Some remarks on exchange rate regimes

*Commenting on the background to sterling's entry into the exchange rate mechanism, the **Governor** reviews[(1)] post-war experience with both fixed and floating exchange rate regimes, including the ERM. He notes the benefits others have obtained through pursuit of rigourous counter inflationary policy within the framework of the ERM, and expresses his confidence that the United Kingdom too will make a success of membership by maintaining its firm anti-inflation policy.*

*The **Governor** goes on to discuss some of the issues in the debate on economic and monetary union in Europe, arguing in particular that monetary union would only be feasible when the individual economies had converged sufficiently no longer to need divergent interest rates. Given that such conditions are a distant prospect, he urges the advantages of the United Kingdom's 'Hard Ecu' proposals as a more practical and attainable way forward.*

Mr President, it is a very great pleasure to join you here this morning. This is my first visit to Japan for some years and I am therefore anxious to learn as much as possible about conditions here and your perceptions of developments in Europe, and particularly the United Kingdom. Given business is the heart of our economic life and the source of our prosperity, I especially welcome this opportunity to meet representatives of Japanese industry and commerce. I am delighted Mr President that it is the first meeting in my schedule.

Although it may sometimes seem that central bankers are interested exclusively in complex economic models and in official statistics showing the aggregate position of the economy, the reality is of course somewhat different. In the United Kingdom, the Bank of England greatly values its relationship with individual businesses. We have a number of small branches around the country and one of their main functions is to pass on to Head Office their impressions of how the local business community is faring. This anecdotal evidence is extremely valuable as a complement to our analysis of the monetary data and real economy statistics. In recent weeks and months, for example, it has greatly added to our confidence that the UK economy is slowing down and that inflation is due to fall substantially next year, in response to the tough monetary policy we have pursued over the past eighteen months or so.

It is this confidence that underpinned the decision of the British Government to announce on Friday a very modest interest rate cut—from 15% to 14%, which remains high and tough; and sterling's entry into the exchange rate mechanism of the European monetary system. This is a great event in our economic life. It is something I have looked forward to for a very long time.

Sterling's participation in the ERM will have very considerable implications for UK businessmen, Japanese among them, and also I think for our trading partners; implications, I should stress, that I believe can be profoundly beneficial in the long run. ERM membership will also have implications for world foreign exchange markets since sterling has remained one of the most heavily traded currencies. We owe it to our colleagues here in Japan to explain the background to, and effects of, our membership. And I shall be doing that in my private meetings with Governor Mieno and Finance Minister Hashimoto.

Before our discussion begins, I hope you will therefore permit me to make some brief remarks on the exchange rate mechanism.

Fixed *versus* floating rates

All of us here recall the difficult conditions in foreign exchange markets in the late 1960s and early 1970s, and the broader problems they created. The Bretton Woods system had, we should not forget, served the developed world well in the post-War period. But for a variety of reasons it became unworkable; growing current account imbalances and, critically, a reluctance in some countries to bear down sufficiently upon inflation were just two of the reasons. The move to free floating ushered in a new era of international finance; almost a new world.

Our experience of floating has been mixed, however. I do not doubt that the decision to wind up Bretton Woods was the right one in the circumstances of the day, but equally we should not hide from the fact that a world of floating exchange rates has been less satisfactory than we all hoped, and many expected.

(1) In a speech to the Keidanren, in Tokyo, on 8 October.

The most obvious costs have stemmed from the propensity of rates to overshoot—in both directions—and the exceptionally high levels of volatility. Financial markets have, as one would have expected, found partial solutions to the volatility problem, developing an array of hedging techniques. Techniques that are, however, inevitably imperfect and by no means costless. I think it is hard to contest the argument that exchange rate volatility has complicated both business planning and the operation of macroeconomic policy.

One could, of course, argue *theoretically* about the pros and cons of floating versus fixed exchange rates almost *ad infinitum*. But the fact that the G7 authorities—which obviously include Japan—felt that they should try to do something to improve the situation was amply illustrated by the Plaza and Louvre Accords in 1985 and 1987. And I think it is accepted that while the G7 cannot—and should not try to—buck economic realities and must work with the grain of markets, its efforts at bringing about a modestly more stable exchange rate environment have been worthwhile.

There are of course limits to how far we could sensibly try to go. Measures designed to achieve a *high degree* of exchange rate stability make most sense when the economies of the countries concerned are adequately converged *and* there is a strong commitment to maintaining *internal* price stability. But where a reasonable degree of convergence already exists, mechanisms to limit exchange rate variations can actually help to foster further convergence.

The European exchange rate mechanism

Nowhere is this more obvious than in the exchange rate mechanism of the European monetary system. Attempts to create a European successor to Bretton Woods commenced in the early 1970s. Initially they did not meet with much success, perhaps because they were over-ambitious; and perhaps because of the first oil price crisis and inadequate responses to it.

The ERM, established in 1979, has been a different story. The system's successes did not come overnight, however. During its early years there were a number or realignments which, as you will know, are permitted within the rules. But more recently, the member countries have shown great determination to hold their parities and, where pressures arise, to take the economic measures necessary to deal directly with those pressures, rather than resort to realignment. In fact, there has not been a general realignment since January 1987. The turning point, I think it is generally recognised, came in 1983 when France revised its economic objectives and decided to pursue a rigorous counterinflationary policy within the ERM framework.

This success has not been costless for the member countries. It is generally accepted, for example, that France and Italy have suffered a short-term loss of competitiveness. But in the process they have gained greatly in their battle against inflation and have thus been laying the absolutely necessary foundations for sustained growth in the longer run.

The United Kingdom's entry into the ERM

I believe the system can bring similar benefits to the United Kingdom. We have gone in with a central rate of 2.95 against the deutschemark and with 6% bands of fluctuation, rather than the 2¼% bands employed by most members; this has become usual for newly participating currencies as it gives time for markets to adjust and economies to converge more closely. I am confident that these terms are fully consistent with maintaining firm downward pressure on inflation. The immediate reaction of the markets in London and New York on Friday indicates that they too have this confidence.

As elsewhere this process will not be painless. The defeat of inflation never can be. Perhaps the key point is that, by putting an effective floor on sterling's exchange rate, we have introduced an extra discipline—a discipline for policy-makers and for both sides of industry and commerce. Companies will find it more difficult to pass on inflationary wage increases by raising their output prices. They will need to restrain unit costs; if they fail to do so, they will not be able to look to a depreciating currency to given them temporary relief. I should stress that depreciation can only provide just that: temporary relief. And what is worse, it gives the impression of reducing the need to deal with fundamental problems of competitiveness, while in fact only aggravating them and putting them off for a later day.

In terms of how soon and at what short-term cost the benefits of membership come through, a good deal depends on the effect on expectations. I am therefore glad we have been able to join before this winter's pay round gets under way as, although I believe we have quelled the excess demand in the economy, I am concerned about cost-push inflationary pressures.

In sum then, I believe that ERM membership will reinforce our counterinflationary strategy. In addition, it will help our economy to converge with the economies of our Community partners; and will help business by bringing greater exchange rate stability against other European currencies, and possibly more widely, and thus a better environment in which to plan and invest. I hope it will make the United Kingdom an even more attractive place for Japanese investment, which has of course already been strong in recent years.

But, as I have said many times before in anticipation of our joining, the ERM is *not* a panacea. Its benefits will have to be worked for, most of all by maintaining a *firm anti-inflation policy*.

The debate about economic and monetary union in Europe

It is partly the ERM's success that has prompted a debate about whether the European Community should go further and irrevocably fix exchange rates or even introduce a single currency. I hope you will find it interesting if I say just a few words about this debate on economic and monetary union, since it is certainly something that is preoccupying central banks and finance ministries in every European Community capital.

The introduction of a single European Community currency would obviously be a massively important *symbolic* measure, since it would show the extent to which centuries of antipathy between the various European countries have been overcome. But it would be a good deal more than symbolic; a fact which may be insufficiently recognised. A single currency would entail a single monetary policy for the whole area of Europe affected. That is to say, *interest rates would have to be identical throughout Europe, rather than varying so widely as they do today.*

I think in very broad terms two conclusions can be drawn from this. First, monetary union would necessarily entail a loss of sovereignty over monetary policy on the part of individual member states. And secondly, it would only be economically feasible when the economies of the European Community were sufficiently converged as to make one interest rate appropriate for the whole of Europe.

We are a long way from those conditions now. Notwithstanding that, however, some of our Community partners wish to press ahead as fast as possible to a single currency, and would like to establish a European Central Bank at the earliest opportunity. For the reasons I have indicated, which are very practical ones, the UK does not support this approach.

We believe that the immediate question is how to build on the ERM and the single market, while taking nothing away from the pursuit of internal price stability and also fostering further economic convergence in the Community. A scheme of this sort would plainly be desirable on its own and would also represent a concrete and prudent step towards greater monetary integration.

Before the summer, the UK Chancellor of the Exchequer, John Major, proposed a way forward to this end. This is the proposal, which you may have heard about, for the establishment of a new Community institution, the European Monetary Fund, to manage a new currency which we have so far called 'the Hard Ecu'. The name 'Hard Ecu' is rather ugly but it captures one of the key features of our proposal, which is that the Hard Ecu would *never* be allowed to devalue in the ERM, making it at least as strong as the strongest national currency in the ERM. It would therefore be a currency with outstanding anti-inflationary credentials.

But the proposed system would do more than that. It would introduce a *common* currency for Europe rather than a single currency and thus would not require only one European interest rate; it would underpin counterinflationary discipline throughout the Community through the operations of the EMF, which would need to be dedicated to price stability; it would help bring about further economic convergence in the Community; and it would be a way forward towards greater monetary integration led primarily by the market, which would decide the role and growth of the Hard Ecu.

It would be too much to claim that our Community partners are totally persuaded of the details of the Hard Ecu plan. But it has already performed the extremely useful function of bringing to the surface concerns that others held about convergence and transition; because it has addressed those problems head-on and has offered a solution—a solution that is within our reach—for others to consider.

The United Kingdom's contribution to this debate is therefore very positive. There will be intense discussions over the next few months in the lead up to an Inter-Governmental Conference on EMU that is due to start on 13 December. The results of this conference are impossible to predict, but I believe there is, as there must be, an increasingly pragmatic approach to this fundamentally important question concerning the future of Europe's monetary arrangements.

Our first task, however, is to make a success of our membership of the ERM, and that I am confident we shall do by continuing with a very firm counterinflationary policy.