Speech by Tommaso Padoa-Schioppa (London, 25 September 1981)

Caption: On 25 September 1981, Tommaso Padoa-Schioppa, Director-General of Economic and Financial Affairs at the European Commission, reveals to the Italian Chamber of Commerce for Great Britain, in London, the difficulties posed by the entry of the pound sterling into the European monetary system (EMS).

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[...]

The greater complexity and volatility of the financial markets have increased the need for adequate monitoring and control. In the City there has been a tendency towards self-regulation by the main participants to ensure fair, orderly markets, and towards supervision by the authorities, for the protection of customers and for economic policy purposes.

Parallel to the evolution of market supervision and regulation, has been a double shift in emphasis in government economic policies: an increase in the role of monetary policy in the broader field of macroeconomic policies (a field that includes fiscal and incomes policies as well); and an increase in the emphasis given to the control of the quantity of money, in the wider range of variables to which the monetary authorities pay attention (a range that also includes the volume of credit, the level of interest rates, the exchange rate, etc...). Control of the monetary aggregates has been applied with some success and in a fairly pragmatic way in West Germany and Switzerland over the years. The Barre Government in France has fixed targets in terms of M2 between 1976 and 1980. More recently a monetary target has become a central feature, I would say a conceptual corner stone, of the anti-inflationary policies of the UK government. Even more recently it has become prominent in the strategy of the Reagan administration in the United States.

Concentrating on the monetary aggregates implies that interest rates tend to be more variable, even if they are not left entirely free to find their own level. So while monetary policies are introduced with the intention of achieving greater domestic stability, their immediate consequence can sometimes be to lead to greater instability in the foreign exchange markets. Relatively high interest rates in the United Kingdom were one of the factors behind the appreciation of sterling during 1979 and 1980. In 1980, and again in 1981, we have seen how closely the movements in interest rates in the United States are watched by the foreign exchange markets. The new rise in UK interest rates last week, partly in response to international market pressures, reminds us that no country in the modern world is entirely free to pursue its policies independently of international developments.

Just as new financial techniques, regulatory arrangements and approaches to monetary policy have been developed within countries and markets in response to growing uncertainties and instabilities at both the level of individuals and the level of the national economy, so it is also necessary to improve arrangements and institutions to deal with the problem of governing monetary and financial phenomena at the international level. Most of the difficulties which we have had to face in the post-war world could never have been overcome if countries which are strongly interdependent had acted independently of each other. A highly cooperative approach has inspired the great achievements of the last 35 years in the field of international economic organization (from the Marshall Plan, to the European Communities, to the Agencies promoting economic development in the Third World), an approach in which the benefits to be gained could be shared and the negative effects of actions by any one country on others can be minimized. The European Monetary System is a major development of this kind and I will devote my remaining remarks to it and to the problem of British membership.

Since serious debate on European monetary integration was relaunched by Roy Jenkins in Florence four years ago, the difficult and sometimes painful search for monetary stability in our countries has explicitly taken on a Community dimension.

In its more immediate aim of greater monetary stability in terms of exchange rates the EMS can so far be judged a considerable success, some may even think, "too much of a success". During a period when the exchange rate volatility of major world currencies has been more extreme than ever before, the participants in the system have managed to keep variations in their bilateral exchange rates within the agreed limit without too much difficulty. Relatively small adjustments of central rates have been made on three occasions, involving three currencies (the DM, the Italian lira and the Danish krone); these changes were made smoothly and without causing disruption to the foreign exchange markets.

Less success can yet be claimed for the EMS in its wider and ultilately more important aim of promoting greater monetary stability in terms of prices, and hence of convergence and improvement of economic performance. The first two years in the life of the EMS have coincided with a period of almost unprecedented economic turbulence: the second oil shock, a world recession, profound changes in the fundamental approach to economic policy in countries such as the United Kingdom or the United States, huge swings in the dollar interest and exchange rates, to mention only some. In these circumstances inflation rates in our countries have become both higher and more divergent. Even in the United Kingdom, where the Government has been more successful than elsewhere in its fight against inflation, prices are rising today roughly at the same speed as in early 1979. Should we blame the EMS for this disappointing performance? Nobody would, not even its most severe critics. On the contrary, everybody agrees that the process of seeking price stability in a period of external shocks and domestic imbalances would have been even more difficult for participating member states had the European Monetary System not existed.

The United Kingdom took part in the original negotiations, signed the agreement adopting the EMS mechanisms and is party to joint proceeding of EMS central banks. But the pound does not participate in the exchange rate arrangements that are at the centre of the EMS in its present form. At the time when the EMS was first established, the British government, while subscribing to the basic strategy, judged that conditions were not appropriate for the pound to join. Since then, the decision has been re-examined, but not changed.

Now that the pound is once more approaching what many observers would consider realistic levels, and that dangers of moving too far downwards may arise and threaten an anti-inflationary policy that has had some considerable success, I want to suggest that full British membership of the EMS should be given serious positive consideration once again.

Let me focus on what appear to me as three deeply rooted, and yet not always explicitly expressed objections to British membership of the EMS. They are related respectively to the conduct of monetary policy, the role of the City and the structure of British foreign trade.

First, from the point of view of the conduct of monetary policy, there may be worries that joining a fixed exchange rate agreement would limit the options open to government, and might especially lead to conflict with the objective of controlling domestic money growth. The commitment to buy (or sell) foreign exchange at a given rate may lead to the creation of domestic money in amounts greater (or smaller) than would be necessary to hit the chosen target.

To this argument the answer is that there should be no systematic conflict between exchange rate and monetary targets if the two objectives are set as part of a consistent policy. Serious problems only arise if the targets are contradictory. Lesser problems, such as those created by the fact that functional relationships between economic magnitudes are never exact nor perfectly foreseeable, are just marginal, and can be dealt with within the rules of the system without sacrificing the main objectives of policy, particularly so when this objective is an anti-inflationary one. In practice, most of the countries in the EMS have quantitative monetary targets, and their experience, notably that of Germany which in the last ten years has been the country that has had the greatest success in the fight against inflation, does not show any impossible difficulties.

Indeed, it would be quite a paradox if a country strongly committed to an anti-inflationary policy, such as the United Kingdom were to be hindered in the pursuit of its objective by its participation in a system, like the EMS, which itself has monetary stability as its principal objective. Finally, if problems do arise, the system is flexible and the possibility of realignment of central rates is not ruled out.

The second objection is that EMS membership would threaten the special role of the City of London in world financial markets. London is in a sense an off-shore centre from the point of view of the United States, and the financial links with the dollar area are strong. Fears exist that if the pound became fully integrated into a different system, a system which may be seen as the embryo of a European alternative to the dollar system, then the special financial relationship with the United States might be weakened and the City's ability to compete for business on a world-wide stage could be lessened.

It seems to me that these fears are exaggerated; there is nothing intrinsic to the EMS that would prevent the City from continuing as a major provider of financial services throughout the world. On the contrary, important opportunities for the providers of insurance and other financial services are likely to grow in Europe as a true common market in services is gradually established. More stable exchange rates should help this process and should reduce the risks involved in dealing with the Community as a single market. Furthermore as the ECU increases its role as a reserve currency and becomes more widely accepted for a variety of financial and commercial uses, a growing business in new financial instruments denominated in Ecus is likely to develop. But such an increase in the use of the ECU will be held back, and the City's share of this new business is likely to be smaller, if the United Kingdom does not join the EMS.

The future of the City's role in the world may be subject to greater threat if the relative decline of the UK economy during the post-war era is not arrested. It may become increasingly difficult to maintain London as a strong financial centre if the rest of the economy weakens and if domestic economic and financial policies come more into conflict with the requirements of an open international centre. The disappointing performance of the UK economy has many explanations, but an important feature has been a vicious wage/price spiral which at several stages has been given a boost by exchange rate movements. Membership of the EMS could go part of the way towards establishing conditions in which policies for encouraging domestic stability could have more chance of success.

The third objection to UK membership of the EMS which I shall mention here follows the lines that the United Kingdom is a major world economy which has important trading and other commercial relations throughout the world, and that the outlook of the UK is not predominantly towards Europe. It is argued that the Community countries of Continental Europe are much more closely enmeshed economically and so they have more to gain from linking their currencies together.

It is true that historically the economy of the United Kingdom at the zenith of its power was primarily oriented overseas. But this argument, when used today, ignores the very rapid changes which have occurred in the structure of British trade and other relationships. Changes were already under way before the United Kingdom joined the European Community in 1973, and have accelerated since. In 1958, some 20 per cent of total UK exports of goods went to the present nine other members of the Community; by 1973, this had already risen to 32 per cent; by 1980 it was 43 per cent. This final figure compares with the proportion of total Community exports traded within the Community, equal to 53 per cent in 1980. The smaller countries tend to push this average up; so the structure of UK trade is no longer so markedly different from that of the other major Community countries. Economic zones with closely integrated trading links stand to benefit most from moves towards a common currency, and the UK should be able to share in these benefits to the Community.

Even if these thoughts were fully shared by those who decide, there would still be the hard choice of the moment at which to join. When the EMS was created, many observers thought that the pound was too weak to accept the constraint of a declared parity. That fear proved unfounded. The pound went, up and up, and what I have heard in 1980 and for most of this year was that the pound was too strong to join the system. So, for the pound, the right time to join has apparently never come. That reminds me of a story that I heard when I was a student at MIT. Professor Rosenstein-Rodan, many years earlier a professor at the London School of Economics, said once, that when he was young, Ladies liked men with grey hair, not young men like him. But when he grew older and his hair had become grey, tastes had changed and Ladies liked young men. So, like the pound, he never had a chance. But listening to that, Professor Samuelson immediately observed that, by the so-called "fixed point theorem", there must have been a point of time in which Ladies liked men of exactly the age of Professor Rosenstein-Rodan. Catching that instant could have made a happy marriage. The age of a man does not go up and down as exchange rates do. For the exchange rate, the opportunity of a happy marriage may just be coming again.