PRIME MINISTER

EXCHANGE RATE MECHANISM

There were a number of interesting pieces on the ERM over the weekend.

The first is a pro piece in the Economist. It argues that the commitment to sustain a specified exchange rate will have an important effect on expectations which will allow inflation to be brought down at a lower cost in unemployment.

The second, from the Sunday Times dismisses the expectations effect arguing that people will continue to press for higher wages or higher prices until they are actually hit by higher unemployment or lower profits.

The third piece is by David Morrison, Gavin Davies' partner in the economic team at Goldman Sachs. He points out that output and world trade have grown strongly in a decade of floating rates and that France and Denmark, while bringing down inflation, have suffered rising unemployment.

The final piece seeks to answer whether removing exchange controls will make a big difference to France and Italy. It observes that differences between domestic interest rates and Euro-currency rates for the franc and lira have all but disappeared, indicating that exchange controls are porous. It draws the inference that there will be not much further impact when the remaining controls are removed.

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Andrew Turnbull
6 November 1989

c:exchange (MJ)

# Why peg the pound?

**The disagreement between Nigel Lawson and Sir Alan Walters centred on whether it makes sense for the British government to try to hold its currency steady. The answer is that Mr Lawson was (mostly) right: it does make sense**

## ECONOMICS FOCUS

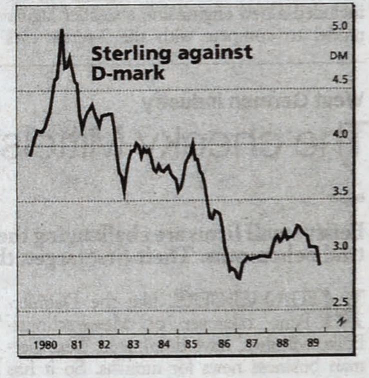
IN THE notorious article that precipitated Mr Lawson's resignation as chancellor, Sir Alan Walters described the EMS as "half-baked". In a way, it is. The system lies somewhere between a pure float (where currencies are moved to and fro by market forces) and a fully fixed exchange-rate system (such as the pre-1914 gold standard or a full monetary union with a single currency, where parities are irrevocably locked). Such a compromise does have drawbacks.

Problems arise for an exchange-rate system that is only semi-fixed if one country has a persistently higher inflation rate than the others. Supporters of the EMS would immediately reject the premise, and point out that the system has succeeded in bringing the inflation rates of countries like France and Italy (which used to be as inflation-prone as Britain) almost down to that of West Germany (the low-inflation anchor of the system). Yet if the system's supporters were fully confident of its power to make inflation rates converge, there would be no need for the option of realignments. The system could be fully fixed, not semi-fixed. In effect, a semi-fixed system presupposes inflation differentials, and hence the need to move the parities from time to time.

Very well. Suppose Britain takes its inflation into the system. Difficulties could arise in two distinct stages. In the first, monetary policy begins to work perversely. At the start, the currency markets will expect the floor under sterling to hold. British interest rates will therefore fall, because investors will no longer need to be compensated with high interest rates for their expectation that the pound will slide. Allowing for the difference in inflation, Britain's real interest rates might easily be lower than West Germany's. In which case, monetary policy would be looser in the high-inflation country than in the low-inflation country.

In the second stage, if the inflation differential persisted, the markets might begin to expect the pound to be devalued against the D-mark. Thanks to the first stage, this devaluation would have been both delayed and amplified by looser monetary policy. When it arrived it might therefore be big enough to cause large fluctuations in domestic interest rates. To take an extreme example, the belief that the pound had a 50% chance of being devalued by 5% within the next month would produce an interest-rate differential of 2½% a month (more than 30% at an annual rate) to offset it. An unappealing prospect: periods of monetary laxity followed by bursts of interest-rate volatility.

All this is a simplified, hypothetical model, and it leads to disaster. So why has disaster failed to strike the EMS? Sir Alan's answer is capital controls. By locking capital in at home, the governments of France and Italy (for instance) have been able to deny domestic investors the interest rate they would demand in a free market. Sir




Alan expects trouble next year, when the French and Italian controls are due to be removed. Time will tell. However, France (especially) and Italy have already shed many of their capital controls, with no sign of ill-effects as yet (see page 132). Moreover, realignments of the system have become increasingly rare. The system's ability to force inflation down has reduced the need for large and frequent parity changes, and thereby prevented pre-realignment jitters.

So the actual working of the EMS, it seems, has produced a quite different result from Sir Alan's hypothetical nightmare. On closer examination this should not be surprising.

Inflation is driven by expectations. Workers demand higher wages because prices are rising and expected to keep on rising; firms agree to pay up for exactly the same reason. One way to break this cycle is with a recession: rising unemployment tames wage demands, and shrinking markets force firms to keep prices down. In an open economy, another way is for the government to make it clear that it will not accommodate inflation with a currency devaluation. This tells companies that price rises will make their goods uncompetitive abroad, giving them a big incentive to resist higher costs.

This powerful discipline seems to have done the trick for the present members of the EMS. In Britain this discipline has been lacking. Since the early 1980s, when a rise in sterling (rather than a contraction in the money supply, please note) squeezed inflation down, the pound has been allowed to move erratically lower against the D-mark (see chart). With luck the anchor of a more stable exchange rate would have worked as well in Britain as it did for the other inflation-prone EMS members—though Britain's labour market is stubborn enough to leave an element of risk.

As well as luck, there are two other requirements for a successful anti-inflation policy. One is an undoubted commitment to defend the currency. If companies think they can persuade the government to devalue whenever they have priced themselves out of markets at home and abroad (as British firms do at present), attempts to stabilise the pound are likely to end in tears.

The other requirement is an instrument of policy to influence demand in the domestic economy, once interest rates have been devoted to the different task of pegging the pound. Without this extra instrument, a rise in demand (caused, say, by a change in attitudes to borrowing) can lead to a big increase in the external deficit even if the credibility of the exchange-rate target keeps inflation in check. If the external deficit gets big enough to undermine that credibility, the hard landing beckons once more.

Shadowing the D-mark in 1987 and 1988 failed because neither of these requirements was met. Mrs Thatcher and Sir Alan denied Mr Lawson credibility. But Mr Lawson denied himself the extra instrument he needed: fiscal policy. Saying it had no role, and thus tying one arm behind his back, he tried to use interest rates both to keep the pound steady and to control demand. In much of 1989, by unhappy coincidence, that was possible. In 1987 and early 1988, when the rot of excessive demand set in, it was not. Soon, the government will be torn between cutting interest rates to cushion the economy's slowdown, and keeping them up to prevent a slide in sterling. Pegging the pound makes sense—but you need both arms to be sure of success.

EXCHANGE MECHANISM NO PANACEA, SAYS BRIAN READING

# Is ERM all a bluff?

BRITAIN has lost a chancellor who was brilliant at reforming the economy but awful at running it. His fixation with fixed exchange rates was his undoing. Interest rates can be used to stabilise the currency, in which case the economy goes up and down; or to stabilise the economy, in which case the currency goes up and down. Nigel Lawson preferred the former, causing both the past boom and the coming recession.

Britain is more prone to inflation than West Germany. When we grow at the same rate, or when our unemployment is as low as theirs, our prices go up faster. Unless pegging the pound to the D-mark in some miraculous way changes this, all it will mean is that we have to accept slower growth and higher unemployment than Germany.

Lawson says that if the government shows itself determined to defend the currency, at whatever cost to the economy, unions will be more reluctant to demand higher wages and employers more reluctant to pay them. He believes that joining Europe's Exchange Rate Mechanism (ERM) is the best way for the government to show its determination. If he is right, inflation will be reduced without unemployment being increased. But it's a game of bluff which the government must lose. Politically no government can allow the economy to go to hell in a handcart to save the pound. It either caves in or is voted out.

Lawson has convinced many people that this time the bluff will work. ERM is the magic ingredient. The ERM is awfully complex. Simplifying it greatly, it works as follows. Upper and lower limits are set for every member's currency against each of the others. These mostly allow a maximum change of 4.5% from top to bottom. The French franc, for example, is allowed to move between Fr3.2792 and Fr3.4305 to the D-mark. The Bank of France is obliged to sell any amount of D-marks at the lower limit, Fr3.4305 to the D-mark, to stop the franc falling lower. The Bundesbank must sell any amount of francs at Fr3.2792 to the D-mark, to stop the franc rising higher.

Instead of waiting until the franc hits the floor, the Bank of France also sells D-marks at higher rates to stop it getting there. It does this when, measured against all currencies, the franc gets too weak. This automatic intervention keeps currencies trading in their given ranges, but it costs money. The Bank of France can therefore automatically borrow D-marks from the Bundesbank to support the franc, and vice versa. But ultimately the D-marks have to be repaid.

Intervention is reinforced by co-ordinated measures to deal with the economic forces making currencies weak or strong. Changes in interest rates are an example. But when all else fails, governments get together one weekend and agree new exchange rates between their currencies.

The ERM is thus a system in which exchange rates move very little from day to day, but occasionally move a lot over a weekend. These occasions are rare. The last was in January 1987. Another is expected shortly. But they occur.

As there is nothing in the system itself which makes economies less prone to inflation, it only works when member countries accept the growth rates and unemployment levels which the fixed exchange rates allow. Having stood high unemployment and slow growth as long as possible, governments devalue. In other words, they are bluffing.

If governments were not bluffing, exchange rates would be fixed for ever. Then we might as well all use the same money. That would be a good idea. As it is, the ERM is a half-baked half-way house between sensible floating and a sensible single European currency.

Keynes had a lot to say against this sort of nonsense. In his day, differing price levels were more important than the rate at which prices were rising. But his remarks apply equally to efforts to slow inflation. He opposed Britain's return to gold in 1925, because at the pre-war parity British prices were 10% higher than German prices. In the 1925 pamphlet "The Economic Consequences of Mr Churchill", who was then chancellor, Keynes argued that Churchill was "committing himself to force down money wages and all money values, without any idea how it was to be done".

Keynes wrote: "If everyone was to accept a similar reduction at the same time, the cost of living would fall, so that the lower money wage would represent nearly the same real wage as before. But in fact there is no machinery for effecting a simultaneous reduction."

He did not think the return to gold would itself cause all money wages and prices to be lowered simultaneously. So he continued: "Deliberately to raise the value of sterling money means, therefore, engaging in a struggle with each group in turn." This should continue "until those who are economically weakest are beaten to the ground".

Further on, Keynes says: "To begin with there will be a general depression in the export industries. This in itself will be helpful, since it will produce an atmosphere favourable to the reduction in wages. The cost of living will fall somewhat" ... but not sufficiently until ... "wages have fallen in the sheltered industries". And this, he believed, could only happen through unemployment in those industries.

The way to do this is by credit restrictions through the Bank of England. These can deliberately intensify unemployment until wages do fall. Keynes told Churchill that "it would not be politically safe to admit that you are intensifying unemployment deliberately in order to reduce wages". The pound cannot be permanently pegged to the D-mark unless British inflation slows to German levels. Joining the ERM will not persuade anyone to be first to accept smaller wage rises. Everyone will wait for inflation to come down. It will not do that until unemployment goes up.

Every time the pound has been fixed and chancellors have tried to force wages and prices to adjust to the exchange rate the results have been disastrous and they have failed. There is nothing in the ERM to ensure things now will be different. So the same goes for Lawson.

*From Mr David Morrison.*

Sir, The attitude of several politicians, and the Financial Times, to semi-fixed exchange rates in general and the EMS in particular is unjustifiably biased.

The support for these exchange rate regimes lacks beef. I make the following practical points in defence of flexible exchange rates.

- World trade volume has increased by an average 6 per cent a year between 1983 and 1989; a period of turbulent exchange rates.
- Industrial countries' real GNP growth has averaged 3.5 per cent a year over the same period. There has been no recession in the Group of Seven, as a group or in any individual country, during this period.
- Inflation in the G7 has averaged 3.8 per cent a year over 1983-1989; it has been low and stable in recent years, and the dispersion between high and low inflation economies has narrowed markedly.
- Investment as a share of real GNP in the G7 has risen sharply through this period – from about 20 per cent to 23 per cent.

Yet many commentators seem to believe that the flexible exchange rates have harmed the world economy. Where's the beef?

Leaving aside Professor Sir Alan Walters's timely criticism of the exchange rate mechanism, Mrs Thatcher's desire for fair play on cross-border financial flows and services, and vague notions of the UK being a "bad European," it would be at least honourable to write about the costs of entry to the ERM, as well as its supposed benefits.

First, while it may be true that French inflation is lower now than it would have been had the French franc stayed out of the ERM, it is well-documented that the French "sacrifice ratio" (the unemployment cost needed to reduce inflation) has been substantially higher than Britain's.

And it is more than arguable that the recent deterioration in this unemployment/inflation comparison for the UK is a direct result of ill-judged attempts to peg sterling to the D-Mark, first at too low and then too high a level.

Second, compare the Danish débâcle with the French "miracle." Real GNP growth in Denmark in 1987 was minus 0.7 per cent, in 1988 minus 0.4 per cent and this year 0.8 per cent. Over the same period inflation has risen to 5 per cent from 4 per cent, unemployment has climbed, and short-term interest rates have been in double-digits almost throughout the period. Ask a Dane if there is beef in an ERM-burger.

Flexible exchange rates are to the world economy what oil is to a Formula I car: you need movement to lubricate the system efficiently.

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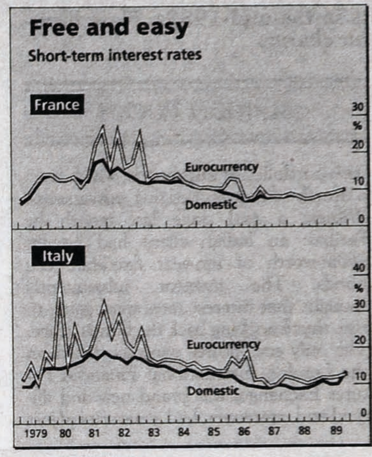
FINANCE

Exchange-rate mechanism

# Premature entry?

IN JULY 1990 France, Italy and Belgium must abolish their remaining exchange and capital controls under the first stage of the Delors plan for greater European monetary convergence. Spain and Ireland have until 1992, Portugal until 1994. Open to the currency winds since 1979, Britain has used the lingering of these continental controls as an excuse to delay its own entry into the Exchange-rate mechanism (ERM): no point in entering the mechanism, so the argument runs, if it is going to unravel at the first sign of French franc or lira weakness once capital flows are free. Are such fears exaggerated? They are.

France and Italy have already removed most of their controls and the ERM looks more stable than ever. Tax-cheating Frenchmen still cannot open a foreign bank account (though companies can). But there is not much else left to scrap. Italy has only a bit more to do. Italian individuals cannot hold foreign bank accounts, nor can they buy certain short-term assets. But in both countries the really powerful constraints—ones preventing companies from moving money abroad, or from advancing or delaying trade payments, or from borrowing their curency to sell it—have largely gone. Spain, too, has seen much liberalisation; few restrictions on non-peseta borrowing remain.




One test of the effect of the remaining controls in France and Italy is to compare the interest rate in the protected domestic money market with that in the unregulated Euro-currency market. The more extensive the controls, the wider the divergence in rates (see chart). Once Britain abolished exchange controls in 1979, its two rates converged. In the early 1980s there were big differences in the rates for France and Italy, reflecting pervasive controls. As these were relaxed, differences have narrowed—perhaps because governments chose to keep domestic rates in line with the Euromarkets'; more likely, because the remaining controls are having no significant effect.

As it happens, as controls have been relaxed, many of the liberalisers have seen large net inflows of capital. Money goes where the return is highest. Spanish and Italian interest rates are among the highest in Europe. Last year the inflow of capital into Italy was roughly twice the size of the current-account deficit; similarly with Spain (so both countries' reserves incrased). The peseta and the lira face upward pressure on their exchange rate. After the Bundesbank's more recent rise in interest rates, Spain and Italy were the only two ERM members not to follow suit.

The absence of exchange and capital controls in the weaker-currency countries will make it more difficult to postpone exchange-rate realignment when (and if) the market thinks one is inevitable. Postponing inevitable realignments is not a good idea anyway; it just adds to uncertainty. If countries want to peg their rates to the D-mark they have to run similar monetary policies as the anchor country, West Germany. This is the lesson France has learnt. Inflation there is 3.4%, just 0.1% higher than in West Germany, the smallest-ever difference.

Malaysia's and Singapore's stockmarkets

# Separating the twins

KUALA LUMPUR

THE dowdy Kuala Lumpur Stock Exchange has long suffered from an inferiority complex towards Singapore's, its more sophisticated rival to the south. So now the Malaysian government is doing something about it. All companies incorporated in Malaysia are to be made to cancel any joint listing on the city-state's stockmarket. The decision will halve the S$112 billion ($57 billion) capitalisation of the Singapore market. For Kuala Lumpur's stockbrokers it is the best news in years—if, a big if, they can handle the increased business that should now come their way.

Datuk Daim Zainuddin, Malaysia's finance minister, announced the decision in his budget presented to parliament on October 27th. Both markets fell when they reopened for business on the following Monday. Investors were flummoxed as to how the decision will be put into practice.

The move is no surprise. Once as close as Siamese twins, the two markets have been drifting apart. They have different listing requirements and use different trading and settlement procedures. Since 1987 Malaysian companies have been banned from seeking a new listing in Singapore.

Of the 317 companies quoted in Singapore, 182 are incorporated in Malaysia. So far this year the volume of Malaysian stocks traded in Singapore has been greater than total trading in Kuala Lumpur. By comparison, only 55 Singaporean companies are quoted in Kuala Lumpur, out of a total of 300. They account for only 2% of trading.

C'mon back, Sime

Singapore's dominance has been helped by being in favour with foreign investors, some of whom would have trouble finding Kuala Lumpur on a map. They tend to stick to blue chips such as Sime Darby, a diversified Malaysian conglomerate with a market capitalisation of M$4.8 billion ($1.8 billion). On October 30th, for each Sime Darby share that changed hands in Kuala Lumpur, 13 were traded in Singapore.

The Kuala Lumpur exchange will have to grow up a lot to cope with this increased business. It will need to automate its trading and to establish a centralised clearing system. Local brokers also have much work to do. In 1986 the rules were changed to let local banks take stakes in brokers. Some of the larger outfits that have emerged, such as Arab-Malaysian Securities, have the capital to provide liquidity to a larger market, but few can produce research that matches that from Singapore.

Foreign securities houses are only allowed to buy an initial 30% stake in a Malay-