

**BUCKING THE MARKET**

by

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## 1. INTRODUCTION

There is a growing consensus in Britain that urgent membership of the Exchange Rate Mechanism of the European Monetary System is required to cure Britain's inflation and to secure the re-election of the Conservatives at the next election. The argument put forward by proponents of membership is, however, flawed and many of those who argue for membership have secondary reasons unconnected with sound analyses of the problems facing the British economy. Most of these arguments skim swiftly over the economic reasons for membership to concentrate on the political or the future of the EEC. And, indeed, many proponents of ERM are also unapologetic supporters of full monetary union.

It is interesting that the clamouring for membership of the ERM is only now being put forward as a panacea for our inflationary problems. It was not so mooted as a cure for the inflation faced by Britain in the early 1980s. Is it a coincidence that the current calls for membership of the ERM occur at the same time as those in favour of full monetary union are pressing ahead on the next stage of their plan?

This paper seeks to scrutinise the major arguments put forward in favour of ERM membership - whether it be early membership, or even membership "when the time is right". It argues that membership of the ERM would not solve the problems faced by Britain. It seeks to establish this by concentrating on the following areas:

- i) by exposing the flaws in the economic argument in favour of joining the ERM;
- ii) by highlighting the political implications of membership.

## 2. PEGGED EXCHANGE RATES: THE FAILURE OF BRETTON WOODS

The experience of pegged, or fixed exchange rate policies, has been as disastrous as the various attempts at price and incomes policies. Both attempt to suppress the workings of the market mechanism, both have eventually collapsed in ignominy and both give rise to consequences that the policies were designed to eradicate. When a price or wage freeze collapsed, or simply ended, it was usually followed by a rapid burst of wage rises and price increases as people sought to catch up. Similarly, fixed exchange rate policies led to enormous speculative pressure against a currency as "fundamental disequilibria" in the exchange rate forced a realignment of the rate.

The fear of the free market that followed the depression of the 1930s, which led to the establishment of the welfare state, also gave rise to a new international monetary system. In 1944, at Bretton Woods in New Hampshire in the USA, representatives of the Allied Powers set about developing a system of fixed exchange rates and the establishment of the International Monetary Fund. The objective was to try to prevent fluctuations in the exchange rates between currencies that were caused by factors other than fundamental changes in the value of currencies. In other words, they were meant to prevent speculation and sudden crises of confidence. They were also meant to prevent countries from engaging in problems such as unemployment.

The system involved the US authorities agreeing to convert US dollars, held by overseas monetary authorities, into gold at a rate decided upon by the US. The overseas authorities would themselves then decide at what rate their currency was to be converted into US dollars. This rate was to be fixed within a narrow band and it was up to each authority to maintain this value by intervening in the market with its own reserves of gold or foreign currency (usually dollars and Sterling).

The only way in which this "pegged" exchange rate could be changed was as a result of a "fundamental disequilibrium" in the balance of payments.

The Bretton Woods system survived three major rounds of exchange rate adjustments but ultimately collapsed in the early 1970s after nearly thirty years. There were two principal reasons for its collapse.

The first was that with the increased volume of world trade that occurred in the decades after 1945, the reserves of the monetary authorities of each country in the system were soon insufficient

to counter the effects of short-term fluctuations in exchange rates.

The second, and more fundamental problem, was the realignments that were required as a result of long-term disequilibria. Such disequilibria became apparent to the markets as soon as, if not before, they became apparent to the monetary authorities. As a result, people wisely switched their money out of a currency which was believed to be about to be devalued. For traders in foreign currency it was a one-way bet, the worse that could happen was everyone knew which way it would go. Consequently, there were currency crises in the periods leading up to realignments. Rumour of a realignment could have disastrous effects on the foreign exchange markets, much more so than the crises of confidence that sometimes occur in a freely floating currency market.

The ERM has been in existence for eleven years but the pressures which led to the collapse of the Bretton Woods system are just as prevalent. To date the ERM has not been faced by currency crises prior to realignments despite there having been eleven in its short history. This is because they have been arranged in a way that results in the 2.25% bands, before and after the realignment, overlapping. There is, therefore, no guarantee of a profit from speculation. The realignments have been possible because only minor adjustments have been required. This would not be so if there were more turbulence in world markets which economic history suggests will be inevitable.

The fundamental problem with a fixed exchange rate system is that it requires a distinction to be drawn between day to day fluctuations in the currency and fundamental alterations in the value of a currency. Proponents of a fixed exchange rate have a misunderstanding of how the market place works. In all markets, the price mechanism supplies huge amounts of information about the level of demand for a product or commodity and its availability. In a freely floating foreign exchange market, hundreds of currencies are valued on a minute by minute basis. Speculators, who are more prevalent in a fixed rate system (and indeed in a system in which it is believed the authorities have a policy of maintaining a certain par value for their currency), act as arbitrageurs in a freely floating system ensuring that temporary disequilibria are ironed out more rapidly than they would otherwise be.

A free market system, without intervention by central banks, should lead to less volatile currency market. Exchange rates will move gradually, reflecting the changes that are slowly taking place in the economy. In a floating system, therefore, there is no need for periodic realignments of exchange rates, no need for central banks to decide whether pressures on a currency are temporary, speculative or fundamental, and there is no opportunity for central banks to make incorrect assessments of the true value of a currency.

Conclusion

The parallel between the ERM and Bretton Woods is clear and it is possible that, given a more turbulent world economic climate, the ERM could collapse too. Proponents of the ERM seem not to fear such a consequence and do not make such comparisons. Perhaps this is because they aim to take the system through to full monetary union which they believe to be more stable.

Assembling the material for the preparation of this paper has been enormously difficult to find a coherent argument in favour of joining the Exchange Rate Mechanism which is not based on wider political considerations. In assessing the benefits of membership it is necessary, in the first instance, to consider the long term international economic arguments for membership.

The ERM

The European Monetary System (EMS) was established by the ERM in 1979 and includes within it the Exchange Rate Mechanism (ERM). Member states of the EMS are members of the ERM and most are participants in the ERM - the exceptions being Greece, Ireland and the UK. The stated aim of the ERM is to achieve exchange rate stability but many see it as a method of maintaining the overall stability of the participants. When a country enters the ERM an exchange rate is agreed with which the country is permitted to diverge by 2.25% either way. Thus, if a country entered at a rate of 100 it would be permitted to fall to 97.75 or rise to 102.25. Such bands have sometimes been negotiated for the early stages of a country's entry. For example Spain entered in June 1987 with a band of 6.66%.

The two methods by which the objectives are kept within limits are automatic and manual. The first is for the central banks of participating countries to intervene in the currency market to buy or sell a currency which is falling or rising in the market place which threaten to take the exchange rate beyond its band. If a country's reserves are low it can only last for a limited period and will not be able to maintain its exchange rate.

The second method, which needs to control national price pressures, is for the government of the country whose currency is in danger to take domestic economic policy measures to reduce the trend. Principally, this involves raising interest rates. Thus, if a currency is falling, the government will be forced to raise interest rates and if the currency is rising, the government will be forced to lower interest rates.

It becomes apparent that neither of these actions is sufficient to reverse the pressure on the currency. The only way in which the ERM can agree to a change in the rate is a

### 3. THE ECONOMIC FALLACY OF THE ERM

In assembling the material for the preparation of this paper it has been enormously difficult to find a coherent economic justification for joining the Exchange Rate Mechanism which is divorced from wider political considerations. In assessing the benefits of membership it is necessary, in the first instance, to establish the long term fundamental economic arguments for membership.

#### What is the ERM?

The European Monetary System (EMS) was established by the EEC in 1979 and includes within it the Exchange Rate Mechanism (ERM). All member states of the EEC are members of the EMS and most are also participants in the ERM - the exceptions being Greece, Portugal and the UK. The stated aim of the ERM is to achieve exchange rate stability but many see it as a method of disciplining the domestic economies of the participants. When a currency enters the ERM an exchange rate is agreed from which the currency is permitted to diverge by 2.25 % either way. Thus, if Sterling entered at a rate of £1 to DM3 it would be permissible for Sterling to fall to DM2.93 or rise to DM3.07. Wider bands have sometimes been negotiated for the early stages of participation, for example Spain entered in June 1989 with a band of plus or minus 6%.

There are two methods by which the currencies are kept within their agreed bands. The first is for the various central banks of the participating countries to intervene in the currency markets to buy or sell a currency which is subject to fluctuations in the market place which threaten to take the currency beyond its bands. With finite reserves this intervention can only last for a limited period and will not withstand more deep-rooted pressures on a currency.

The second method, which seeks to redress medium term pressures on the currency, is for the Government of the country where currency is under pressure to take domestic economic policy decisions to reverse the trend. Principally, this involves alterations to interest rates. Thus, if a currency is falling, interest rates will be forced up. If the currency is rising interest rates will be forced down.

If, however, it becomes apparent that neither of these actions is effective in reversing the pressure on the currency, the participants in the ERM can agree to a change in the rate - a



realignment. This would obviously be a devaluation when the pressure on the currency has been downwards and a revaluation when upwards pressure has been the problem.

### The Long Term Arguments for the ERM

There are two principal economic reasons given for joining the ERM. The first is that it leads to stable exchange rates and the second is that it acts as a pressure against inflation in each of the economies of the participating countries.

#### (a) Exchange Rate Stability: the myth exploded

In a recent speech Samuel Brittan argued [1] that "the two obvious gains from ending or reducing currency fluctuations are the eliminations of transaction and uncertainty costs."

He quoted from a European Commission Report to Ministers on Economic and Monetary Union, published in March 1990, which states that a 100,000 ECU bank transfer across currencies costs, on average, 0.4% and increases to 12% for very small transactions.

Stable exchange rates do not lead to more than a marginal reduction in transaction costs. In a system of fixed exchange rates it is still necessary to exchange currencies and for accounts to be kept in different currencies for overseas operations. The argument that ERM leads to a reduction in transaction costs can only apply if ERM is seen to lead to a single European currency. Clearly if there was one European currency it would not be necessary to exchange currency within Europe. As discussed later, European Monetary Union (EMU) has enormous disadvantages which far outweigh the savings made in bank charges. As an argument for joining the ERM and not EMU the reduction in transaction costs is not applicable.

The second cost - uncertainty costs - are, according to Samuel Brittan, far more important than transaction costs. He admits that companies have little difficulty in hedging standard transactions in the forward currency markets but that it is more difficult to hedge long term transactions. He says:

"Unfortunately, floating exchange rates have not lived up to the hope originally placed in them. The problem is not short term fluctuations, but major swings and misalignments going far beyond the inflation differentials and other factors to which businessmen in principle could adjust."

Samuel Brittan seems to be arguing the case for monetary union rather than for membership of the ERM.

It is interesting that Samuel Brittan concedes that companies can adequately use the services of the City and high street banks to

hedge short and medium term currency fluctuations since many in the business community see this as the main advantage of ERM membership. It would be far more efficient if business were educated in using the facilities of banks to hedge their exposure to currency fluctuations than to involve Britain in fixed exchange rate mechanisms.

Businessmen may balk at having to pay banks for the service of removing the risk of exchange rate fluctuations but experience suggests that whenever national governments (let alone international governments) involve themselves in what the private sector can supply, it will invariably do so more inefficiently and at a greater cost. Thus, it is far better to let the private sector financial institutions take the risk of currency fluctuations than to involve government in action which attempts to remove the risk.

The argument that ERM removes long term fluctuations in exchange rates, which the private sector banking system cannot insure against, simply is not true. The ERM does not claim to do this. Realignments of exchange rate levels are seen as methods of redressing fundamental changes in the value of currencies. It does not remove uncertainties arising from long term investments or projects that are undertaken in foreign currencies.

Those who argue for the case for membership of the ERM on the basis of the advantages of stable exchange rates are in fact arguing for EMU. There are almost no advantages for business from ERM; the arguments put forward are those applicable to EMU.

#### Exchange Rate Stability - The Evidence

The claim that the ERM produces more stable exchange rates proves to be a myth when the evidence is examined. Between 1979 and 1988 there were 10 realignments, although it is fair to say that most of these were in the early years. But since 1979 the Franc has dropped by 47% against the DM. The Italian Lira has fallen by 64% against the DM. Outside the ERM Sterling has remained relatively stable and has only fallen 25% against the DM.

Table. 1

Exchange Rate Movements 1979-89

Year	DM/£	DM/FFR	DM/IL
1979	3.887	0.431	0.002206
1980	4.227	0.430	0.002121
1981	4.556	0.417	0.001992
1982	4.243	0.369	0.001794
1983	3.870	0.335	0.001681
1984	3.790	0.326	0.001620
1985	3.784	0.328	0.001536
1986	3.183	0.313	0.001456
1987	2.941	0.299	0.001385
1988	3.124	0.295	0.001349
1989	3.079	0.295	0.001370

Source: CSO Economic Trends

Nevertheless, as Table 1 shows, the recent history of the ERM has revealed less volatility among exchange rates and interest rates amongst the members, although not necessarily more convergence of interest rates. There are, however, a number of reasons for this stability, not least the strength of the DM in world exchange markets.

A fundamental reason for the stability has been the convergence of the rise in unit labour costs in France and Italy with those in Germany. There is a correlation between the rise in unit labour costs within a country compared to that of its competitors and the fall in the value of its currency against that of its competitors. (See Appendices 1 and 2.)

In the early years of the ERM when French and Italian unit labour costs were rising faster than those of Germany they simply devalued their currencies within the ERM. In recent years the stability of exchange rates in the ERM can be explained not so much as a result of the ERM but because France and Italy have brought their unit labour costs under control by adopting sensible monetary policies. It may well be that membership of the ERM has persuaded Italy and France to adopt such policies but ERM membership is clearly not a prerequisite to pursuing sound monetary policies. Since 1981 the rise in British unit labour costs has been broadly in line with those of Germany without Britain being a member of the ERM. (See Appendix 3.)

#### (b) Pressures Against Inflation - The Myth Exploded

The principal argument given for membership of the ERM has been that linking Sterling to the DM would act as a pressure upon domestic UK inflation. The independence of the German Bundesbank, with its tight monetary policy, acts to keep inflation at very low levels in Germany. By linking Sterling with the DM, it is argued, Sterling too will maintain its value and consequently inflation will be kept under strict control.

The logic is that, in the normal course of events, when inflation begins to rise, the inflationary cycle is allowed to continue as a result of Sterling falling in the foreign exchanges. Membership of the ERM, it is argued, results in the value of sterling being maintained thus preventing companies acceding to high pay settlements comfortable in the knowledge of remaining competitive as a result of a lower value of sterling. Such an easy option for Sterling is removed by membership of the ERM. The short term intervention of the European central banks would maintain the value of Sterling thus acting as a pressure to reduce costs to remain competitive.

In addition, it would be necessary for the British Government to take remedial action such as raising interest rates in order to ease the pressure against the pound and to avoid a potentially embarrassing realignment of the currency. In essence it is meant to act as an institutionalised mechanism to force member

Governments to act in an anti-inflationary manner. In the words of Robin Leigh Pemberton: [2]

"The ERM framework is often seen as one in which the Federal Republic [of Germany] through the disciplines exerted by the Bundesbank, provides the anchor against inflation, with other member countries pursuing domestic price stability essentially by maintaining a stable exchange rate against the Deutschmark"

He goes on to say:

"By pegging their currencies to the DM, other, more inflationary economies are likely initially to lose competitiveness against the Federal Republic [of Germany]. This in turn will tend to have a disinflationary effect upon the partner country - as its trade balance and the level of domestic activity declines with a moderating effect on prices and wages in that country."

The main reasons given for why the ERM acts to eradicate domestic inflation are therefore:

(a) that central bank intervention prevents a free market devaluation in times of inflationary pressure, and;

(b) that the system inflicts political pressure on domestic governments to eradicate inflationary pressures in the economy.

Both arguments are true and consequently it is argued that membership of the ERM is, at least, harmless and at best a positive influence. But the ERM does not remove government's need to conduct an anti-inflationary policy. The ERM is not a magic wand which will eradicate inflation. Government spending, monetary targets and interest rates will remain as key instruments in the battle against inflation. The advantage of the ERM is that it gives impetus to the policy, and in the case of socialist governments, an excuse to their own supporters as to why cuts in expenditure or high interest rates are necessary. This is certainly a factor in the Labour Party's recent conversion to the cause of ERM membership.

However, as the British Government demonstrated before 1988, membership of the ERM is not a precondition for lower inflation. As Table 2 demonstrates, an examination of the inflation records of the major economies over the past two decades shows that the 1980s were a better decade for inflation than the 1970s - both for ERM members and for those countries with free floating exchange rates.

Table. 2

Average Annual Inflation Rates (1)		
	1970-79 %	1980-88 (2) %
UK	12.7	7.4
FRANCE	8.9	7.8
ITALY	12.3	11.7
GERMANY	4.9	2.9
NETHERLANDS	7.0	3.1
SWEDEN *	7.9	7.4
USA	7.1	5.6
JAPAN	9.1	2.5

Notes: (1) Rates calculated using consumer price indices  
 (2) Latest year figures available

Sources: OECD - Main Economic Indicators  
 \* Institute for Fiscal Studies

We now approach the fundamental argument of this paper and the fundamental economic problem with the ERM and fixed exchange rates in general. The problem can best be put by describing the events of early 1988 in Britain and the Government's policy of pegging the £ to the DM.

Proponents of ERM membership argue that the history of Sterling in recent times has been one of long term decline against other major currencies such as the DM, and as such is part and parcel of the almost institutionalised inflationary cycle that plagues the British economy. They argue that pegging Sterling against the DM would help to halt the decline and add an institutional framework to halt the inflationary cycle. This argument, however, overlooks two important factors:

- a) What happens when the value of Sterling rises to the top end of the band, and
- b) The fact that membership of the ERM, or even of fixed exchange rates, cannot prevent fundamental falls or rises in the value of a currency.

#### The Upper Limit

The foundations for the recent inflationary resurgence in the economy were laid in early 1988. Following the stock market crash in October 1987 interest rates were reduced in order to ward off the threat of a recession. This coincided with an attempt by the government to "peg" sterling against the DM at around DM3.15. As a recent report by the City Merchant Bank, Salomon Brothers states:[3]

"...short-term rates were reduced sharply in the first half of 1988 as the exchange rate surged, but the policy shift extended the boom in a rapidly-overheating economy..."

Exchange rates are part of the workings of a free market system which has within it many checks and balances. Whatever the reason for the strength of Sterling in early 1988, had it been allowed to rise beyond the artificial ceiling imposed by the government, the effect would have been to put a brake on the economy at a time when it began to look as though it was overheating. Had Sterling been allowed to float upwards the effect would have been that British exports would have become more expensive (and imports cheaper). Higher export prices would have put pressure on firms reliant on exports to keep costs under control. It would also have reduced demand for British goods. In short, it would have acted as a safety valve in an overheating economy.

What in fact happened was that domestic interest rates were reduced in order to keep Sterling at its target level. Lower interest rates added to domestic demand while the artificially low level of Sterling removed any pressures on companies to keep

costs under control. Inflation picked up and the spiral of inflation began again.

Others say that this problem would be obviated by joining at the correct level. But who can say what is the correct level? Nigel Lawson in 1987 thought that the correct level was DM 3.15. This was disastrously wrong. Leaving such decisions to politicians rather than the market is bound to lead to entry at too low a level. There will always be pressure from industry for a low level of Sterling to reduce the pressure on them to keep costs under control.

In particular a Labour Government would be faced with pressure from the Trade Unions and the manufacturing lobby to devalue within the ERM if the alternative was higher short term unemployment. Although John Smith, the Shadow Chancellor, recently said [4] "Devaluation will not really be an option" it is significant that in the same interview he said that "of course, devaluation is not ruled out completely; there can be realignments within the ERM." His Shadow Cabinet colleague has gone further still and has questioned the desirability of maintaining the value of Sterling. [5]

Furthermore, there will always be political pressure against a revaluation. But, even if it were politically possible to realign Sterling at a high rate, it is unlikely that the necessity of doing so will be apparent. A rising pound acts as an early warning system in an overheating economy, but in a quasi fixed exchange rate system such as the ERM how do the administrators of that system distinguish such a rise from a rise caused by short term speculation? If a revaluation does not occur in these circumstances the economy will once again be faced with the same problems which arose following the policy to prevent Sterling rising to its natural level in early 1988.



#### 4. SHORT TERM ARGUMENTS FOR ERM

As June 1992, the last month the Prime Minister can chose for the General Election which will judge her government's third term, draws closer so arguments are put forward to show how early membership of the ERM can assist the Government's re-election. The peripheral argument is that joining would undermine a central plank of the Labour Party's attempts to appear to have a credible alternative economic policy from that of the Conservatives.

The main argument, however, was put forward by 'The Economist' on 28th April 1990 [6] in an article which appears to draw on the research carried out by Salomon Brothers [7] The argument is more political than economic and runs as follows.

The only way in which the government can win the next election is if inflation and interest rates are significantly lower. If the government were to reduce interest rates without joining the ERM, the Salomon Brothers paper argues that:

"... a monetary policy easing of sufficient size to reduce mortgage rates to desired levels will risk a Sterling crisis that would threaten a reversal of policies ... Without external support ... easing monetary policy sharply to encourage a reduction in mortgage interest rates will founder on the rocks of lower Sterling and higher inflation."

In the words of 'The Economist', "the trick [is] to cut interest rates without causing an immediate economic crisis." The Economist admits that joining the ERM for the purpose of achieving early cuts in interest rates will cause problems later.

The argument is that cutting interest rates would not only lead to lower mortgage rates but to a fall in the Retail Price Index (RPI) as mortgage costs decline. The way to avoid the financial markets reacting to the cut in interest rates would be to join the ERM. In so doing the government would, in effect, be guaranteeing the value of Sterling against the DM. If this promise were sufficiently convincing the pressure on Sterling from the financial markets would be lifted and lower interest rates permitted to remain.

In effect the policy would be a confidence trick, or as 'The Economist' says if the Government were to take this course of action it would have only "pretended to put the economy right". [8] The exponents of this argument concede that following the election the economy would once again be beset by inflationary

problems. For the policy to give rise to the electoral benefits of lower interest rates in the timescale envisaged, it would be necessary to join at a rate lower than required for the longer term health of the economy. As the Salomon Brothers paper cynically argues

"We contend that longer term policy conflicts will take a back seat in attempts to secure possible short run benefits of membership ahead of the election." [9]

If Britain were to join the ERM at a level above the current market rate interest rates could not fall sufficiently to result in a reduction in mortgage rates that would be large enough to have a major impact on headline inflation figures, nor indeed large enough to sweeten the mortgage-paying voter. In the words of Samuel Brittan:

"... a high entry rate policy might yield relatively large benefits in the second year after entry, but not until then."

Thus too late.

If Britain were to join at an exchange rate below the current market value, interest rates could be allowed to fall fairly rapidly. In the words of the Salomon Brothers report,

"Retail price inflation would fall, but only because of the artificial impact of lower mortgage rates. In contrast, underlying inflation would turn up six months after the devaluation and accelerate over the following year." [10]

To join the ERM at too low a level would reduce inflation figures for too short a time for the Government to safely hold (and win) a general election. The conclusion drawn, therefore, and the conclusion being currently mooted, is for Britain to join at a level just above the market rate. This, it is argued, would give rise to sufficiently low interest rates early enough to win the election. But the inflationary problems would not surface until well after a general election.

The leading article in the 'Financial Times' of 19th May 1990 put the argument against such a scenario very well. It argued that if Britain joins the ERM for the wrong reasons, that is to artificially bring down interest rates to win an election, the whole policy would be undermined.

The surge in the stock market which took place in the week ending 18th May 1990, as a result of rumours of impending ERM membership was, in the words of the Financial Times, "a suggestion of ignorance" of the economic effect of joining the ERM for the wrong reasons, and consequently at the wrong rate.

This ignorance is slowly being dispelled as the debate on the exchange rate level at which Britain should join progresses.

This debate is bound to accelerate in the next few weeks. The result will be a consensus that if Britain joins it should be at a high exchange rate. This will mean no short-term reduction in interest rates as a result of membership, no "golden scenario" for the Government.

The objective of the report is to show that membership of the ERM will lead inevitably to full European monetary and political union as set out in the De Larosière Report. It also states a number of points to be taken by Britain as to whether this is how it wishes to proceed. The time for that decision is now and it should be made before a decision is taken on entry into the ERM.

The Report of the De Larosière Committee was published in April 1973 and proposed moving from the ERM to a full scale "monetary and political union."

Stage One of the report requires all member countries to be full members of the ERM. It involves completion of the process towards the 1970 single market including a stronger competition policy. There will be closer monetary co-operation, and the strengthening of the powers of the Central Bank Committee.

Stage Two is a transitional stage leading to Stage Three which involves irreversibly locked exchange rates, a Central European Bank and ultimately a common European currency to replace national currencies. This new Central European Bank would be independent and would be responsible for monetary policy and exchange rate policy with countries outside the ERM.

The objectives of the De Larosière Committee are best summarized by General de Larosière, a proponent of monetary union, as follows:

"The official objective of the Community is not just monetary union, but economic and monetary union. The De Larosière Committee decided that what is meant by economic policy is fiscal policy - not so much taxes, but the balance of the various national budgets."

It is clear that the intention of the report is that as soon as all the member states are fully participating in the ERM and are

## 5. ERM IS MERELY A STEPPING STONE TO EMU

"The dilemma looming for the UK concerns more than ERM membership: it is nothing less than a commitment to accept a common European currency by the mid-1990s." [11]

"The impetus behind the drive for European money, and especially for full monetary union, is more political than economic. Many people favour the idea of European Monetary Union because they see it as a step towards a United States of Europe. Others are against it for that very reason." [12]

In this chapter it will be shown that membership of the ERM may lead inevitably to full European monetary and political union as set out in the Delors Report. At some stage a decision needs to be taken by Britain as to whether this is how it wishes to proceed. The time for that decision is now and it should be made before a decision is taken on entry into the ERM.

The Report of the Delors Committee was published in April 1989 and proposes moving from the EMS to a full scale "Economic and Monetary Union."

Stage One of the report requires all member countries to be full members of the ERM. It involves completion of the process towards the 1992 single market including a stronger competition policy. There will be closer monetary co-operation, and the strengthening of the powers of the Central Bankers' Committee.

Stage Two is a transitional stage leading to Stage Three which involves irrevocably locked exchange rates, a Central European Bank and ultimately a common European currency to replace national currencies. This new Central European Bank would be independent and would be responsible, inter alia, for determining monetary policy and exchange rate policy with countries outside the EEC.

The objectives of the Delors Committee are best summarised by Samuel Brittan, a proponent of monetary union, as follows:

"The official objective of the Community is not just monetary union, but "economic and monetary union", EMU.... The Delors Committee ... decided that what it meant by economic policy was fiscal policy - not so much taxes, but the balance of the various national budgets." [13]

It is clear that the intention of some is that as soon as all the member states are fully participating in the ERM and are

operating successfully within the  $\pm 2.25\%$  bands, the move to fixed exchange rates will follow shortly thereafter to be rapidly followed by irrevocable fixed exchange rates.

Robin Leigh Pemberton concedes that monetary union brought about Delors style could have dangerous consequences. [14]

"For example, economic shocks or domestic policy mistakes might cause competitiveness to get out of line from time to time. If exchange rate realignments were ruled out (as by definition they would be once a common currency was introduced), other means of adjustment would have to take the burden.

"This could result in persistent - or even cumulative - deflationary or inflationary pressures if for some reason - such as language barriers - labour mobility did not occur spontaneously. Any stickiness in nominal wages would tend to translate into unemployment or excess demand."

This consequence is also foreseen by Delors who responds by saying that increased regional aid across Europe will be the answer to unemployment caused by such "stickiness".

A Europe-wide economy dependent on a plethora of transfer payments is not the liberal free market that many in Britain believe to be the consequence of further European integration. It is, however, a direct consequence of fixed exchange rates and a common currency imposed on Europe before the real economy itself has become unified. A unified economy will develop naturally over time as barriers are removed and people become used to travelling and working across borders. It is at this stage that a common currency may well develop as a natural consequence.

It has already been demonstrated in this paper that the main motive which lies behind the vigour of many of the proponents of the ERM is that they see it as a stepping stone towards full monetary union, a single European currency.

Thus, arguments for membership of ERM are not confined to the economic arguments about the advantages of belonging to a fixed exchange rate mechanism. They extend to representing Britain's participation in Europe and symbolise its commitment. The argument runs that if Britain joins the ERM it will demonstrate our commitment to Europe and consequently will guarantee our participation in the debate about how Europe should develop. If we do not participate Britain will have no say in how Europe develops, but will be dragged, "screaming and kicking" into whatever system is decided by the others.

This view has been expressed by the Chairman of the National Westminster Bank, Lord Alexander. He says that while Britain is postponing its decision to join the ERM:

"In the meantime ... the concept of the European Community will continue to evolve. While Britain remains in self-imposed exile from the mainstream of European political and economic development, decisions will be made in its absence which will take the other EC member states further along the road to monetary union and a common currency." [15]

The point is, however, that joining the ERM, just as signing the Single European Act, does not just entitle Britain to participate in the debate over the future of Europe, it actually implies commitment it to a certain mode of development. The Delors Report spells this fact out when it says:

"... a decision to accept Stage one would be a decision to embark on the entire process."

Consequently it is important that the debate should take place prior to membership not after.

If Britain were to join, the pressure would then turn towards the next stage of monetary and political union, for example the establishment of a Central European Bank. Britain would be asked to support this development and it would then be argued that unless Britain participated in the project it would have no say in its development. And so on. At some stage Britain will have to ensure that the issue is confronted and debated.

A move towards European Monetary Union is more fundamental than such policies as the privatization of the water and electricity supply industries, moves towards lower taxation or the abolition of the GLC and the metropolitan councils. These policies were all included in various Conservative Party manifestos and so should a policy commitment towards full monetary union, if that is the direction the Government wishes to recommend to the British public.

## 6. CONCLUSION

The move towards a common currency certainly would not lead to any firmer control of inflation. As discussed above it is likely, in many circumstances, to lead to excess demand. Furthermore, the anti-inflationary pressure that is believed to derive from membership of the ERM does not come about as a result of co-ordinated exchange rates but as a result of each member state conducting domestic policies which are anti-inflationary. Whether a European economy directed by a Central European Bank would conduct an anti-inflationary policy would ultimately be up to the policy makers.

These policy makers would not be the British government, or indeed any national government. A move towards a common currency would remove national sovereignty in relation to monetary policy and lead to a major reduction in political and economic decision-making powers. Whatever safeguards were constructed to make the central bank "accountable" it would not be subject to the control of the British Parliament.

It may well be the case that the majority of the British people wish to transfer such a major area of sovereignty from the British Parliament to a new European institution. It is important, however, that they be given the chance to make the choice. It is now, before joining the ERM, that such a choice must be made.

If political and psychological arguments in favour of joining the ERM outweigh the economic arguments, it should be made clear that it will not be the panacea which some describe it as, and will be no substitute for sound national policy. It should also be made clear that the arguments for monetary union have yet to be made.

## 7. FOOTNOTES

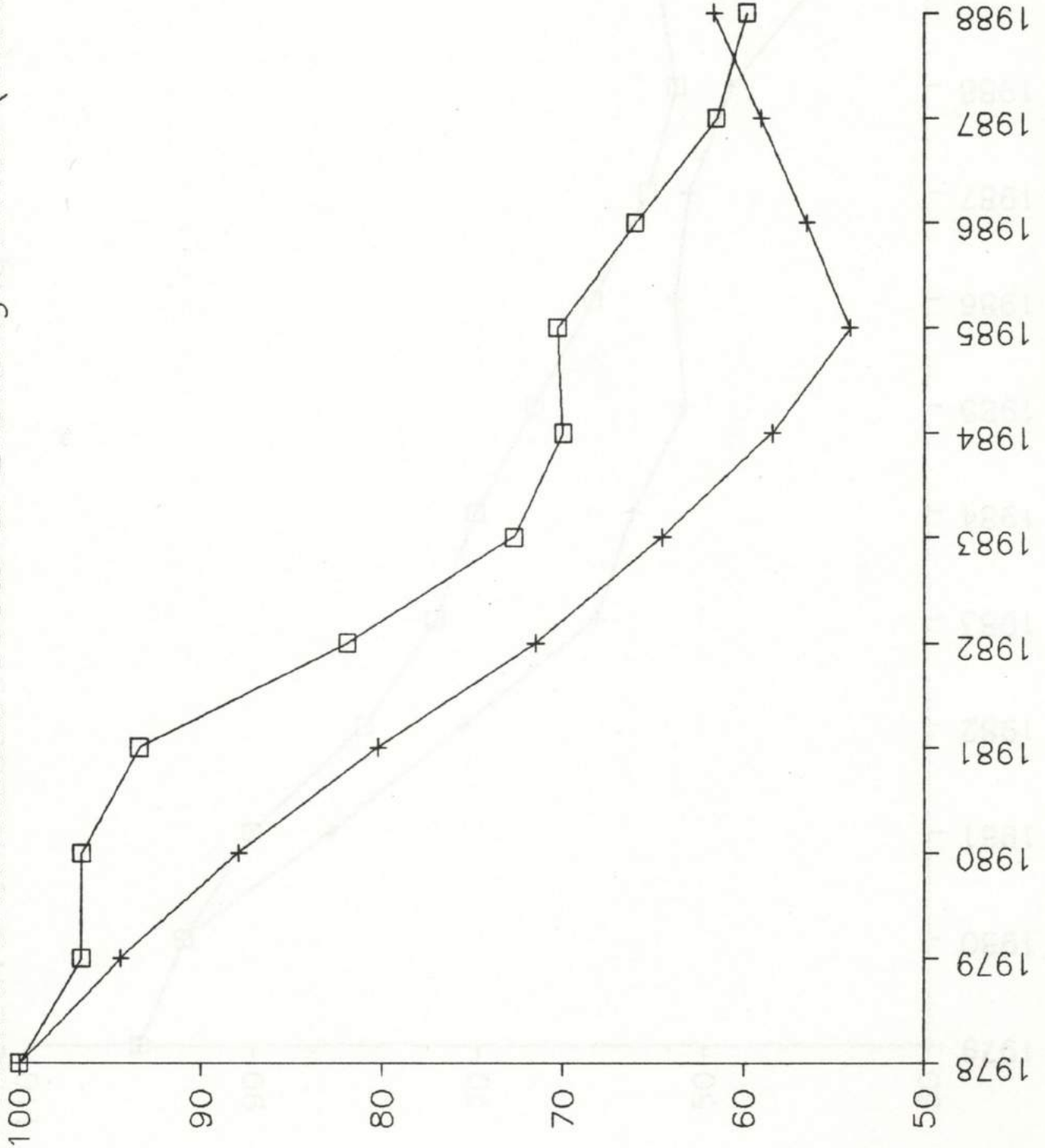
- [1] Speech to the Royal Society of Arts, April 1990
- [2] Speech to the West German Savings Banks and Giro Association. 16th June 1990
- [3] "When Will Sterling Join the ERM? - Domestic Versus European Timetables". Salomon Brothers, March 1990
- [4] 'The Independent on Sunday', May 6th 1990
- [5] "A Future for Socialism" by Bryan Gould, Published by Jonathan Cape, Pages 82-85
- [6] "With a Wave of the EMS Wand", 'The Economist'. 28th April 1990, Page 29.
- [7] "When Will Sterling Join the ERM? - Domestic Versus European Timetables". Salomon Brothers, March 1990A
- [8] 'The Economist' 28th April 1990
- [9] "When will Sterling Join the ERM? - Domestic Versus European Timetables". Salomon Brothers, March 1990
- [10] "When Will Sterling Join the ERM? - Domestic Versus European Timetables". Salomon Brothers, March 1990
- [11] "When Will Sterling Join the ERM? - Domestic Versus European Timetables". Salomon Brothers, March 1990
- [12] Samuel Brittan. Speech to the Royal Society of Arts, April 1990
- [13] Samuel Brittan. Speech to the Royal Society of Arts, April 1990
- [14] Speech to the West German Savings Banks and Giro Association, 16th January 1990
- [15] "The Observer", 22nd April 1990



Relative Unit Labour Costs & Exchange Rates (Germany/France)

—+— GR/FR ULCs

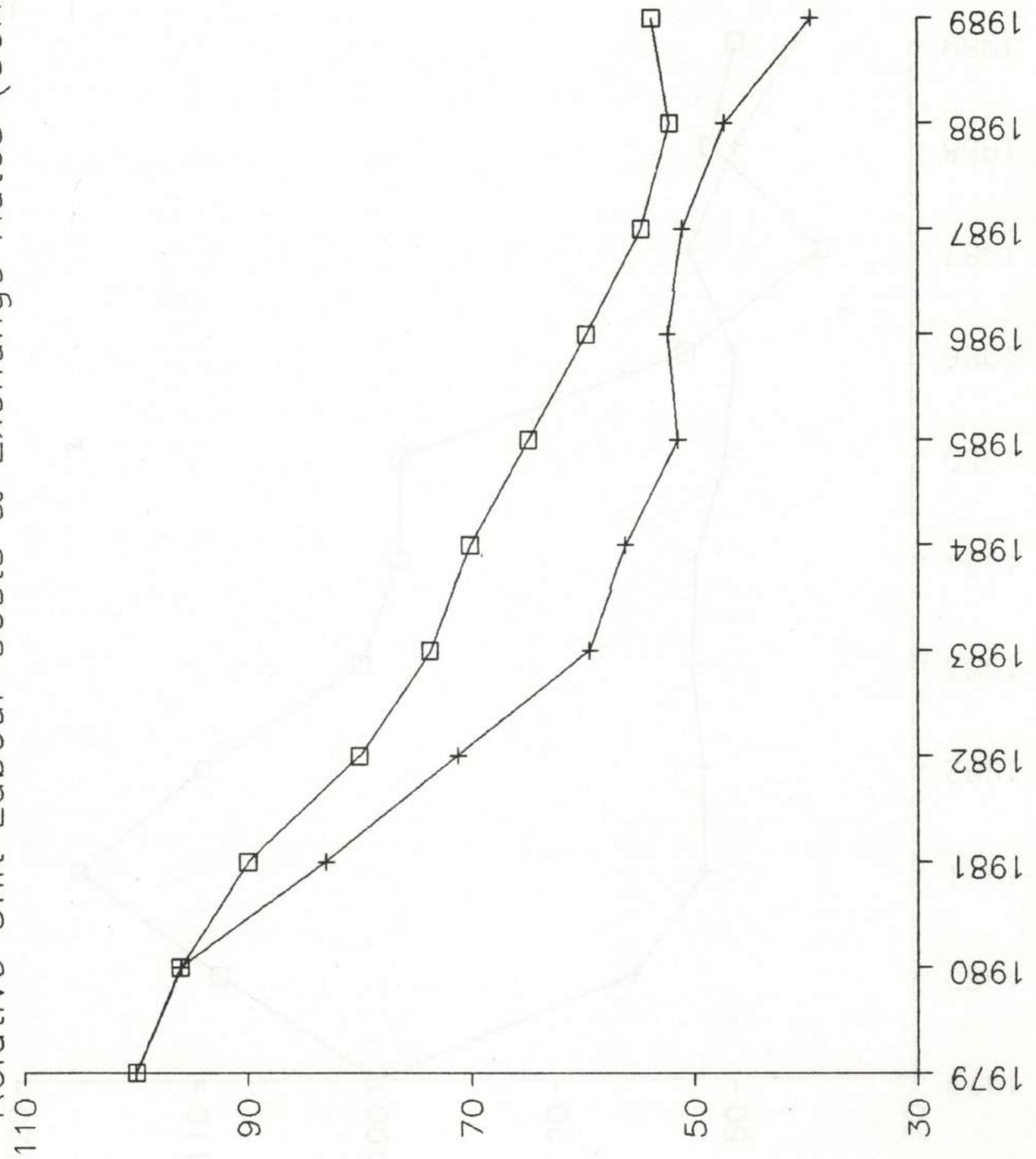
—□— DM/FFr ERs

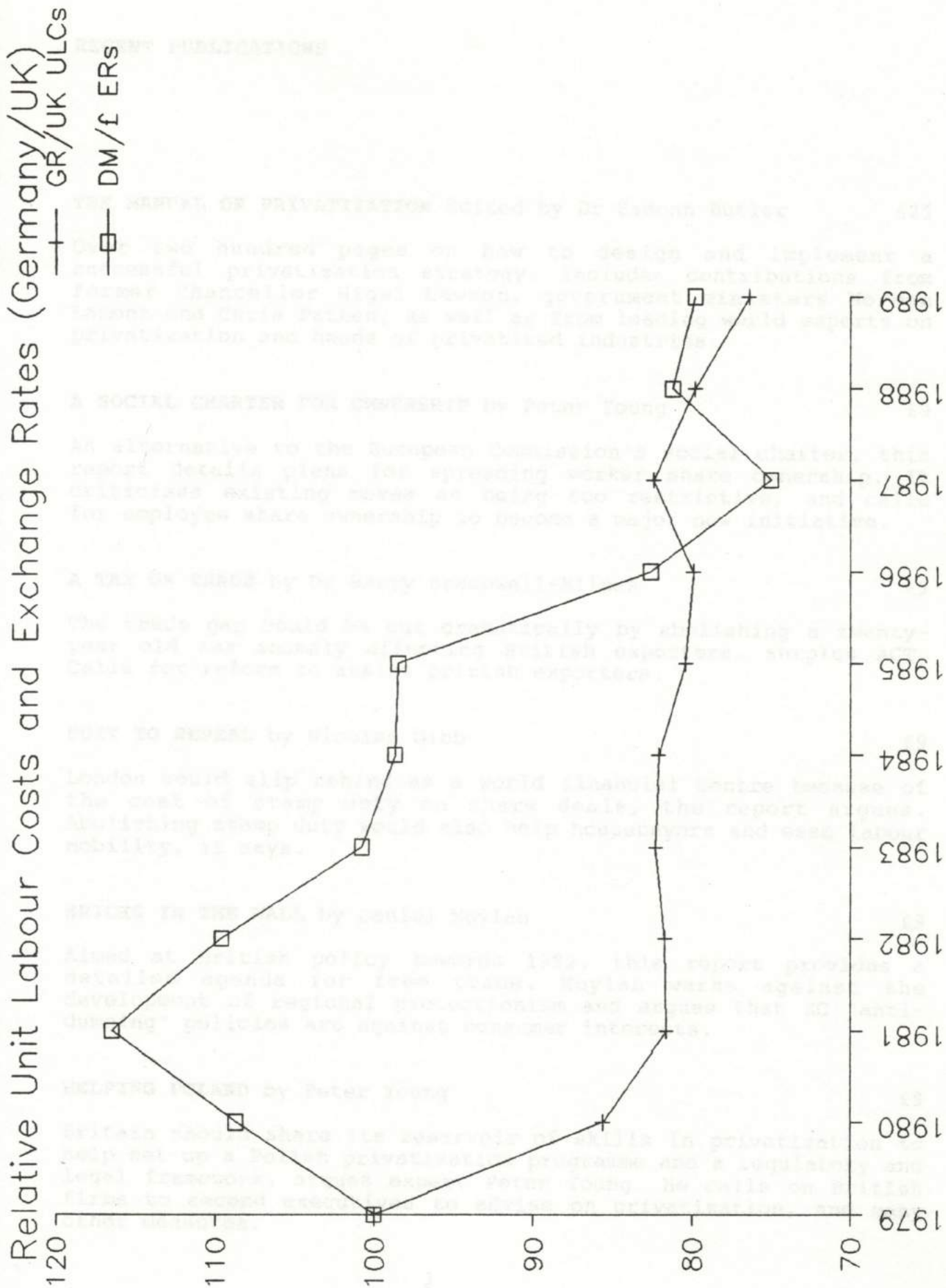


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