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ABSTRACT

The United Kingdom and the EMS*

The reasoning effectively governing the UK's abstention from the EMS has changed over time. Reservations were based initially on fears for UK competitiveness and subsequently on a desire to exercise monetary autonomy in a counter-inflationary 'medium-term financial strategy'. Difficulties with that strategy led to an interest both in policies to reduce exchange rate variability and in the EMS as an arrangement which could simultaneously serve this objective and provide a framework for controlling inflation. Commitment to an exchange rate reached its zenith in the 1987-8 episode of 'DM shadowing'. This episode revealed an early example of the 'excess credibility' problem. It suggests that if the UK were to participate fully in the EMS it might need to be prepared to make more active use of fiscal policy as a counter-inflationary instrument.

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NON-TECHNICAL SUMMARY

The paper deals with the progress of opinion about the desirability of the UK's full participation in the European Monetary System (EMS). Starting with the objections voiced by the Callaghan Government, which were based principally on an apprehension that a rigid EMS would condemn the UK to a loss of competitiveness, British opposition was sustained under the Thatcher government on the grounds that membership would prevent the exercise of independent monetary policy. However, practical experience in using monetary policy to bring down inflation encountered a number of difficulties. There was an unexpected and severe over-appreciation of the exchange rate and the monetary aggregates were disturbed by financial innovation. This laid the ground for a swing in policy towards the exchange rate.

At the same time the EMS proved itself to be a viable system in which an early phase of 'crawling' came to be seen as the necessary prelude to a gradual counter-inflationary hardening. The System scored important gains, relative to the UK, in exchange rate stability and then demonstrated that it could also be used as an effective framework for beating inflation.

While the appeal of the System for the UK grew for these reasons, some important problems remained. Sterling was seen as an important vehicle currency and membership as involving a close relationship between London and Frankfurt. Other major partners were protected by exchange controls. Fluctuations in oil prices had important implications for the sterling exchange rate.

An experiment in 'shadowing the DM' conducted over a period of 12-13 months from February 1987 might have demonstrated that these problems were manageable but in fact revealed a problem of 'excess credibility'. High UK interest rates were seen as over-compensating for exchange depreciation risk and the task of preventing the exchange rate from rising implied that interest rates were lower than desired. The problem can be viewed as a classic 'Tinbergen shortage' problem: there are two targets, inflation and the exchange rate, and only one instrument, the rate of interest. A theoretical solution is to free fiscal policy from political constraints.

In the circumstances, the experiment set back, rather than successfully advancing, the cause of EMS membership. While the government at the Madrid Summit was widely perceived to have made a significant concession in stating explicit conditions for full UK participation in the EMS, there is no other sign of increased commitment.

1. Introduction

The long-standing reluctance of the United Kingdom to participate fully in the EMS is well-known. To rationalize the decision to stand off from full participation a changing set of reasons has been offered by successive administrations and today there remains doubt about the substantive extent of the apparent change in approach evoked by the Madrid Summit of July 1989. This might be interpreted as a clear indication that there are deep underlying objective reasons governing the British attitude, were it not for the fact that large bodies of opinion in Britain outside the government (or, more precisely, outside prime ministerial circles) take a favourable attitude to the prospect of full participation. This suggests, rather, that the UK's continued non-participation merely represents a very particular sectional opinion.

However, this paper does not set out to be an exercise in political speculation. Rather, it takes as its theme the question whether economic analysis can provide some convincing reasons for the British attitude. The paper starts by reviewing the principal landmarks in the evolution of British opinion on the subject and goes on to examine more closely the particular reasons cited at the time for non-participation. It does appear that the method of conduct of British macro economic policy at the present time is inimical to joining the EMS; we draw this out in Section 3. However, this is not a fatal objection in itself although as will be seen the problem identified may not be peculiar to the UK. In conclusion we argue that there is no fundamental, uniquely British problem dictating a continuation of previous policy towards the EMS, though there may be a need for a special adaptation of the terms of entry. Whether this makes it likely that the Madrid "conditions" will be favourably interpreted when the time comes is left to the reader's speculative capacity.

2. The Time is Never Ripe (Right)

The Inception

The preliminary work to establish the EMS was undertaken during the period of office of the last Labour administration in the UK (that of Mr. Callaghan) and (up to a point) UK officials participated fully in it, as described in Ludlow (1982). Nevertheless, the Callaghan government declined to participate in the System it had helped to create on the grounds that to do so would be prejudicial to the economy's competitiveness. What the government had in view was that a system inimical to changing the exchange rate would impose a competitive penalty on an economy prone to inflationary shocks: as Mr. Callaghan put it in December 1978, membership of the EMS "would place obligations on us that might result in unnecessary deflation and unemployment". The history of the Labour Governments 1974–1979 clearly indicates the inflation-prone nature of the British system as it must have appeared at the time and the balance of payments crises of the period had equally given emphasis to the need to maintain competitiveness. However, it would be fair to say that there was also at the time considerable scepticism about the survival-chances of the EMS. The UK had, after all, been a member of the Snake arrangement for an exceptionally short period of time and it was easy to read the fate of the Snake as a forecast for the EMS. Opposition to membership of the EMS, at least at the start, was by no means confined to Labour Party opinions: the expert witnesses testifying to the hearings of the House of Commons Expenditure Committee on the subject in November 1978 were, unusually, united in their opposition to it. (See House of Commons, 1979, pp. 60-76).[2] In sum, dominant opinion in the UK foresaw the need to devalue more often than not and believed that the EMS, if successful, would tend to prevent this and so condemn the UK to an uncompetitive fate:[3] in any case, the EMS might well not succeed at all.

The Thatcher Government

Upon assuming power in 1979 Mrs. Thatcher's first administration had the opportunity to reverse the Labour Government's decision but did not do so. The reasons for remaining aloof from the System changed, however. The new government was intent upon beating inflation by following a gradualist monetary strategy: this preempted the EMS option as a regime of fixed or quasi-fixed exchange rates is inconsistent with an independent monetary policy. The full statement of the new policy - the Medium Term Financial Strategy (MTFS) - when it became available in 1980 was in fact unusually forthright in its explicit unconcern for the exchange rate stating that the exchange rate "is assumed to be determined by market forces" (see Table 1).

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2 This unusual display of unity among economists provoked comment from the Committee's Chairman at the time, as Ludlow (1982) notes. However, the reasoning offered for the common opinion was far from uniform.

3 There was a recrudescence of this view much later in a House of Commons Report in 1985, by which time, however, it had become unrepresentative of mainstream opinion.

TABLE 1

DESIGN OF THE MTFS: EXTRACTS FROM THE FINANCIAL STATEMENT AND BUDGET REPORT

March 1980

"To maintain a progressive reduction in monetary growth...it may be necessary to change policies in ways not reflected in the above projections...But there would be no question of departing from the money supply policy, which is essential to the success of any anti-inflationary strategy"... "The exchange rate is assumed to be determined by market forces."

March 1982(i)

"External or domestic developments that change the relationship between the domestic money supply and the exchange rate may...disturb the link between money and prices. Such changes cannot readily be taken into account in setting monetary targets. But they are a reason why the Government considers it appropriate to look at the exchange rate in monitoring domestic monetary conditions and in taking decisions about policy".

March 1982(ii)

"...Interpretation of monetary conditions will continue to take account of all the available evidence, including the behaviour of the exchange rate".

and

"....structural changes in financial markets, saving behaviour and the level and structure of interest rates".

March 1985

"....Equal weight will be given to the performance of M0 and £M3, which will continue to be interpreted in the light of other indicators and of monetary conditions. Significant changes in the exchange rate are also important. It will be necessary to judge the appropriate combination of monetary growth and the exchange rate needed to keep financial policy on track: there is no mechanistic formula".

"....The Government's overriding aim will be to maintain monetary conditions consistent with a declining growth rate of money GDP and inflation. Short term interest rates will be held at the levels needed to achieve this".

March 1986

"Policy will be directed at maintaining monetary conditions that will bring about a gradual reduction in the growth of money GDP over the medium term...."

"Monetary conditions are assessed in the light of movements in narrow and broad money and the behaviour of other financial indicators, in particular the exchange rate...."

"There is no mechanical formula for taking the exchange rate into account....a balance must be struck between the exchange rate and domestic monetary growth...."

March 1987

No target for £M3 "which remains difficult to interpret..."

March 1988

"A declining path for money GDP growth requires a reduction in monetary growth over the medium term".

"MO has continued to be a reliable indicator of monetary conditions".

"While, as last year, there is no explicit target range for broad money, the assessment of monetary conditions continues to take broad money, or liquidity, into account."

"Interest rate decisions are based on a comprehensive assessment of monetary conditions so as to maintain downward pressure on inflation. Increases in domestic costs will not be accomodated either by monetary expansion or by exchange rate depreciation. Exchange rates play a central role in both domestic monetary decisions and international policy co-ordination."

"The PSBR is now assumed to be zero over the medium term: a balanced budget. This is a prudent and cautious level and can be maintained over the medium term. It also provides a clear and simple rule with a good historical pedigree."

The Experiment in Action

The experience of the Thatcher government experiment in independent monetary policy produced widespread disillusionment and a swing of both opinion and policy in favour of exchange rate targets. The paper by Artis and Currie (1981) yielded an analytical landmark, providing as it did a comparison of the merits of monetary and exchange rate targets as intermediate means of the control of inflation. This was fertile ground for a further shift of opinion in favour of full participation in the EMS.

The Thatcher experiment turned out unexpectedly in a number of respects. First, far from adhering to its "gradualist" credentials the experiment involved, by mistake, a precipitate exchange rate appreciation and a sharp and deep economic recession. Secondly, the experiment succeeded in reducing inflation - ahead of what was being achieved in Europe - despite continuing large increases in the money supply, as measured in the MTFS by a broad money concept, £M3.

The principal causes of the surprise seem to be threefold: first, there was an autonomous shift (increase) in the demand for (broad) money; second, there was the impact of the second OPEC oil shock on the exchange rate as the UK became self-sufficient in oil at this time; third, there was a lack of understanding of the effects ("overshooting") on the current exchange rate of perceptions that policy was and would remain "tough".

The instability in the demand for money was particularly critical because an important ingredient in the new policy was its self-declared precommitment to a path of monetary deceleration. Because of this, to have executed a U-turn immediately after announcing the strategy would have been received as a first order defeat for the programme. Thus the degree of flexibility that might have been expected of policy was not present.

Nevertheless, the pressures were so strong that the stringency of policy was relaxed[4] and the policy itself reformulated so as to give greater room to the exchange rate in diagnosing the need for monetary correction; this was practised before it was announced but it was made very clear in the restatement of the MTFS in 1982. Tables 1 and 2 illustrates this change, together with the accompanying de-emphasis of targets for the broad monetary aggregate £M3, the subsequent de-emphasis of monetary targets altogether and their replacement by targets for nominal GDP with narrow money as an indicator variable. Several observers (e.g. Pliatzky, 1989) have complained that the MTFS offends the Trade Descriptions Act by describing as the same thing policies of quite different types; this point aside, however, it also seems clear that the most recent formal expression of the MTFS has entirely failed to capture the attention of informed observers. Rather, the dominant perception of current monetary policy is that policy actions focus on the control of interest rates with inflation as a direct target and the exchange rate as an intermediate one. (We return to this formulation later). In 1987, following the Louvre Accord, the Chancellor of the Exchequer hardened the concern for the exchange rate into a policy of shadowing the D-mark at a ceiling of 3DM to the £. Chart 1 illustrates the force of this policy.

This phase came to an end, amid recriminations, in February 1988 when the exchange rate was allowed to rise strongly and there was a return to a more pragmatic policy stance, one in which the exchange rate was certainly still important but not so privileged as it had been in the Louvre episode. The immediate cause of the recriminations is now recognized as the "excess credibility"

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4 Walters (1986) notes how evidence from Niehans was critical in this regard. Niehans' evidence consisted in showing that measures of narrow money indicated that policy had been very harsh - contrary to the impression generated by the over-target expansion of broad money. (For those who prefer to regard narrow money as an endogenous variable, Niehans' figures were simply another way of showing that the UK had entered a severe recession.)

Chart 1: STERLING/DM RATE

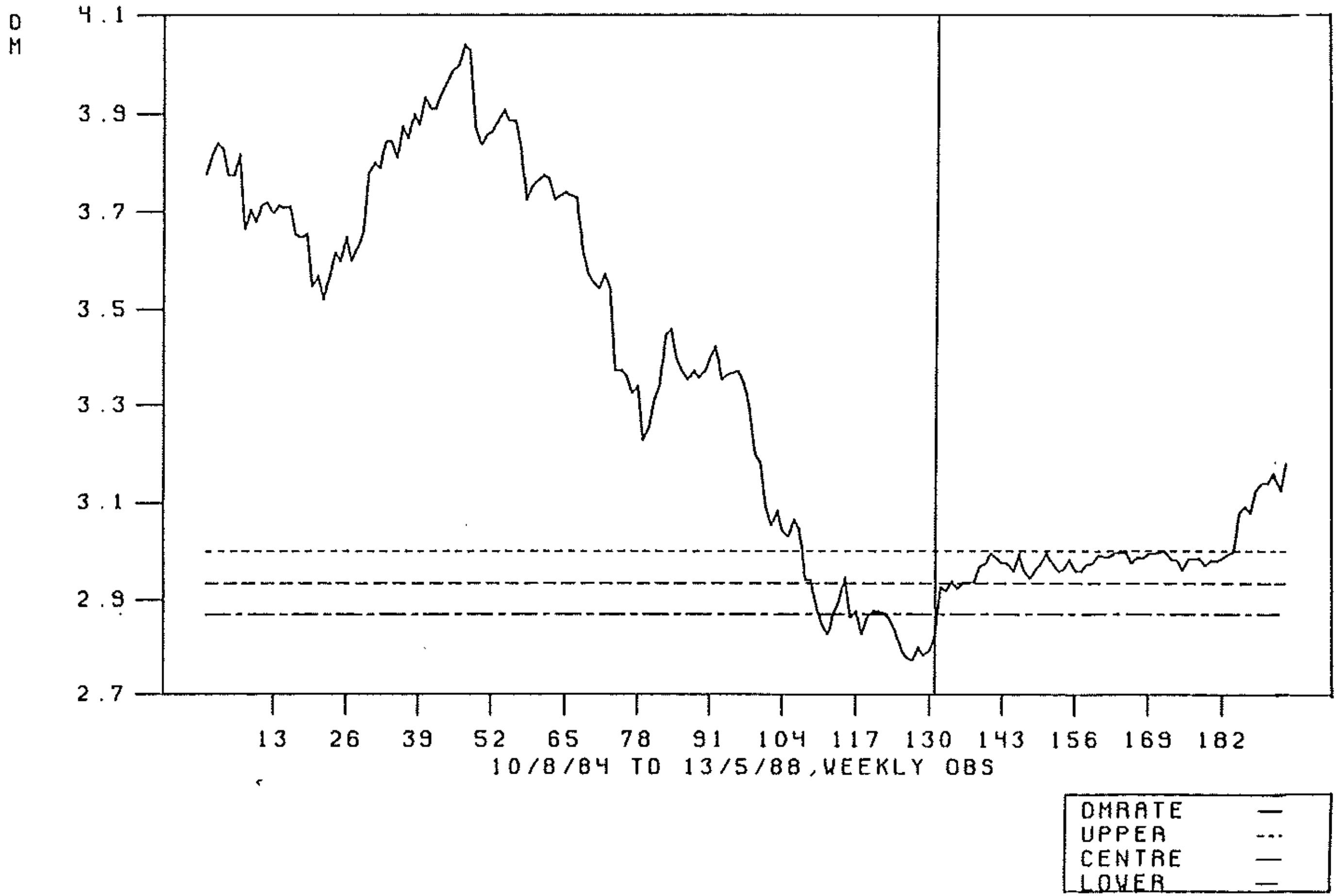

TABLE 2

CONTENT OF THE MTFS

	4-year forward ranges quoted
March 1980	£M3: PSBR
March 1981	£M3: PSBR
March 1982	£M3: M1; PSL2; PSBR
March 1983	£M3: M1; PSL2: PSBR
March 1984	£M3: MO; PSBR
March 1985	£M3; MO: Money GDP: PSBR
March 1986	MO; Money GDP; PSBR; £M3
March 1987	MO; Money GDP; PSBR
March 1988	MO; Money GDP; PSBR (zero)

1 Target ranges except as noted below. PSBR as % GDP

2 "broad medium term objective"

3 "illustrative ranges" for 1987/88 on

4 "illustrative ranges" for 1988/89 on

problem. During the period in which the policy of shadowing the DM was pursued there were signs of a gathering inflationary pressure (itself due to earlier stimulatory policies). But to prevent the exchange rate from rising beyond the unofficial ceiling of 3 DM required interest rates to be held down at a time when. for counter-inflationary reasons. a rise (and/or a rise in the exchange rate) seemed to be the required policy response.

There has therefore been a substantial evolution of policy in the UK. Starting from the pursuit of monetary targets without regard for the exchange rate through a 180 degree U-turn the opposite pole was reached during the 1987/8 phase of DM "shadowing". That phase might have led on. in other circumstances. to full participation in the EMS. In fact it was an experience which led to a restatement of monetary policy in which the interest rate is used to realize. directly. an objective for inflation. responding to the exchange rate in the light of this target.

Attitudes to the EMS

The policy evolution described above could not help but lead to a reappraisal of British attitudes to the EMS given the parallel and successful evolution of the EMS itself.

The House of Lords Report

A report prepared by a committee of the House of Lords in 1983 was an important early marker of this process of reappraisal. That report concluded that the UK should seek "early. though not necessarily immediate" entry into the full EMS (ibid.. p. xxiv). Important evidence provided to the committee included that of Neils Thygesen. Thygesen emphasised that the experience of the EMS to date provided evidence of considerable flexibility, in contrast to the rigidity which had been apprehended by its critics in the UK, whilst at the same time the System produced greater stability in exchange rates than might otherwise have come about. Thygesen also anticipated a future "hardening" of the System, much as has in fact eventuated. This achievement (and the prognosis) appealed to the Committee which, however, noted reservations about full UK membership of the System in two respects: first, the problem of oil; second, the prospect of speculation in what would be a "bipolar" (London-Frankfurt) system. At this time it was only just becoming possible to show that the EMS had exerted a stabilizing effect on exchange rates[5] - Sam Brittain in a famous phrase had been led by the System's flexibility in its early phase of operations to characterize it dismissively as "a mere crawling peg" (Financial Times, 24 March 1983). Nevertheless by contrast with recent *British* experience, there was an attractive degree of exchange rate stability. Moreover, the System had survived, albeit at the cost of incurring Sam Brittain's withering description; and it became clearer with the passage of time that this first phase of accomodating flexibility was the price of a survival which enabled the System thereafter to become a harder counter-inflation discipline.

The House of Lords Report presaged a considerable development of interest in the EMS within the UK. Two further parliamentary reports were to come, one each from the House of Commons (1985) and the House of Lords (1988) which were addressed directly to the issue, whilst a number of other investigations by the influential House of Commons Treasury and Civil Service Committee (e.g. the First Report 1981-82 and the Fifth Report 1983-84 and 1984-85) devoted a substantial amount of time to the EMS question. The policy evolution towards

5 See Ungerer et al. (1983).

an exchange rate target provided a natural trigger: it was easy to see that such a target would be more credible as part of an EMS commitment than as a go-it-alone option. The reduction of inflation in Europe at large brought attention to the possible benefits of using the EMS as a beneficial framework for counter-inflationary policies, reducing the costs of controlling inflation. The argument has been set in terms of the value of the added credibility given by a commitment to the EMS (which is in effect a commitment to a peg against a low inflation currency, the D-mark)[6] and has been given added strength by reason of the continued instability in the principal monetary aggregates. Thus, Currie and Dicks (1989) have argued that renewing the MTFS is an unconvincing option in view of its past history of changing content in the light of the unstable behaviour of the monetary aggregates (see Tables 1 and 2 again), leaving membership of the EMS as the only way of asserting a credible precommitment to a tough monetary policy. Implicitly, they rate the current policy of using interest rates to target inflation directly as lacking in precommitment value.

At the same time, the benefits of the EMS for exchange rate stability became ever better established. Many studies are now available to show that intra-EMS exchange rates have been stabilized by the EMS;[7] there is some dispute in respect of the effect of the EMS on member countries' overall effective exchange rates. It is perfectly possible that a country could find that in stabilizing its EMS (mainly DM-) rate it destabilizes its dollar rate with ambiguous effect for its

6 In a variant of this argument de Grauwe (1989) has argued that whilst the "short sharp shock" may provide credibility more quickly, because of the excess appreciation of the exchange rate, membership of the EMS may make it harder to lose credibility, once it has been earnt. It must be admitted that the facts do not appear to strongly support the value of the System as a counter-inflationary device - see Artis and Nachane (1989), de Grauwe (1989), Giavazzi and Pagano (1988).

7 Representative of the predominant approach is Ungerer et al. (1986).

overall effective rate.[8] This is particularly important for the UK, the composition of its effective rate being more heavily weighted towards the dollar and less heavily weighted towards the DM than that of any other EMS country.[9] However, trade patterns have changed markedly for the UK, as Table 3 shows. The data in the table show the proportionate weights in the effective rate indices of the dollar, DM, the ERM currencies as a whole and sterling, for the UK and for the ERM countries individually (excluding Spain). As can be seen, the proportionate weight of the dollar in the UK index has fallen between the old and the new indices[10] and that of the DM and the ERM currencies has risen sharply. Correspondingly, the weight of sterling for the ERM countries has risen along with the weight of the ERM currencies; that of the dollar has fallen sharply. As a result, the dollar has become *relatively* more important for the UK than for ERM members than it was, though the weight of ERM currencies in the UK index now exceeds 50 per cent. According to results obtained by Fratianni (1988) the operation of the System has in fact produced a net destabilizing effect on overall effective rates for most countries, though Artis and Taylor (1989), using different techniques, contradict this – albeit they find evidence of a less strong stabilizing effect on overall effective than on intra-EMS exchange rates.[11]

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8 This is, after all, simply the reverse side of Germany's interest in promoting an EMS in order to dilute the vulnerability of the DM to swings of opinion about the dollar.

9 These statements refer to the composition of the IMF's MERM-weighted effective rate indices.

10 The old index, based on 1977 total trade flows was replaced by the new one, based on 1980 manufacturing trade flows, in November 1988. The change in trade flow definition is responsible for part of the difference shown between the old and new indices.

11 Some opponents of EMS membership also stress the possibility of another "volatility transfer", from exchange rates to interest rates; however, Artis and Taylor (1987) find that EMS experience (which, however, may be dependent on the presence of capital exchange controls) does not confirm any such transfer.

TABLE 3

EFFECTIVE INDEX WEIGHTS (%)

	Old Index				New Index			
	$	DM	ERM	£	$	DM	ERM	£
UK	24.6	14.1	41.6	-	20.4	20.1	51.1	-
Belgium	16.2	23.2	62.0	2.1	9.2	27.6	65.8	10.1
Denmark	24.0	11.2	35.3	7.1	9.1	24.7	44.7	11.8
France	22.7	20.1	46.0	4.1	12.1	27.4	57.2	10.1
Germany	21.6	-	41.7	4.8	13.4	-	46.7	10.9
Italy	20.7	27.8	48.5	5.1	11.6	27.6	57.6	9.3
Netherlands	19.3	20.2	54.6	3.2	10.2	31.0	62.4	10.9

The figures show the weight in the index, for any country, of the currencies listed. "ERM" is the sum of the weights of the ERM currencies (excluding Spain). The basis of the new and old indices is explained in the source references. In the new index, introduced in November 1988, Australia was dropped from the list of countries involved.

Source: Quarterly Bulletin of the Bank of England, March 1981 and November 1988.

For these reasons, opinion at large in the UK has been increasingly receptive to the prospect of full participation in the System. Nevertheless, the dominant view in the British government has remained opposed. The change of formal approach at the Madrid Summit in July from the previous unspecific "when the time is ripe" conditional agreement to one in which explicit conditions have been laid down appears highly significant at some levels.[12] But whilst there is a clear sense that a concession was made, there has been no sense of a genuine shift in opinion: still less any sign of even qualified enthusiasm. It might be pointed out that there is little available by way of reasoned reservation either. However, the book by Alan Walters, *Britain's Economic Renaissance*, does contain some reasoned reservations and as his advice is influential with the Prime Minister it seems fair to assume that it may be consulted as an authoritative source to explain British government attitudes.

3. Reservations

The principal points of reservation mentioned either in official reports (including reports of parliamentary committees) or in Professor Walters' book are the following:

i. The vulnerability of sterling to oil price movements.

ii. The prospect of speculation in a bi-polar system.

iii. The loss of monetary independence.

iv. The exchange control "logic" of the EMS.

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12 These conditions are that, before entry: (i) there should be a lower inflation rate in the UK; (ii) exchange controls within the EMS should have been removed; (iii) sufficient progress should have been made towards the single EC market; (iv) financial services should be liberalized; (v) there should be agreement on competition policy.

v. The insufficiency of instruments to control competitiveness inside the EMS.

vi. The insufficiency of instruments to control inflation inside the EMS.

This is not an exhaustive list of reservations, but includes the principal serious and non-ephemeral ones: an associated issue - not so much a reservation as a comment on the terms of entry - concerns the rate at which to join and the width of the band. This we deal with in an ensuing section of the paper.

Oil. The problem posed by the "petrocurrency" status of sterling was twofold: normative and positive. First, "permanent" changes in oil prices ought to be allowed to affect the sterling exchange rate in the light of the UK's self-sufficient position. (HM Treasury calculations suggested, as of 1985, an elasticity of the equilibrium sterling effective exchange rate to the oil price of about .3 (see House of Commons, 1985, HMT Evidence, p.41).) There was a perception that this adjustment might not be conceded inside the EMS. The positive problem perceived was that oil price shocks would, willy-nilly, blow the System apart if sterling was not able to be revalued within it. In retrospect it may seem that both these concerns were overdone. Indeed, outside the EMS, sterling was vulnerable to an "excess" oil price response, which membership of the EMS might have removed (this point was made in the House of Lords Report).

Speculation. The problem of speculation was addressed more generally, e.g. by the House of Lords Report. The perception was that as sterling still retained some status as a vehicle currency, the potential for destabilizing speculative shifts of funds between sterling and the DM was bigger than the potential for such shifts between (say) the franc or the lira and the DM; in any case these currencies were protected by exchange controls. Continental observers exhibited some doubts about the capacity of sterling to adhere to the System without the benefit of such controls (see e.g. the evidence given by Melitz to the House of Commons 1985 enquiry).

The perception that sterling membership of the System might pose special problems of the management of speculation may have been reduced in the light of the System's increased capacity (since the Nyborg agreements) to counter speculation and the discovery by the UK Chancellor of the Exchequer of the "paradigm" EMS realignment - the changing of the central rate and bands without affecting the market rate.[13] Nevertheless, it remains a prominent consideration, recently cited by the Bank of England in its evidence to the 1988 House of Lords enquiry and again in the Governor's Speech reprinted in Bank of England (1989). The problem of speculation could be largely solved by sufficient cooperation but this raises the third objection, the key reservation of principle of the Thatcher government.

Loss of Sovereignty: Adherence to a fixed, or quasi-fixed exchange rate system makes a country's money supply and interest rate endogenous to that goal. Monetary policy cannot therefore be used to pursue any other policy goal. Although this is true, it seems fair to say that hitherto the proponents of EMS membership for the UK have so far had the better of the argument. In the kind of "natural rate" model taken as standard in much policy discussion these days, the only virtue of an independent monetary policy (and hence, a floating exchange rate regime) is the ability to "choose" a different inflation rate. But

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13 Peter Kenen (1988) has computed that some 70 per cent of EMS currency realignments have been of this type. The UK Chancellor advertised the paradigm to wider circles in his address to the International Monetary Fund in September 1987.

this choice seems a negligible advantage when the inflation rate apparently offered by EMS membership is so low and steady. Thus, broadly speaking, the point of the reservation has been accepted in logic but turned on its head in practice.

The Exchange Control "logic" of the EMS

It is notable, however, that until the recent trend towards the removal of exchange controls the existing member countries of the EMS did not feel too strongly the constraint upon their monetary independence. Rightly so, for exchange controls provide an added "degree of freedom" enabling a country to recover a degree of monetary autonomy.[14] Not accidentally, it is with the removal of these controls that the movement towards the EMU has been instigated, a movement which promises the recovery of a degree of sovereignty by sharing in a collective decision-making.

Short of the EMU solution, however, it is not difficult to appreciate why the EMS can be thought of (Walters, 1986) as predisposed towards exchange controls.[15] These yield monetary independence as well as serving a counter-speculative function. Since British policy abolished exchange controls in 1979 there was no inclination to be forced to adopt them again. (None of the proponents of EMS entry for the UK has argued for this, it might be noted).

Competitiveness: an insufficiency of instruments

This reservation is a repetition, essentially, of the Callaghan government's viewpoint, and also can be found, sharply expressed, in the 1985 House of Commons

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14 The exchange controls in force in Italy and France have been outward-looking, yielding an opportunity to maintain lower interest rates than otherwise would have been required.

15 See also, again, Melitz's observations on the question in House of Commons (1985).

Report. The argument is that nominal exchange rate variation is essential to control competitiveness and that this control would be jeopardized by membership of the EMS. The counter-inflationary objectives of EMS lend support to this view: for, with these objectives in mind, EMS policy has been to ensure that exchange rate realignments "under-index" the exchange rate as a means of exerting a discipline on inflation. Over the long run such a policy, in the face of persistent country-specific inflation shocks simply forces the real rates of exchange cumulatively away from equilibrium. There is some evidence that this is in fact what has happened: Artis and Taylor (1989) tested the intra-EMS bilateral-DM real exchange rates for evidence of "mean reversion". In other words, they looked to see whether real exchange rates appeared to be self-stabilizing or not. Their finding was negative: so far, real exchange rates seem to be drifting away from equilibrium. The competitiveness reservation has not so far re-established itself as a central objection, however, for two reasons. First, the real sterling exchange rate has fluctuated enormously during the late '70s and '80s outside the EMS. It seems inconceivable that it could have become as sharply misaligned had sterling been in the exchange rate mechanism of the EMS. Second, the efficacy of nominal exchange rate adjustment for *lasting* real rate adjustment is now widely questioned: the effects appear to be short term, though not unimportant.

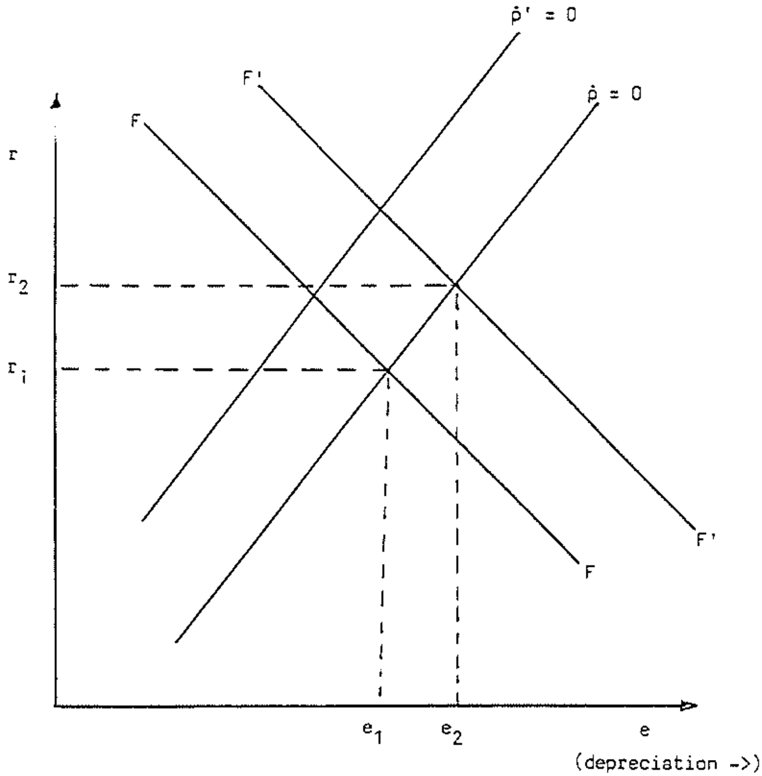
Inflation Control: an insufficiency of instruments

Perhaps more surprising at first sight is the objection that membership of the EMS would *not* yield the best available framework for beating inflation. But this reservation appears in Walters (1986) and is in fact now more than ever of significance in the UK.

In Walters (1986) the argument is put as follows: in a fixed exchange rate system, nominal rates of interest must be the same in every participating country. Then, a country experiencing a positive inflationary shock will find that its *real* rate of interest falls whilst a country experiencing a negative shock will experience a *rise* in its real rate. But these movements are *contrary* to the direction of adjustment required for a stabilizing reaction. The argument belies the EMS in that it ignores the possibility that a currency could be expected to fall (or rise) within the bands, but it is apposite for the case where the market invests the current exchange rate with credibility whether this be at the band limits or at an intermediate position.

In current policy conditions in the UK the argument can be restated as follows. There are two types of policy available in principle, fiscal and monetary; however, government spending is determined by medium term planning considerations having nothing to do with inflation whilst tax rates can only be changed once a year in one (downward) direction. This is a political constraint, but a constraint just the same. Monetary policy consists in changing the rate of interest with a view to hitting demand and the exchange rate, impacting on inflation. Diagram 1 (due to Walter Eltis) illustrates the argument. $p = 0$ is the locus of zero inflation combinations of the rate of interest and the exchange rate. FF is a foreign exchange market line relating the rate of interest and the exchange rate. If FF should shift - say to $F'F'$, then the rate of interest should be increased from r_1 to r_2 to offset the inflationary effect of the depreciation as the exchange rate depreciates from e_1 to e_2. Suppose now that $p = 0$ shifts, say to $p' = 0$. Then, for a given exchange rate, the rate of interest must be increased to keep inflation down. This cannot happen if the rate of interest is constrained to stay the same. The argument relies on less than perfect goods market integration (for in that case an exchange rate peg would be sufficient inflation

Diagram 1



control and $\rho' = 0$ would be vertical) and on the absence of an alternative stabilization tool. The former is a reasonable assumption but the latter is an imposed political constraint which could be removed: fiscal policy could be used -if necessary - to supply the counter-inflationary pressure required.

The argument is, however, important not just for the UK but for any other EMS country which may now experience an insufficiency of policy instruments to control inflation: once again, countries deploying measures of exchange control were in effect giving themselves an additional policy instrument which, under the provisions of 1992 they are constrained to give up.[16]

4. The Rate Upon Entry

Evidently some of the reservations mentioned are less important now than they were at the time they were first voiced. In other cases, perception of the scope for policy has changed so that former reservations are no longer so important. A problem that is recurrent, however, is that of the "appropriate rate upon entry". This problem is particularly important in current circumstances. There is a general perception that sterling is overvalued at the moment. For example, sterling was some 16 per cent above its "fundamental equilibrium level" in mid-88, as calculated by Barrell and Wren-Lewis (1989). Since part of the point of joining would be to ensure a favourable climate for counter-inflationary policy the option of "arranging" a prior devaluation does not seem very sensible. It might be possible to anticipate an early realignment, but the objection to this is that it would be undesirable from the viewpoint of credibility even if it

16 Currie and Dicks (1989) treat this difficulty as one only of transition. It is certainly true that the problem illustrated is most acute for a high inflation country like the UK contemplating a transition to low inflation inside the EMS. But the argument is just as true for inflationary shocks arising in an initially low inflation context.

was allowed. A solution is to join at the top of the band. i.e. with the central rate some way below the market rate.[17] This option might be extended to include a wider band. not only to accomodate a larger adjustment but also because this can be advocated as a suitable counter-speculative modification. With a wider band. speculative movements could be absorbed more frequently in a rate adjustment and would less often require an interest rate adjustment which might not be desirable on domestic grounds.[18]

Conclusions

The UK has remained aloof from full participation in the EMS so far. for a mix of reasons. One of these, the "petro-currency" reservation. has clearly waned in significance. Of the remainder, the speculative vulnerability of sterling in an EMS framework. if less strongly apprehended than was the case before Nyborg. nevertheless remains a plausible apprehension. Wider bands might be a suitable modification. The objection from loss of control over competitiveness suffers from comparing EMS membership with a hypothetical regime itself sharply different from what the UK has actually experienced. The other reservations hang together. Adherence to the EMS would undermine monetary sovereignty and failing solution by EMU or by exchange control, would compromise UK counter-inflationary policy as at present practised. However, there is a solution to this. so the reservation is not ultimately fundamental.

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17 Note that the solution of joining at the top of the band is only feasible if the "excess credibility" problem has already been solved: otherwise. the expected downward drift will not materialize and counter inflationary policy will be weakened as interest rates are reduced to prevent the rate rising through the top of the band.

18 Against this, if exchange rate expectations are extrapolative it may never be useful to exploit a wider band.

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