European monetary stability

In a speech to the American Chamber of Commerce on 22 September, the ***Governor*** *discussed Europe's monetary and exchange rate arrangements in the light of the pressures which forced the widening of the ERM bands. He argued that exchange rate stability within Europe is important in order to realise the full benefits of the single market, but is best achieved by EC countries committing themselves to the pursuit of domestic price stability.*

Last September—after a turbulent summer—the United Kingdom and Italy were forced to drop out of the European exchange rate mechanism. It was possible—just possible—to argue then that this was a result of particular problems affecting particular countries, without any more general implications for the European Monetary System as a whole. That is much harder now, when, after a further year of turbulence, the remaining ERM countries have been obliged to move to a general regime of 15% margins.

The decision to move to much wider margins has eased the immediate market tensions, while keeping the ERM framework intact. It provides an opportunity for calmer reflection on the way forward in Europe, and I should like, this afternoon to think aloud a little about the experience with the ERM and about where Europe goes from here.

My starting point is that exchange rate stability within Europe matters. It has an important part to play not just in helping to ensure that we can reap the full economic *benefits* of the European single market, but in helping to ensure that we *sustain* the single market. It matters particularly in the present climate of massive, and still rising, unemployment in Europe, when the temptation to protectionism is never far away. There is a danger—as there is at the wider international level in connection with GATT—that if we don't make progress we will begin to fall back.

But it is the stability of *real* exchange rates within Europe that matters in this context—not just the stability of nominal rates. And it has been generally understood that domestic stability— and disciplined domestic policies—are a necessary condition for stable nominal exchange rates in the medium and longer term. All of this I take as given. The debate is about the ERM as the means to these (agreed) ends, not about the ends in themselves.

Superficially the ERM is about exchange rates—providing specifically for fixed, but adjustable, nominal exchange rates. But for many of its supporters it is about much more than this. To varying degrees it has been used as an external mechanism to reinforce—or even as the primary means of enforcing—domestic discipline. And beyond this, of course, there is a broader political dimension, with the ERM seen in some countries as the precursor of full monetary union, which is itself regarded by many as the spearhead to wider economic and political union within the Community.

In its economic aims, at least, the ERM was reasonably successful in the 1980s. It certainly contributed to greater progress towards internal stability in several member countries, and it produced a long period of nominal exchange rate stability after 1987. By the earlier part of last year—and under the political overlay of the Maastricht Treaty—step by step progress towards economic convergence, and steady progression to monetary union through the medium of the ERM, were quite widely regarded as realistic possibilities.

From this country's perspective I have little doubt that our own membership of the ERM from late 1990 was helpful in lowering inflationary expectations and in contributing to the necessary stabilisation after the excesses of the later 1980s.

So what went wrong?

As with any complicated situation there are many strands to the explanation. A weakening of confidence in the political commitment to European union, associated with uncertainties about the ratification of Maastricht in a number of countries, was one factor. And in some countries deteriorating budgetary positions called the sustainability of domestic stability into question. The exaggerated weakness of the dollar last year was also a complication.

But I want to concentrate on three particular explanations—competitiveness, divergent policy needs and 'speculation'.

After a long period of nominal exchange rate stability, it is hardly surprising that some countries with relatively high domestic inflation should have experienced a *loss of competitiveness* through *real* exchange rate appreciation. Such changes in competitiveness are difficult to measure in practice. Relative prices, costs and profitability will often tell different stories; and each of these indicators is likely to be affected by cyclical and structural factors so that changes in the underlying competitiveness position can be difficult to detect, even over quite long periods. The uncertainties are such that there is often plenty of scope for legitimate argument in this or that particular case. People still debate, for example, whether or not sterling was overvalued within the ERM. But I would accept that lack of competitiveness, whether actual or perceived, was a factor—even, in some cases, an important factor—in the exchange market turbulence over the past year and more.

But competitiveness is certainly not the *whole* story. A number of countries argue—with a good deal of justification—that their 'fundamentals were sound', sounder indeed, in terms of domestic price stability, competitiveness and their balance of payments, than in Germany. Yet still these countries were engulfed in the turmoil.

The simple explanation for this is *divergence*—divergence between the domestic monetary policy needs in Germany (suffering the inflationary consequences of the shock of reunification), on the one hand, and other countries (without significant inflationary pressure and sliding into recession) on the other. Even with narrow bands, the ERM could, and indeed did earlier on, tolerate a degree of normal cyclical divergence around its anchor currency, the Deutsche Mark. But it could not, in the event, accommodate the quite abnormal divergence of the past couple of years. The crucial point is that fixed exchange rate relationships can be forced apart by divergent domestic policy needs even when the 'fundamentals' in the member countries *are* apparently sound.

Some would still deny that possibility, or at least maintain that it simply demonstrates that what happened was the result of mindless 'speculation' based on a lack of understanding of how sound the fundamentals were. There have even been suggestions of a plot by 'speculators'—specifically Anglo-Saxon 'speculators'—who, acting collectively, deliberately and wilfully, set out to wreck the ERM.

It is true that there is a huge volume of liquidity in the world's money markets that can move suddenly from one currency into another. And the freedom of capital movements—which brings great benefits in terms of the efficient international allocation of investment—is a real complication for those seeking to preserve exchange rate stability. It is a particular problem in relation to tightly structured exchange rate arrangements such as the ERM, which present the markets with fixed rates that can suddenly be changed.

Among those controlling these liquid funds, there are, certainly, pure speculators—not all, I have noticed, with English as their native language—who take open positions in currencies simply in the hope of making profits. In doing so, of course, they expose themselves to corresponding losses and they tend, therefore, not to take very large positions unless they are very confident in their view.

But there are legions of others (who *look* exactly like speculators), often managing other people's funds, who are seeking to protect the value of the assets they control against losses, by diversifying risks or covering their currency exposures. And all these principals transact their business through bank intermediaries, which are typically restricted in the size of the positions which they themselves may take.

The whole point about financial markets—and above all the foreign exchange market—is that they comprise tens, perhaps hundreds, of thousands of different participants, with different resources, different responsibilities and objectives, and different expectations about values. In most situations where expectations are diffused, quite small movements in prices will be enough to balance *market* supply and demand. The problems arise when market expectations are all one way. That can produce unnecessary, disruptive, price movements if, in the event, those expectations prove to be unfounded. But, in the case of the recent ERM turbulence, the divergence between the domestic monetary policy needs in different member countries was real and substantial. It is difficult to argue that market expectations were without foundation—in this instance, when there was an evident danger of quite unnecessary deflation in some countries.

Despite some initial—and understandable—expression of frustration, I am not aware of any government or central bank that is seriously arguing that the way ahead for monetary integration within Europe lies in the reintroduction of exchange controls, or other techniques for inhibiting the free movement of capital, however these are dressed up. Most would see that as a retrograde step—as indeed I would. It is very doubtful whether, in today's internationally integrated financial markets, such administrative intervention could be made sufficiently effective to preclude unwelcome exchange market disturbance; and it certainly could not do so without damaging other, economically beneficial, capital movements in the process.

In somewhat similar vein, there have been some suggestions that the exchange rate problem posed by the free movement of capital can only be solved by an early move to a European single currency. And so it could in principle. But, of course, the underlying problem of divergent policy needs would not simply go away. The associated single monetary policy would then necessarily be either excessively tight in areas of deflationary pressure, or excessively loose in areas where inflationary pressures were stronger. This would have potentially *more* damaging implications for the pattern of activity and employment within the Community. At the economic level at least, the dangers of a premature move to EMU have been very generally understood, which is why the Maastricht Treaty places so much emphasis on the need for convergence as a *precondition* for locking exchange rate parities.

So what, then, is the way ahead?

It is possible that the particular divergence, so much in evidence over the past two years or so, will now gradually subside. German interest rates are off their peak and there are some indications, in some of the latest data, that the recessionary forces in some other ERM countries might begin to ease. There will, in that case, be a temptation to restore narrower margins and put Humpty Dumpty together again.

But unemployment seems certain to go on rising in Europe for some time to come, and it is not at all clear that policy needs *will* converge again at all quickly. Given what has happened, it would be critically important that the financial markets were convinced not just that convergence had been restored, but that it was here to stay. Otherwise the arrangements would be likely to face an early challenge.

Even then, the *longer-term* risks exposed by the recent experience would remain. Future asymmetric shocks cannot be excluded. And, short of that, there would be continuing scope for tensions resulting from cyclical divergence, or from differences in the mix of fiscal and monetary policy. There would be scope, too, for changes in relative competitiveness even with nominal exchange rate stability.

It is argued that these risks can be overcome if only there is sufficiently prompt and timely policy adjustment—especially exchange rate adjustment. The recent trouble, on this view, lay in the premature hardening of the ERM rather than in the arrangements as originally envisaged.

I wonder whether it is as simple as that. However desirable in principle, prompt parity adjustment is not at all easy to achieve in practice. In part—as I suggested earlier—this is because the need for adjustment is, as a technical matter, difficult to identify with confidence, and it is certainly no easier for the authorities than it is for the markets. Prompt adjustment is anyway something of a contradiction, when the reasonably stout defence of existing parities is seen as an intrinsic part of the ERM's function as an external discipline. And there is a political inhibition to changing a parity—especially to devaluation, which is invariably seen as a political defeat.

There is a danger, in the context of internationally mobile capital, that the remedy of 'more timely adjustment', whether or not that was actually achieved in practice, could undermine the credibility of the arrangements and come to mean more frequent exchange rate crises.

It is clear that the ERM route to sustained real exchange rate stability, and through that possibly to European monetary integration, depends upon sustained convergence. There are, however, risks—risks that we will not in fact achieve or maintain sufficient convergence—which recent events have served to emphasise. I would hope that, however events unfold, these longer-term risks will be carefully reassessed in the months ahead before narrower margins are restored.

In the meantime the wider, 15%, ERM margins provide a breathing space. But the flexibility which they allow is itself not without risks. As it now stands the ERM provides very little guidance for the conduct of individual national monetary policies, which is especially serious for those countries which had placed heavy emphasis on the ERM as their principal policy discipline. Equally, as it now stands, the ERM provides very limited protection against exchange rate volatility among the European currencies, or even against competitive exchange rate behaviour.

If the previous, narrow, margins now seem to have been too tightly drawn for the circumstances that arose, the present, wide, margins—on their own—look to be somewhat *under*specified. There is a case for buttressing them with clearer Community-wide understandings on the domestic policy objectives to be pursued *within* the looser exchange rate framework.

The essential basis for such understandings is already to hand in the convergence criteria established as the precondition for EMU in the Maastricht Treaty. Those criteria—notably the implied commitment to low inflation (but also the emphasis on fiscal prudence and the implied balance between fiscal and monetary policy)—are wholly appropriate *national* policy objectives in their own right. If they were consistently, and successfully, pursued by each individual member country, that would go some considerable way towards delivering, *de facto*, exchange rate stability between the member currencies in the medium term. The credibility of such arrangements might be increased if there were an explicit commitment to achieve price stability in the medium term, which would serve not only as a clearer *guide* to the conduct of national monetary policy, but also as a benchmark against which to assess the competitive implications of national monetary policy action. Meanwhile there would still be flexibility to accommodate short-term tensions through exchange rate movements, and the exchange markets would not in general have fixed targets at which to aim.

Arrangements of this sort would allow each country to pursue the stability objective in its own way, taking account of its national circumstances. Some—particularly smaller countries—might nevertheless choose an external anchor pegging their exchange rate more narrowly to another currency. Others might choose to rely primarily upon domestic intermediate targets for the money supply, or, directly, upon inflation targets. The important thing is to ensure that each member country does in practice stick firmly to its commitment to achieve stability. For this we may need to adapt our institutional arrangements and develop codes of behaviour that provide the basis for vigorous collective monitoring of performance.

Some will regard this as an unambitious approach to achieving the monetary stability in Europe we all agree we need. But we start from a position in which there is something of a vacuum as things stand at present, and a greater awareness of the risks of *over*ambition.

Somewhere at the heart of all this lies a difference of perception—a difference between those who think that the exchange rate can drive domestic stability and those who think that stability—like charity—must begin at home. I tend to be in the latter camp, believing in convergence first. But I entirely agree that the aim has to be *both* domestic, and exchange rate, stability within Europe. No matter what the regime, exchange rates are too important to be a matter of indifference; and—as I said at the outset—exchange rate stability within Europe is necessary to the realisation of the full economic benefits of the single market and as a protection against sliding back into economic nationalism. But, without domestic policies within member countries directed to stability, stable exchange rates will be an illusion. It is important that we use the period ahead to develop arrangements within Europe that help to secure that outcome, whatever the exchange rate regime.