Point of view of Hugh Dykes (3 November 1978)

Caption: On 3 November 1978, Hugh Dykes, member of the British Conservative Party, outlines the consequences of the European Monetary System (EMS) for the United Kingdom and for international monetary policy.
Source: Parliament-House of Commons-Expenditure Committee (Ed.). The European Monetary System, First report from the Expenditure Committee, session 1978-79, together with the minutes of the evidence taken before the General Sub-committee in session 1978-79 and appendices. London: Her Majesty's Stationery Office, 1978. 159 p. ISBN 0 10 206079 7.

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The case for joining the European Monetary System

Paper submitted by Mr Hugh Dykes, MP

The political aspects

No one in favour of the EMS will deny that it is seen by France and Germany as being a valid stage in the process of European integration; they do not merely envisage technical mechanisms for parity stabilisation but exertions by the participants to rationalise their economic capabilities via increasingly harmonised policies. They consider that this will best be facilitated by mutually agreed aims on exchange rate policy. However the debate must not be conducted on the usual blind-faith “pro” and irretrievably pessimistic “anti” lines, because although clearly useful to the political progression of the EEC it *does not* mean that the EMS will immediately lead to full economic and monetary union, the French President and German Chancellor do not envisage this, or the setting up of a European Reserve, as happening for some time. What they do recognise, and what we must come to terms with if we do not join, is that a two-class Europe will emerge with an “elite” in the EMS that takes the major economic decisions for Europe.

Although it may not matter to those opposed to our membership of the Community, our decision not to join the EMS will also adversely affect our influence in important sectors of Community decision-making, especially the Common Agricultural Policy. The CAP itself is a good example of something that we had no part in establishing, but that we had to join eventually. The same could happen with the EMS, and like the CAP it may be much to our disliking when we finally realise we cannot be left out; precisely because we were not in at the start.

Still on the CAP it is worth pointing out that the EMS, via currency stability, would bring about greater streamlining of its mode of operation.

The utility of the floating rate system

The worth of unrestrained depreciation policies by member states, in terms of what it has and may achieve obviously must be weighed carefully against the merits of the proposed EMS. The scheme however must not solely be considered as meaning constantly fixed rates of exchange; it is generally held in France and Germany that allowances for devaluation will be necessary in the EMS because of the varied inflation rates and economic abilities, hence “fixed but adjustable” rates.

Both France and the FRG do not believe that floating exchange rates provide the environment in which deep-rooted economic insufficiencies can be dealt with. The Germans see that floating permits other EEC states to pursue policies of inflation. Seeing their own long-term economic health tied closely to the rest of Europe they would like to see fixed exchange rates imposing discipline on governments to adopt policies favouring long-term economic stability. The effects on exports of a high Deutsche Mark is seen as less of a problem and within the bounds of management. Controversy in the FRG is more about the degree of discipline that the EMS should operate and, importantly for them, the terms surrounding loans from the “central fund,” because this will have an effect on inflation in the FRG.

There is strong agreement in France that floating rates are not conducive to economic recovery because, firstly, the mileage made by depreciating as regards competitive ability is soon swamped by the consequential effects of inflation. Secondly, they see floating as permitting procrastination in taking measures to tackle the deeper economic faults. They feel that the means of adjusting their economy to the circumstantial competitive environment is only to be found by keeping the Franc as high and stable for as long as conditions permit.

Freedom to depreciate and thus maintain British competitiveness in prices must not be blindly assumed to be conducive to our ability to overcome our economic problems. It does make things “easy” in the short term. But the cumulative effect is to make us more and more economically inefficient and an increasingly low-income country. That is not to foolishly claim, however, that it would be feasible or desirable to have long spells of fixed exchange rates, particularly as incentives to modernisation in industry need to be revitalised, but the fact remains that currency depreciation is merely a mode of industrial protection. The British economy cannot hope to progress to a situation of high productivity with greater technology, whilst it is over-cushioned against the effects of international competition. If we can extract a substantial commitment of reserve and loan support from the FRG, it will bolster the already *relatively* sound BOP situation that North Sea oil is placing us in. This situation though will not last; the oil is finite, postponement of entry to the EMS would destroy this advantage. In academic, journalistic and business spheres there is a growing feeling that the inflationary tendency of depreciation soon negates the advances made by its initial usage.

The “automatic” nature of depreciation of sterling to a large extent keeps it out of political debate and public awareness; this permits delay in getting to grips with the basic economic faults. In the EMS the political nature of decisions to devalue would produce far more political and public pressure on the Government to rather adjust the economy to the prevalent climate of competitiveness.

No one would claim to prove absolutely that trying to stabilise sterling will undoubtedly force our industry to adjust to international pressures of competition, but the present course certainly will not do so. Taking a calculated chance on it is better than remaining as we are.

The extent and scope of intervention

The French, British and Italians consider that large loans will be vital, especially if the parity grid system is used.

The Germans, together with other “snake” countries favour a smallish fund of limited access, because they are wary of the effects that may occur on their inflation rate with a large, easily-milked fund. The Bundesbank may also raise constitutional objections to having to commit funds. However, the Germans might concede to committing large quantities to aid those currencies that are heavily burdened by speculation. They would not take lightly the point that a large fund would enhance the credibility of the EMS.

Valuation measure for currencies

There are two options: the “parity grid” and a “currency basket”. The former is, as in the current snake, a system where each currency is linked to the others individually, with a margin of fluctuation for each specific cross-rate. If these margins are broken then the responsibility of intervention lies with the two central banks concerned. The parity grid system then, would give a more balanced responsibility of intervention between all the participants than would the basket system. The weaker economies would be under more pressure to diminish their inflation and deal with balance of payments irregularities.

The currency basket system means each currency would be linked only to the “ECU”, bestowing the responsibility of intervention and adjustment on the currency that is deviating. The stronger currencies are, under this system, clearly going to be called on to adjust more frequently than the weaker, the Deutsche Mark being the main candidate. This would increase the money supplies of the stronger states, perhaps leading to exacerbated inflation rates. A more symmetrical situation would therefore result from the basket system than the parity grid.

The parity grid system is favoured by the FRG as the basket appears too inflationary for them, the French have agreed that the parity grid should be used, the British Government however object to it. The Belgian suggestion of a compromise (parities in ECU’s but intervention as in the parity grid) is of no consequence as it too closely resembles the grid.

Parity-fixing structures

The prevention of large movements of capital will have to be facilitated by parity-change mechanisms. All the nine agree on this, especially as this will help bolster credibility in the system. On the other hand though it is also agreed that over-frequent adjustments in exchange rates will harm confidence in currency relationships, thereby destroying a major plus in the establishment of the EMS. The solution to this is likely to appear in an agreement that parity adjustments should be accompanied by *policy initiatives* by the government involved, that will raise economic confidence. This does, however, still leave wide open the question of who should have the responsibility of adjustment when currencies deviate.

The cost of entry for Germany (FRG)

The FRG will have to provide funds to support the weaker participants, together with direct support grants. The Schmidt administration recognise that the EMS can only succeed if there is a not inconsiderable transfer of resources to deal with the regional imbalances.

Growth bias of the EMS

A low-growth bias, a fear expressed about the implications of the EMS, depends on the format under which parity adjustments and currency aids are facilitated. Also important is the “European” inflation rate that participants would have to aim for. Limits on growth to combat inflation can clearly be accepted in the short term if the future reward is greater stability and consequential growth. However, this does not mean the scheme *will* have a low growth tendency; if commitment to the EMS is given, greater confidence in abating inflation will occur.

It is also important to bear in mind that the FRG is unlikely to be able to avoid some increase in her domestic inflation rate. Thus we will probably be having to aim for a somewhat higher inflation rate than is being assumed, with the consequential diminished requirement for deflationary action.

The dollar

It is wrong to assume that there will be an accelerated rush from the dollar to the strengthening European currencies as they appear more attractive to dollar holders. EMS dominance of the dollar by usage as a reserve currency in trade is a consideration for the longer term only.

Even if a rush from the dollar to ECU’s did take place, we must bear in mind our close trade and economic links with Europe now when thinking about the merits of the EMS, not assuming that we must protect the interests of the USA *above* those of Europe.

Plausibility of the scheme

The risks of joining are due to the disparities between the economic abilities and outlooks of the member states. The degree of risk involved is dependent on certain factors: the extent that faith in the enterprise can be generated in the currency markets that members are willing to pursue converging policies; the extent of reserve commitment by the stronger participants; and the mechanisms chosen for parity-change and currency linking.

It is argued that parity changes will destroy faith in the scheme and cause massive flows of funds by encouraging speculation, and because of the substantial divergence in economic capabilities that the scheme would commence with, this could induce the EMS to fail. This argument is valid, but dependent on two factors: if parity-adjustments are minimal in degree and not excessive in quantity, speculation could be largely abated; the anticipated disparity between us and the other participants is also crucial here.

It is also argued that expensive interventions by central banks will have to occur to diminish the frequency of parity adjustments. (This has been the case with the present snake.) Again, the validity of this depends on expected divergence and the restraint involved in parity adjustments.

Much that is wrong with the current economic ill-health is caused by the uncertainties involved in predicting exchange rate variations; this undermines business confidence. The EMS would ideally give business a clearer view of the parity-adjustment mechanisms and therefore a boost in confidence in the export-import industries could be expected as short-term fluctuations no longer adversely affect them.

Also useful to the business sector will be the greater predictability of government monetary policy, as the EMS will mean a more disciplined and determined attitude will be conditional for success, but again, the worth of this largely depends on faith in the governments’ commitment to stabilise exchange rates.

It is claimed that our economy is too weak to withstand the competitive pressures without frequent changes in parity, and that this would make our membership pointless in economic terms, or dangerous by inciting speculation to grow before parity adjustments. Once again it must be re-emphasised that this kind of argument is only valid if special care is not taken in designing the parity-adjustment mechanism with regard to sterling.

Much of the opposition to the EMS in Britain comes from the notion that the scheme can do nothing for our economy that we could not bring about ourselves by careful planning. However it must be borne in mind that the political promises of governments to adopt such measures cannot hope to have the confidence-inspiring effect on investors and currency markets that commitment to the disciplines of the EMS would have. Apart from the confidence-gaining aspects of joining, we cannot assume that confidence in the British economy will remain at a norm if we do not join. A quite severe loss of confidence can be expected from the rest of the world, not to mention the immediate shrinking in political standing that will take place for Britain, when she is clearly seen to be not willing to take part in the future major economic decision-taking body in Europe.

The question of economic convergence, especially inflation rate rationalisation, will on balance tend to be in the direction of the stronger economies. Our desire not to join the EMS would quite rightly be seen as firstly that we lack the will to revitalise our economy, and consequently the notion that we are simply unable to do so will be firmly acknowledged.

Joining the system we could anticipate a fall in *expectations* of inflation, and be more committed to monetary and fiscal measures designed to prune inflation, especially by the need to avoid devaluation.

As economic convergence occurs, especially on inflation, it can be expected that the stronger participants will be able more to help the weaker by measures such as reflation; this will have a cumulative effect on the success of the scheme and the ease with which it is being achieved. It is a dubious assumption that we could, on our own, force ourselves to achieve the same convergence external to the scheme; there is too much temptation for party political ends to choose the laxer short-term options.

Conclusions

The debate has largely centred on the immediate technical aspects of the scheme. Although insistence that the system is well constructed is obviously laudable, there has been inadequate consideration of the *long-term* implications for Britain, domestically and within Europe, and the implications for the world monetary order. These issues must be discussed.

In the scheme we would not be “caged” by fixed parities. This is a misconception and largely deflates the arguments of those who fear the worst for unemployment and production if we join. The FRG will have to concede to the weight of opinion of France, Italy, and Britain in agreeing to a more flexible set-up.

It must be clear to even the most optimistic opponents of the scheme that there will be limits on the options of British policy-making imposed by the EMS whether we are a member of it or not. Our margin of economic decision-making freedom will be highly constrained outside the system, anyway.

This fact has been taken too lightly, nor has the historical outlook that shows us the delicate balance of power between the three major European States been considered in terms of what a close Franco-German “union” will mean for Britain’s future European and world role.

There are no guarantees in economic predictions and that is not the purpose of this paper. We recognise that neither side has all the indisputable facts at their disposal, but that in itself is no argument for preserving a status quo which is going to be upset regardless of whether we join. We consider that given all the evidence available, and not denying the fact that our participation will be painful in the immediate term, that the European Monetary System deserves and will eventually reward, British involvement from its start.

3 November 1978