Memorandum by Christopher Johnson (3 November 1978)

Caption: On 3 November 1978, Christopher Johnson, economic adviser to Lloyds Bank Limited, submits a report in which he rejects all the arguments put forward in the United Kingdom by opponents of the European Monetary System (EMS).

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 conclusion of this paper will be that the United Kingdom should join a European Monetary System at the same time as France, Germany, and other members of the European Community. The argument examines a number of current objections to the European Monetary System (EMS), and attempts to refute them.

(1) *The EMS proposed at Bremen is a bad proposal.* It is argued that, even if one is in favour of economic and monetary union in Western Europe, the EMS is the wrong means to the end, and that it is better not to join than to be associated with a failure. The British Government has in fact attempted to improve the Bremen scheme. If it is not possible to secure all the improvements desired by the time of the European Summit on 4 and 5 December, however, it would be better for the UK to join, then seek to improve the scheme further from within after joining. This has been UK policy with regard to the European Community as a whole. The best is the enemy of the good. For the UK to opt out at the last moment would be either to miss the bus, as when the Rome Treaty was signed in 1957, if EMS succeeds, or to be accused of *Schadenfreude* — delight at the misfortunes of others — if it fails.

(2) *The original currency snake failed, so how can a similar experiment succeed?* The UK, Italy and France all left the snake because they could not keep their exchange rates in line. But we understand better today than when the pound was floated in 1972, and left the snake, the link between currency depreciation, money supply increase, and inflation. The snake is not necessarily the wrong basis for a new experiment. If the EMS puts some of the onus on weak currencies, as well as on the strong Deutschemark to intervene to keep exchange rates in line, there is less danger that the inflation rate will rise in West Germany, and thus rob the whole scheme of much of its attraction as a defence against inflation throughout Western Europe.

(3) *The EMS would mean a sacrifice of British economic sovereignty.* During most of the postwar period, the exercise of economic sovereignty has not had particularly successful results in the UK. The acceptance of policy conditions laid down by the IMF, or, more broadly, the spur of competition in world markets, has on the other hand had beneficial effects on British economic policy and performance. As in the European Community, NATO and other international organisations, Britain would in the EMS be exchanging some of her independence for influence on the policy of other countries, with results which might bring greater benefits than an attempt to follow an independent national economic policy.

(4) *The UK exchange rate is impossible to fix against European currencies.* The pound is more widely held as a reserve and as a trading currency than the majority of other EEC currencies, so could be more liable to destabilising speculation. But the UK has shown that it is possible to prevent the pound from rising — even at some risk of excessive internal monetary expansion — and the official reserves of $15 billion, together with EMS credits, would be sufficient to deter adverse speculation unwarranted by more fundamental economic factors. In any case, it has been demonstrated within the existing snake that small parity exchanges are compatible with membership, provided that they are not too frequent. Another possibility, although only for a transitional period, would be some form of “crawling peg” for EMS exchange rates.

(5) *Convergence of inflation rates is necessary for the EMS, but cannot be achieved.* In 1955-71, a period of relative fixity in exchange rates, the compound rate of consumer price increases among the 9 members of the present EEC varied only between 2.6 for West Germany, and 4.7 per cent for France, with the UK just above average at 3.9 per cent. The divergence widened to 20 per cent in 1975, but in the 3 years since then has narrowed to 10 per cent. It is highly desirable that it should be narrowed further — preferably from the top downwards, rather than from the bottom up. Strict convergence of inflation rates is in any case neither necessary nor desirable, in view of national differences in economic structure. Because of North Sea oil, the UK faces a period of at least a few years in which the domestic price level could rise faster than the European average yet with a stable exchange rate against European currencies. This would mean that some industries became less competitive in European markets, but their products would be replaced in the UK trade balance by crude oil. Paradoxically, if UK inflation were today as low as that of West Germany, the strength of the pound could become an argument against Britain entering the EMS at this time.

(6) *Convergence of rates of economic growth is necessary for the EMS, but cannot be achieved.* This is a common fallacy. While some degree of convergence, or at least compatibility of national inflation rates may be required, there is no reason why different regions of an economic and monetary union should not have different rates of economic growth, reflecting the endowments, and perhaps the preferences, of their inhabitants. Both the United States, and the United Kingdom, provide examples of regional divergence in economic growth and living standards under a common level of prices. Divergent rates of growth are reflected in divergent increases in both real and money wages. Such divergence, if continued within the EMS, might raise even greater social and political difficulties than at present. These could be mitigated, but not removed, by transfers of public, banking and investment funds from the prosperous to the poorer regions of the EMS.

(7) *The inability to devalue by the UK will depress employment and economic activity.* This argument presupposes that it is possible to devalue in real terms, in such a way that the gain in international competitiveness is not swamped by a rise in the inflation rate transmitted through import prices. But even where devaluation may have some success in reducing a trade deficit, this may be at the cost of lower terms of trade and a loss in the international purchasing power of domestic wages. What is gained in employment may be lost in living standards. If it is true that the EMS will tend to favour fiscal or monetary deflation over devaluation as a means of payments adjustment, the financial confidence thus engendered may in the medium term be more beneficial to employment and economic activity than a policy which relies on currency depreciation and cheap labour. In so far as certain regions of the EMS find it difficult to remain competitive at relatively high wage levels, their problems may be dealt with either by resource transfers, as outlined above, or by labour migration to more prosperous areas. It is a commonplace of welfare economics that a change increases the general well-being if the gainers can compensate the losers and still be better off. (Economists sometimes fail to add the rider that the gainers should actually compensate the losers, as opposed to simply being in a position to do so.)

(8) *The Common Agricultural Policy should be reformed before Britain agrees to join the EMS.* West Germany and France, which benefit in different ways from the CAP, would be most unlikely to agree to this. But once the EMS was in operation, the UK as a member could point out with added force the absurdity of retaining special “green” rates of exchange for farm products while moving towards monetary union on other fronts. Over a period of 5 years, the green Deutschemark should be revalued upwards, lowering German farm prices, and opening up the Continental market to the more efficient UK farmers, preferably without an increase in farm prices within the UK.

(9) *Economic union comes before monetary union.* Monetary union, it is argued, is putting the cart before the horse if it is not preceded by economic union. The 1970 Werner Plan did envisage rather more co-ordination of national economic policies than has so far been discussed in the EMS negotiations. If exchange rates are to be fixed, and inflation rates to come together, then, it seems, national fiscal, monetary and incomes policies must also be harmonized. It could be said that the process of economic integration has already caused a good deal of economic policy harmonization, and that monetary and exchange rate policy has lagged behind, and needs to catch up. Or it could be objected that, thanks to the well-established relations between Central Banks and Finance Ministries, it is easier to achieve a common policy in monetary and exchange rate matters than in, for example, wage bargaining. The EMS could force countries to align other aspects of economic policy severally, if not jointly. This dispute sometimes takes on a Byzantine character. Common sense suggests that economic and monetary policy should advance hand in hand, even if one sometimes tends to move a bit faster or slower than the other.

Some of the arguments in favour of joining EMS have already been discussed. They can be summarized as follows:

(a) *Anti-inflation.* For a weak currency country, a fixed exchange rate imposes an external discipline against inflation, by preventing import prices from rising, and squeezing margins in export industries. A strong currency country which holds its exchange rate down may, on the contrary, be in danger of importing inflation as it issues its own currency in exchange for foreign currency reserve accumulations. The danger can be averted, either by a rise in demand for imports, or by a more restrictive monetary policy. A common European currency can also be used as a weapon against inflation, if it is defined in terms of national currencies so as to have constant purchasing power. A proposal of this kind, the “All Saints Day Manifesto”, was published in *The Economist* on 1 November 1975.

(b) *A common currency.* The benefits of exchange rate stability are magnified if a further move is made to complete currency convertibility such as exists between the English and Scottish pound and, for the time being at any rate, the English and Irish pounds — or a common currency. A common currency reduces the uncertainty of economic operators about the gains and losses of foreign trade and payments. It would thus accelerate the benefits of economic integration, for whose sake the EEC was formed. The EEC made more progress under fixed rates in 1958-71 than it has made since then, and could again move forward faster if an EMS were set up. The desirability of a common currency, which would at first be parallel with national currencies, is an argument in favour of using the ECU, or “basket” as a central feature of the EMS.

(c) *A reserve currency.* The ECU could be issued to non-European monetary authorities as an official reserve currency, as well as being used as a world trading currency. This would allow the European currency area to run a payments deficit with the rest of the world, permitting a higher level of economic activity within the area. This facility would be of importance in financing a continuing oil deficit with the OPEC countries, and in allowing the candidate countries — Spain, Greece and Portugal — to move the enlarged EEC into overall deficit. The ECU could also help to take off the dollar some of the strain of being, still, the world’s main reserve currency. Financial relations between the dollar, the yen and the ECU, which would doubtless be somewhat more flexible than those within the European area, would then be a matter for high-level European economic diplomacy.