European Communities
Commission

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20 Kensington Palace Gardens
London W8 4QQ
Telephone: 01-727 8090

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Extract from the Esmee Fairbairn Lecture delivered at Lancaster University, England, by Mr Christopher Tugendhat, Vice-President of the Commission of the European Communities on February 11, 1982.

E.M.S., U.K. AND THE DOLLAR

Currency exchange rates instability threatens the trade interests of the Common Market, and makes more difficult (but even more necessary) the coordination of economic and monetary policy within the Community in order to secure renewed growth and to combat inflation. The fluctuations of the dollar are the major currency problem with which Europeans have to deal. To do so effectively, we must organise ourselves more firmly within the European Monetary System (EMS).

Recent statements by the Chancellor of the Exchequer and the Governor of the Bank of England concerning the dollar problem have been very much in tune with the remarks being made at the same time by Chancellor Schmidt of West Germany and Mr Mauroy, the French Prime Minister. All have expressed concern at the prospect of further increases in U.S. interest rates and united to warn the American authorities of the dangers involved.

Yet the United Kingdom is still not a full member of the E.M.S. which provides the best framework for a common European response to the dollar instability. This is an anomaly which should be corrected.

The volatility of dollar interest rates is a major aspect of the problem. They have gone up and down and up with bewildering rapidity, and mobile funds chasing high interest rates have switched rapidly between currencies and played havoc with exchange rates. 1980 and 1981 saw a doubling of U.S. interest rates, a 40 per cent rise of the dollar against major European currencies which inflicted on Europe a "dollar shock" of similar economic importance to the 1980 oil shock, thus further hindering our attempts to renew economic growth.

It is clear that none of us can afford to behave as if the effects of our policies are exclusively domestic, and that our prospects of fighting inflation and unemployment are enhanced by cooperation and coordination on monetary and economic policies with our major trading partners. The European Monetary System was set up in 1978 to help achieve such coordination and to create a zone of monetary stability in Europe.

It has had a remarkable degree of success in keeping the variations of exchange rates of participating countries within E.M.S. limits despite turbulent monetary conditions. There have now been four adjustments of central rates, three of them relatively minor. All of them were carried through smoothly, promptly and without disruption of the markets. The system has shown both a capacity to create stability, through the commitment to maintain parities within certain limits and the common support mechanisms which membership involves, and its ability to respond flexibly to new developments.

The contrast between the stability of E.M.S. currencies and the fluctuations of the pound outside E.M.S. has been quite marked, and British exporters have suffered as a result. A wide variety of reasons have been put forward to explain U.K. non-participation - the pound was too strong, or too weak, or too volatile, or it had a special petro-currency status. It was argued in 1978 by Ministers that E.M.S. membership would have an excessively deflationary effect on the U.K., and it has been argued more recently that it carried inflationary dangers.

It now seems to be more widely accepted by U.K. policy-makers that exchange-rate management is not incompatible with anti-inflationary policy. The German Federal Republic has for some time provided an example of how firm monetary controls could be combined with a degree of exchange rate management to keep inflation down. A major doctrinal objection to U.K. membership of E.M.S. therefore seems to have been unfounded. The objections that remain seem to be largely tactical - that the pound is not at its appropriate level for entry, that economic policies of E.M.S. members are not sifficiently coordinated, or that there are political risks involved.

I do not believe that the doctrine of "unripe time" can be invoked indefinitely and retain credibility. It is natural that the British Government should be cautious given the present state of international monetary affairs and of the U.K. economy, but the absence of a major European currency is a significant weakness in the E.M.S. and unhelpful to the efforts to establish a common approach to third currencies. The improved cooperation between British, German and French central banks and finance ministers which has been evident in the last few weeks in the face of a renewed threat to growth from U.S. interest rates would be all the more effective if it was firmly based on common membership of the E.M.S.

As Europe faces up to the problem of how best to prepare its policies and institutions to deal with large, continued oscillations of interest rates, exchange rates, and economic activity in the U.S.A., it is becoming increasingly evident that a stronger organisation on the basis of the E.M.S. is necessary. It is important for the U.K. not to get left out at this new stage of development. We may not be on the verge of moving to a full-blown European Monetary Fund, as originally envisaged for the second stage of E.M.S. development, but new moves for coordinated dollar intervention and wider use of the European Currency Unit (the ECU) can be envisaged.

We should consider, for example, the replacement of existing bilateral arrangements with a new swap-credit arrangement between the European Monetary Cooperation Fund (E.M.C.F.) and the American Federal Reserve for concerted European intervention vis-a-vis the dollar, and the permanent transfer of a proportion of member state central bank reserves to the E.M.C.F. We should also seek ways of creating greater use of the ECU for official and private transactions. An ECU travellers cheque, for example, could have real practical value. These and other possibilities are being actively studied and discussed, and it is not in the interests of the U.K. to stand on the sidelines. Equally it is not in the interests of an effective European Monetary System that it should do so.

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