small countries. But there is another dimension to the determination of the overall price level, the behaviour of monetary variables. A commonly-held view, which has considerable empirical support in the long run, is that inflation rates reflect monetary growth. Inflation differences between countries, and also exchange rate trends, should therefore mirror differences in monetary growth. (This view can be termed the 'monetary theory of exchange rates'. It is closely affiliated to the better-known 'monetary approach to the balance of payments'.)

In more theoretical language, the price level in any individual country has to be consistent, not only with purchasing power parity between it and its trading partners, but also with domestic monetary equilibrium. Domestic monetary equilibrium is to be understood as equivalence between the quantity of local-currency money balances and the demand to hold them. It is not sufficient, for the success of a fixed-exchange rate system, that inflation rates in terms of traded goods are broadly the same in all participant countries. There is a further vital condition, that the growth rates of the different money supplies are compatible with that similarity in inflation performance.

Applying the framework to the ERM shows the areas of tension

The requirement that money supply growth rates be related in this sense can be very demanding. It is here that tension is created between the interest parity theorem on the one hand, and purchasing power parity and the appropriate conduct of domestic monetary policies on the other. Money supply growth is dominated, in most countries, by the increase in banks' credit to domestic agents, particularly credit to the private sector. In any one country, the interest rate dictated externally by the interest parity theorem may not be the same as the interest rate appropriate for purposes of domestic monetary control. More specifically, in the ERM context, the interest rate needed to keep a currency inside the grid may generate rates of private sector credit expansion (and so, of money supply growth) which are highly inflationary or deflationary. They may be so inflationary or deflationary as to be both socially unacceptable and at variance with purchasing power parity in the long run.

This is the kernel of the general problem of managing a fixed-exchange rate system and the source of the ERM's particular difficulties in the 1980s. Governments have been forced to choose between their diplomatic commitments to promote European currency integration and their national obligations to achieve satisfactory performances on inflation and unemployment. On several occasions in the 1980s, governments have given priority to their

national constituencies and devalued against the Deutschmark. These devaluations have undermined the long-run credibility of both the exchange rate commitments and the ERM itself.

The argument can be expressed in a slightly different way to connect it more clearly with later themes. The ERM contains a large number of countries each of which has its own currency and its own tax system. The distinct currencies have their own histories (of devaluation, inflation, debt repudiation and so on) which largely define their reputations. Associated with a currency's reputation are certain patterns of expectation about future inflation and interest rates. A decision to join the ERM may alter these expectations, but it does not necessarily mean that the inflation and interest rate expectations for every member currency are identical, or even that they converge. Since expectations about inflation and interest rates are an important determinant of the rate of credit growth, the differences in expectations help to explain why — at the common or similar interest rate determined by the interest parity theorem — there can be large differences in monetary growth among the ERM member countries.

Moreover, every European country's tax system is unique in certain respects. This aggravates the problems of currency management, because the demand for credit can be strongly affected by tax considerations. If a country has high tax rates, and most interest payments are deductible from taxable incomes, its borrowers are more tolerant of high interest rates than if it has low tax rates and limited deductibility. Even if inflation and interest rates expectations converge in the way intended by the architects of the ERM, tax arrangements could still motivate differences in credit demand (and of monetary growth) at a common pan-European interest rate.

Systematic differences in monetary growth between countries are associated with contrasting macroeconomic conditions in the short run and diverging price levels in the long run. The divergence in price levels cannot be reconciled with exchange rate stability over a period of years. More concisely, fixed-exchange rate systems such as the ERM suffer from conflicts between the dictates of the interest rate parity theorem and the requirements of the monetary theory of exchange rates. Indeed, unless a quite implausibly long list of conditions (about similarities in inflation expectations, tax structures and so on) are met, these conflicts are inevitable.

The discussion so far has been loosely theoretical. It has identified differences in the demand for credit between countries as a powerful solvent of fixed-exchange rate systems. Much more needs to be said about the origins and character of these differences in credit demand, and about their interaction with monetary growth, before we can examine the real-world background to specific currency crises. We briefly survey the institutions of credit growth and monetary control in three large European economies, those of Germany, France and the United Kingdom.

An examination of the institutions of credit growth and monetary control in Germany, France and the UK...

In Germany, the first page of text in every issue of the Monthly Report of the Deutsche Bundesbank has a table on 'The money stock and its counterparts'. The measure of money under consideration is a broad aggregate, M3, which includes currency and all bank deposits. The dominant counterpart to it is the 'volume of credit', which is lending by both the Bundesbank and the commercial banks to the private sector and public sector authorities. The German notion of the 'volume of credit' is to be interpreted as the sum of 'bank lending to the private sector' and 'the aggregate deficit of the public sector (i.e., the 'public sector borrowing requirement', in UK terminology) minus sales of public sector debt to non-banks'. A large deduction is made for 'monetary capital formation', which represents the incurrence of non-monetary liabilities (such as medium-term bonds) by the banks. (This deduction is conceptually similar to the 'increase in non-deposit liabilities' which appears in the UK's monetary statistics, but it is many times larger, reflecting the greater preparedness of German banks to take on medium-term liabilities.) Other influences on monetary growth — such as changes in 'net external assets' — can sometimes be significant, particularly during foreign exchange crises.

The format of monetary analysis is similar in France and the UK, although the emphasis on a broad monetary aggregate is less pronounced than in Germany. The Banque de France's *Bulletin Trimestriel* includes a table on *Contreparties de M3*, although its *Bulletin Mensuel* does not. In the UK, the focus of official policy during the late-1970s and early-1980s was sterling M3, an aggregate which included notes, coin and virtually all sterling deposits held by UK residents. The credit counterparts were bank lending to the public and private sectors, adjusted for a number of external and miscellaneous items. (Setting external factors aside, bank lending to the public sector is equal to total public sector borrowing minus non-bank purchases of government debt.) The Bank of England stopped compiling figures for sterling M3 in 1989, and most official discussion of broad money developments now relates to M4. The only important additional counterpart for M4, which includes building society deposits as well as all the assets in M3, is building society lending to the private sector. It follows that the growth of broad money can be largely attributed — at least in an arithmetical sense — to the level of bank (or bank and building society) lending to the private sector.

Governments in all three countries are averse to substantial monetary financing of budget deficits. Differences in monetary growth between Germany, France and the UK can therefore be interpreted, in terms of numbers, mostly to differences in the growth of lending to the private sector. We

need to consider what causes credit demand to be of different intensity in the three countries. Some insight into this issue can be obtained by examining the composition of lending. It turns out that, in all three countries, lending for house purchase is the largest single form of credit to the personal sector and, in Germany and the UK, it is also the largest single form of credit to the economy.

In Germany, official figures split lending into two types of loan — ‘housing loans’ and other (i.e., non-housing) loans. In recent years housing loans have typically been about half the total, although with some tendency for their share to decline. Fluctuations in bank credit are determined to a considerable extent by the behaviour of housing credit. In France also mortgage loans are important, although lending to ‘societies’ (i.e., companies) is larger than lending to *ménages* (households). Finally, in the UK, mortgage credit is much the biggest element in bank and building society lending to the private sector (which is relevant for M4). It is not the largest component of bank lending alone (relevant for M3), but there were nevertheless periods in the 1980s when the banks were very heavily involved in housing credit, both as direct lenders to home-buyers and through the finance they provided to building societies.

...highlights the importance of housing finance

In all three countries, therefore, housing finance constitutes between a third and a half of all credit intermediated in the monetary sector. It should be possible to understand, and largely explain, the contrast in credit trends if we can identify the motives behind this one type of borrowing. This emphasis on housing finance and conditions in the housing market may seem exaggerated, since house-building is usually only a low proportion of national output. Two points need to be recognized. First, in many non-housing loans the level and rate of change of house prices are vitally important. In loans to small businesses, particularly to new companies where the self-employed entrepreneur often has no assets other than his house, residential property is the most convenient kind of collateral. Indeed, a reasonable generalization is that lending to small businesses is likely to be higher, the stronger are expectations of rapid house price inflation.

Secondly, the housing stock constitutes roughly half of total personal wealth in all three countries. Thus, in the UK, the Central Statistical Office has calculated that at the end of 1991 personal sector wealth was £2277bn, while the value of residential dwellings was £1130bn. Goldsmith has estimated that, in 1976, residential structures in France were worth almost half of all tangible assets (excluding land). (R. W. Goldsmith, *Comparative National Balance Sheets*, University of Chicago Press, 1985, pp. 216-7.) It is striking, and surely not entirely coincidental, that the proportion of housing to

total wealth is similar to the proportion of housing finance to total credit. The variation in the proportion of owner-occupied houses to the total housing stock is admittedly quite marked, with owner-occupation much more common in the UK than in Germany or France. But this is less significant than might at first appear, because many rented homes are owned by landlords who have taken out mortgages.

The causes of the ERM crises in the UK

The time has come to apply our ideas to the analysis of crises in the ERM during the 1980s. Two episodes will be discussed in some detail. Firstly, the difficulties which confronted the UK's attempt to join the ERM in the late-1980s and, secondly, the tensions within the ERM following German reunification. These tensions, between Germany on the one hand and the UK and France on the other, forced the UK's departure from the ERM on 16 September 1992 and the virtual suspension of the ERM on 1 August 1993.

In late 1985, Nigel Lawson (later, Lord Lawson), the chancellor of the Exchequer, urged Mrs. Thatcher (later, Lady Thatcher) to join the ERM and establish this external constraint as the focus of British monetary policy. Although Thatcher opposed the proposal, Lawson decided in early 1987 to conduct monetary policy as if the UK were already a full participant in the ERM. Between March 1987 and March 1988, the pound's external value varied in a narrow band between Dm 2.95 and Dm 3.05. For most of this time, the pound had a tendency to appreciate against the Deutschemmark. Reasons for the pound's strength included international enthusiasm for the UK's economic performance under the Thatcher administration and a reaction to a large, and probably excessive, sterling depreciation in mid-1986. However, also important was the gap between UK and German interest rates. UK interest rates were significantly higher than those in West Germany. Although no formal announcement of the exchange rate link was made, the foreign exchanges noticed the steadiness of the Deutschemmark/pound rate and assumed (correctly) that Lawson wanted the rate to be semi-fixed. The combination of a semi-fixed exchange rate and a wide interest rate differential created an opportunity for low-risk arbitrage profits, by buying pounds with Deutschemarks and capturing the higher sterling interest rates.

Lawson tried to resist the upward pressure on the pound by cutting interest rates. The interest rate reductions were much criticized at the time and have been judged in retrospect as seriously misguided. They intensified an already-vigorous boom in private sector credit and stimulated very fast monetary growth, which ultimately proved inflationary. By contrast, German monetary policy in 1986, 1987 and 1988 was stable, and there has been little sustained criticism of Deutschemmark interest rates in those years. The question arises, 'why was the level of interest rates appropriate to the West

German economy so unlike that appropriate to the UK economy?'. It could be rephrased, to connect more clearly with the themes of this paper, 'why was the level of sterling interest rates compatible with the interest parity theorem in the Deutschemark-dominated ERM also a level of interest rates incompatible with a non-inflationary rate of domestic credit expansion in the UK?'.

The root of the problem was that, in the late-1980s, credit growth was much slower, at the same interest rate, in Germany than in the UK. This difference in the intensity of credit demand can be attributed to the markedly contrasting historical relationships between interest rates and the rate of house price change in the two countries.

The position in the UK is summarized in Figure 4.1. It shows that over the 20 years to 1987, borrowing to buy a house was financially very rewarding. The increase in house prices, as measured by the Building Societies Association 'all houses' index, exceeded the mortgage rate in 10 out of the 20 years. Moreover, the gains in the 'plus' years (i.e., when house prices went up more than the mortgage rate) exceeded the losses in the 'minus' years. When additional allowance is made for the tax relief available on mortgage interest and the amenity value of living in a house (i.e., the imputed rent in national income statistics) taking out a mortgage was — for almost a generation — one of the wisest financial decisions anyone could make. The role of mortgage interest relief in enhancing the gains needs to be highlighted. Without mortgage interest relief the cumulative capital gain (in excess of borrowing costs) would have been worthwhile, but not spectacular. With mortgage interest relief, the arithmetic was dramatically favourable.

The situation in West Germany was quite different. As shown in Figure 4.2, there were only four years out of the 20 years to 1987, in which the increase in house prices exceeded the pre-tax mortgage rate. Although the calculation in the table does not make allowance for tax relief, it is evident that there was nothing comparable with the UK's history of massive and persistent gains. The cumulative 'loss' (i.e., the shortfall of capital gains behind interest costs) for someone who borrowed to buy a house in 1980 had totalled 30 per cent by the end of 1987.

Of course, there are many details which need to be filled in. But we have a plausible general explanation for the difference in the intensity of credit demand between the UK and West Germany in 1987 and 1988. Over the previous 20 years, borrowing to buy houses in the UK had given an excellent financial return. But borrowing to buy houses in West Germany had been costly for the great majority of home-owners. (The activities of investors/speculators who had bought houses on borrowed money, with the intention of renting them out, had sometimes been disastrous.) Memories, particularly when they are memories based on a whole generation of expe-

%	(1) Mortgage rate pre-tax	(2) Mortgage rate post-tax	(3) Increase in house prices	(4) Capital gain above interest costs	(5) Cumulative capital gain
1968	7.46	4.38	8.9	4.3	4.3
1969	8.06	4.74	4.3	-0.4	3.9
1970	8.58	5.05	7.0	1.9	5.9
1971	8.59	6.01	18.1	11.4	17.9
1972	8.26	5.78	37.4	29.9	53.2
1973	9.59	6.71	32.1	23.8	89.6
1974	11.05	7.40	1.6	-5.4	79.4
1975	11.08	7.20	7.2	0.0	79.4
1976	11.06	7.19	7.3	0.1	79.6
1977	11.05	7.29	7.1	-0.2	79.2
1978	9.55	6.40	17.1	10.1	97.3
1979	11.94	8.36	29.1	19.1	135.0
1980	14.92	10.44	15.5	4.6	145.8
1981	14.01	9.81	0.8	-8.2	125.7
1982	13.30	9.31	3.0	-5.8	112.6
1983	11.03	7.72	11.9	3.9	120.9
1984	11.84	8.29	7.8	-0.5	119.8
1985	13.47	9.43	7.7	-1.6	116.3
1986	11.92	8.46	14.9	5.9	129.0
1987	11.56	8.44	16.0	7.0	145.0

Notes:

1. The house price series used is the BSA's for all houses
2. The post-tax mortgage rate is obtained by multiplying the pre-tax mortgage rate by $(1 - t)$ where t is the standard rate of income tax. The standard rate in calendar years (e.g. 1957) has been taken as the same as in the dominant nearby fiscal year (1957/58) for ease of calculation
3. The 'capital gain above interest costs' in any one year is calculated using the formula:

$$\text{gain \%} + \left\{ \frac{100 + \% \text{ increase in house prices}}{100 + \% \text{ post-tax mortgage rate}} - 1 \right\} \times 100$$

Figure 4.1 Capital gains from borrowing to buy a house in the UK over the last 20 years
Source: Building Societies Association 'A Compendium of Building Society Statistics', BSA press releases and 'Annual Abstract of Statistics'

%	(1) Mortgage rate pre-tax	(2) Change in price of residential buildings	(3) Cumulative shortfall
1968	7.05	2.9	7.1
1969	7.20	1.9	8.9
1970	8.56	3.4	2.8
1971	8.50	5.3	1.4
1972	8.29	5.5	3.0
1973	9.89	6.9	5.6
1974	10.47	7.0	8.5
1975	8.69	6.0	13.8
1976	7.84	4.5	17.4
1977	7.01	3.7	19.1
1978	6.42	2.7	19.4
1979	7.66	4.1	18.6
1980	9.55	5.5	17.8
1981	11.06	6.3	21.7
1982	10.35	5.3	25.9
1983	8.45	3.3	30.3
1984	8.31	2.4	34.0
1985	7.79	2.2	37.1
1986	6.87	-0.2	40.8
1987	6.39	0.2	43.2

Notes:

1. Figures are available for several mortgage rates. The mortgage rate used here is a variable rate and applicable to mortgage loans secured by residential real estate

2. The change in the price of residential buildings is calculated from an 'overall price index for residential buildings', including value added tax, published in the section on 'General economic conditions' in the 'Monthly Report of the Deutsche Bundesbank'

3. The 'shortfall' in any one year is the excess of interest costs over the increase in the value of houses. It is calculated using the formula:

$$\text{shortfalls \%} + \left\{ \frac{100 + \% \text{ increase in house prices}}{100 + \% \text{ mortgage rate}} - 1 \right\} \times 100$$

Figure 4.2 Capital losses from borrowing to buy a house in West Germany over the last 20 years

Source: 'Monthly Report of the Deutsche Bundesbank' and data supplied by the Bundesbank

rience, influence attitudes. Attitudes then influence behaviour. There should have been no surprise that, at the same interest rate, the pace of credit and money growth in the UK was far higher than in West Germany during the Lawson boom.

In early 1988, a fierce debate about monetary policy developed in the UK. One school of thought urged that interest rates be raised sharply to curb excessive growth of credit and money, and regardless of the likely ensuing appreciation of the exchange rate. Another viewpoint was that the rapid monetary growth would prove harmless, and that priority should instead be given to keeping interest rates and the exchange rate down in order to maintain export competitiveness. Lawson, who favoured low interest rates and the stable Deutschemark/pound exchange rate, was largely responsible for the drop in clearing bank base rates to 7 per cent in May 1988. The result was a catastrophe for the Thatcher government, which lost its reputation for competence in running the economy. With interest rates far too low for monetary control purposes, the increase in domestic demand soared to 8 per cent (in real terms) in 1988, the balance of payments lurched into heavy deficit and inflationary pressures increased. Eventually, inflation went above 10 per cent in the middle of 1990.

Indeed, in 1989 and 1990, the respective monetary circumstances of Germany and the UK changed totally. In the UK many government ministers, including John Major, who succeeded Lawson as chancellor, were inclined to blame overheating in the housing market — rather than the excessive growth of credit and money — for the return of high inflation. The government therefore considered a variety of measures to limit the tax advantages of mortgage borrowing. In addition to this structural change to the housing market, it had to deal with the cyclical problem of rising inflation. It hoisted interest rates to 15 per cent and enforced an extremely restrictive monetary policy, one result of which was a fall in nominal house prices for the first time since the early-1950s. The fall in house prices drastically reduced the value of housing equity, and weakened both the appetite and the capacity to incur mortgage debt in future. At any given interest rate, the demand for mortgage credit was lower than in 1991 and 1992 than it had been in 1987 and 1988. (The phrase 'the demand for credit' may be defined, more precisely, as the rate of credit growth deemed satisfactory by both borrowers and lenders.)

Major also agreed with Lawson that the UK ought to join the ERM. After entry in October 1990, sterling interest rates once again had to take note of those in the rest of Europe, particularly Germany. But Germany in late 1990 was, literally, a different country from the West Germany of 1987 and 1988. After the removal of the Berlin Wall in late 1989 and free elections in East Germany in March 1990, the Federal Republic of Germany and the German Democratic Republic achieved monetary union on 1 July 1990, and full legal

and political union on 3 October 1990. German reunification had powerful effects on the macroeconomic situation, increasing tolerance of high interest rates in at least three ways. First, the demand for housing increased in the old 'West Germany' for simple demographic reasons. In 1989, almost 200,000 people moved from East Germany to West Germany, while 360,000 ethnic Germans entered the country from the rest of Eastern Europe. Immigration ran at similar levels in 1990 and 1991, putting further strain on the availability of accommodation. Rents rose sharply. Once again it became worthwhile for landlords to finance the purchase and construction of buildings on borrowed money.

Secondly, the federal government gave fiscal subsidies on loans intended to purchase (i.e., to privatize) and to refurbish the stock of buildings in the new East German *länder*. The interest rate on such loans was therefore well beneath the commercial rate on equivalent loans in West Germany. In an interesting speech on 2 June 1993 Dr. Helmut Schlesinger, president of the Bundesbank, noted that after monetary union, "our ability to slow down credit and with that money supply expansion by changes in interest rates was made more difficult...[The] demand for credit was, and is, ever more strongly concentrated in those areas which are not particularly influenced by the interest rate level...[The] extensive interest rate subsidies for communal and private investment in East Germany work in this way...About 75 per cent of all investment subsidies for the East German economy today consist of cheap interest loans."¹ It is not fanciful to see parallels between these tax subsidies on mortgage loans in Germany and the system of mortgage interest relief in the UK. Just as the memory of the tax benefits of mortgage borrowing stimulated the demand for mortgage credit during the UK's Lawson boom in 1987 and 1988, so the introduction of tax-subsidized credits for the new *länder* boosted the demand for credit during Germany's reunification boom in 1990 and 1991.

Finally, monetary union led to a large once-for-all increase (of about 12 per cent) in the economically-meaningful stock of Deutschemark money balances, because the conversion of Ostmark deposits into Deutschemark deposits occurred at an exchange rate which grossly overvalued the Ostmark. Large subsequent increases in social and infrastructure expenditure also enlarged the German budget deficit. Both the once-for-all administered increase in money balances, and the higher budget deficit, exerted upward pressure on real interest rates.

¹ *Speech and translation supplied to author by British Management Data Foundation, 19 July 1993.*

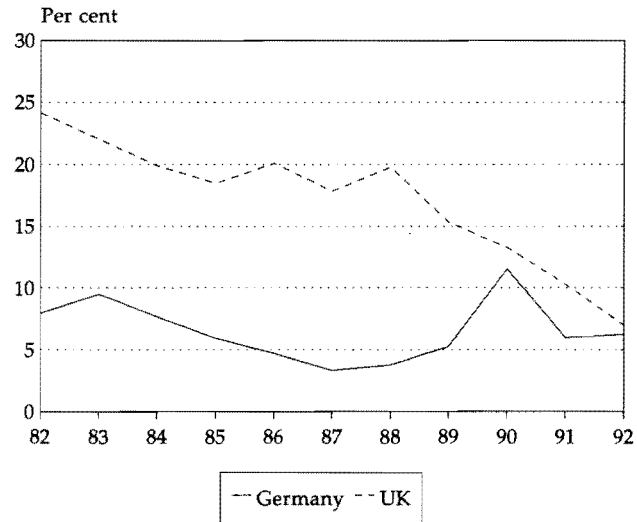


Figure 4.3 Growth rates of mortgage credit, Germany and the UK 1982-92



Figure 4.4 Growth rates of bank credit to the private sector, Germany and France 1984-92

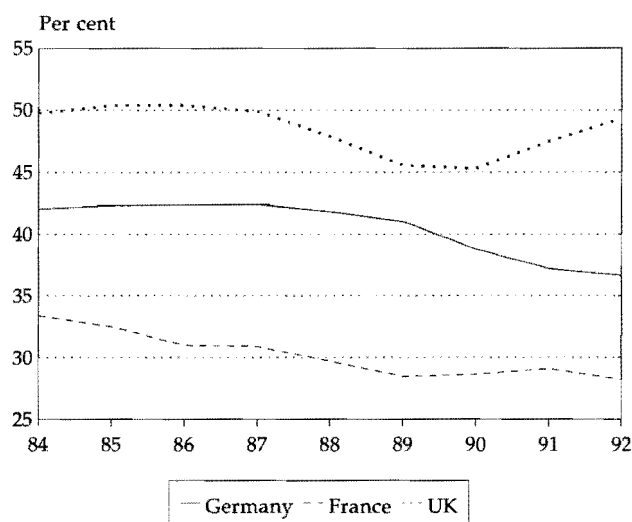


Figure 4.5 Share of mortgage credit to total credit, Germany, France and the UK 1984-92

These developments left a clear imprint on interest rates, credit demand and monetary growth. In 1987 and 1988, the growth of the stock of bank credit (and the money supply) was higher in the UK than in West Germany, even with sterling interest rates much above Deutschmark rates. But, in late 1991 and 1992, the growth of credit and money was higher in Germany than in the UK, at interest rates which were increasingly close together (see Figure 4.3).

In the 1970s and 1980s, clearing bank base rates averaged 12 per cent in the UK, while the stock of bank lending to the private sector usually grew by over 15 per cent a year. By contrast, in the autumn on 1992, clearing bank base rates were down to 10 per cent, but the growth rate of M4 lending to the private sector had collapsed and was still falling. Whereas in the six months to September 1988 M4 lending soared at annualized rate of 27.2 per cent, in the six months to September 1992 it went up by only 4.8 per cent.

The level of interest rates required to keep the pound inside the ERM plainly diverged from the level of interest rates consistent with economic recovery. Departure from the ERM, made obligatory by the massive foreign exchange speculation against sterling on 15 and 16 September, permitted a large decline in clearing bank base rate to 6 per cent on 26 January 1993. Signs of recovery became incontrovertible a few months later. The pound's problems — and the eventual need to leave the ERM — would clearly have

been less compelling had German interest rates been, say, 2 or 3 per cent per cent (i.e., 200 or 300 basis points) lower. The loftiness of Deutschemark interest rates is largely to be explained by the macroeconomic sequelae of reunification.

The causes of the French franc crisis in July 1993

A similar story can be told about the pressures on the French franc in July and August 1993. As Figure 4.4 demonstrates, the rate of growth of private sector credit — which had typically been higher in France than in Germany during the 1980s — decelerated markedly in 1991, 1992, and early 1993. By early 1993, France suffered from declines in house prices and commercial property values very similar in character to those which had afflicted the UK a year earlier. The state of its domestic economy therefore made it essential for France to lower interest rates, but this could not be reconciled with the franc fort policy in the ERM. The 2 1/4 per cent maximum band of currency variation allowed by the ERM had to be suspended on 1 July.

The purpose of this paper has been to analyse some less well-known aspects of the conflict between external and domestic priorities in monetary policy. In particular, it has shown that the intensity of credit demand (and so the rate of monetary growth) is much influenced by conditions in the housing market. The housing market is in turn affected by a host of variables — including demography, the tax system and other institutional factors — which have no direct connection with the traded sector of the economy. A number of potential inconsistencies have been identified between the domestic and external objectives of monetary policy. Most obviously, at an interest rate which satisfies the interest parity theorem, the rate of credit and money growth in one member of the ERM may be much higher or lower than in others. Either the domestic objectives of policy have to be compromised, or the country concerned has to break ranks from its ERM partners. This breaking of ranks may involve devaluation, revaluation or, in the extreme, departure from the system.

Capital controls may be the only way to overcome ERM tensions

Is there any simple means of overcoming the tensions between the three conditions (interest rate parity, purchasing power parity, the monetary theory of exchange rates) for the success of a semi-fixed-exchange rate system like the ERM? One answer would be restrict currency convertibility on capital account. Indeed, the widespread presence of such restrictions may have helped the Bretton Woods system endure longer than would otherwise have been possible. The ERM may also have been easier to defend before the dismantling of exchange controls in Italy, France and Spain in 1990 and

1991. However, it would be an ironic and deeply unsatisfactory outcome if the ERM, intended to promote European monetary union, were able to survive only on condition that the member countries separated their capital markets and banking systems.