

3. ANDREW SHONFIELD:

This is an extremely provocative paper. The rather quiet terms in which Mr. Padoa-Schioppa presented it to us as a "framework for questioning" might have concealed its radical implications. One important conclusion that emerges from it is that the system as now constituted cannot function effectively in the longer run and that we do not therefore have the option of keeping it as it is.

As I read the paper, the author has two main aims. First, he wants to return the EMS to the purpose of limiting *erratic* parity movements. Second, and more important, he stresses its role as a coordinator of medium-term economic policy — that is as a provider of support for positive objectives of economic policy which may not be reflected in the behaviour of foreign exchange markets. Monetary stability is only the beginning of the story; the substance is the character of the objectives of individual nations and the way in which these impinge on their balance of payments with one another. The objective of a stable currency with stable exchange relationships does not have an absolute priority, and accordingly a nation which consistently pursues an

agreed medium-term policy (i.e. one which aims at a sustainable stability in its relationship with its neighbours) is quite likely to change its parity and in some cases to do so not infrequently.

Now I believe that the second of Padoa-Schioppa's aims is in fact logically subsumed by the first, for in order to recognize what are, or are not, "erratic" exchange rate movements one must have a knowledge of what are tenable medium-term exchange relationships. His view is, in any case, that the giving of purely short-term support to a currency under pressure is the lesser role, and that the system under his formula might indeed have *more* parity changes in the short term than it has had in the past. The main thing is that these changes should serve the objectives laid down in the medium-term policy framework. All this makes a great deal of sense to me.

Short-term intervention in the foreign exchange market would have the purpose of avoiding harmful economic distortions of the kind to which Padoa-Schioppa refers, e.g. the disturbance of the relative prices of tradeable and non-tradeable goods resulting from very frequent parity changes. The approach seems to me — if I may take an analogy from the Community's agricultural policy — like introducing a generalized system of MCAs (Monetary Compensatory Amounts) to offset the effects of short-term changes in market prices, due to exogenous factors, which could otherwise influence decisions on production, investment and trade. If the Common Agricultural Policy were to work in this way, then some economic sense might be restored to it. However, as we know, the trouble with MCAs is that they have a tendency to last. Exchange market interventions, because their cost would be clearly visible would be less open to this risk. The analogy with a reformed CAP is introduced simply to draw attention to the fact that the system proposed implies a capacity for consensus on underlying economic trends and relative costs which it would take a major effort to achieve.

This leads directly to the question of the institutions required to make an EMS with a medium-term orientation work. What follows is no more than a rough and preliminary indication. For that purpose I want to use two concrete examples, the United Kingdom and Germany. Beginning with the UK — a European Fund with the objective of achieving sustainable economic relationships between members of the Community (and therefore some degree of economic convergence) would presumably encourage the sale of sterling in the market in order to bring the exchange parity down. It would have first to agree with the UK on a medium-term target parity and on the pace of adjustment to it. How would such an agreement be arrived at — and, in particular, would the discussions preceding the agreement be public or secret? I

presume that total secrecy would in any case not be feasible. In view of this factor alone, there is a strong argument for involving the public in a debate about some interim working document — something like what the British call a "green paper." A model for the process might be the treatment of the German annual report of the Council of Economic Experts. The document concerned would be prepared by economists of acknowledged reputation who were not officials, and then presented to the Managing Board of the European Fund.

What I have in mind can perhaps be best indicated negatively: it would be very unlike an OECD annual report on member countries. It would not have to engage in such careful politeness. The German Council of Economic Experts generally manages to avoid that. There would then be a second stage of discussion and bargaining between the Fund and the government concerned, which would naturally take place behind closed doors. It would go over such questions — still considering the British case — as the magnitude of the projected sales of sterling and of the policy responses to certain hypothetical circumstances. Of course this process could not be kept a hundred per cent secret, since intelligent journalists who would have read the report of the independent experts would continue probing and asking relevant questions. There is no need to go on with the details of procedure; all that I am trying to do is to show that this kind of approach would require the establishment of a powerful political institution with a capacity for intervention in the process of national policymaking, and in the debate surrounding it, which would be new to the Community.

In my other case, that of the German Federal Republic, the role of the EMS would of course be very different — not to help the parity to fall in an orderly manner but to prevent it from rising precipitously. Specifically, it would try to interpose a buffer between the pressures likely to be exerted on the German economy during a period when capital movements away from the dollar and towards the D-mark were pushing the latter far above purchasing power parity values and threatening the medium-term economic objectives of Germany. Such a distortion of international comparative advantage would damage not only the Germans but also be harmful to the European economy as a whole.

Under the present EMS arrangements, the other member countries would in such circumstances either be dragged upwards by the D-mark or be forced into frequent parity changes. The system would then serve very little purpose. In order to be useful to the Germans, the ECU would have to assume a different and more ambitious role: in a word it would have to take over some of the monetary functions of the D-mark. The ECU would have to be in a position to go into the

market and scoop up some of the money which people would otherwise put into Marks. Private operators, as well as central banks, would need to be offered ECUs as the next best thing — meaning not quite as attractive as, albeit not much worse than the D-mark.

How might the ECU come to be recognized as the “next best thing”? The following are some of the conditions which would have to be satisfied. First of all, and most obviously, it would require the kind of reserve backing which would make it a credible intervention currency. Secondly, the effects of intervention in ECUs on the domestic money supply would have to be spread not too unevenly among the member countries of the EMS. If, in the assumed case of a sustained switch of international holdings out of dollars, the ECU were used simply as a vehicle for the acquisition of D-marks, the whole of the money supply effect would be concentrated in one country. The only case in which this consequence could in practice be avoided would be by converting the ECU into a fully-fledged parallel currency. And that means that the Germans would have to engage in an active policy of discouraging the movement out of ECUs into D-mark denominated paper. (I am assuming that Padoa-Schioppa's proposal for an “exclusive role” for the ECU as a means of intra-Community settlement had been accepted.)

Here we arrive at the third, and crucial, condition which is that the German authorities set about creating and using the institutional mechanisms at their disposal to transfer some of the international money flows from the D-mark to the ECU. Interest rate differentials which consistently offered lower rates of return on D-marks than on ECUs are one obvious means. No doubt they would make internal monetary management in Germany that much more awkward; but unless the Germans are prepared to pay some sort of price for the blessing of not becoming a front-line international currency, the whole operation will fail. There are other administrative devices which could be used to make the D-mark *less* attractive. For example, the Bundesbank has explained that an essential part of its tactics in cushioning the effect of the inflow of international funds on the management of its currency has been to channel as much as possible of this unwanted money into assets which have less liquidity and potential mobility.¹ This offers a clear opportunity to the managers of the ECU to supply the market with assets possessing the very features which the German authorities are trying to deny to foreign holders of D-marks.

To show that the latter were really in earnest, they might well go further along this path of attracting more funds away from D-marks

¹ See Bundesbank *Monthly Report*, November 1979, p. 30.

into ECUs, e.g. by issuing some public loans denominated in the European currency on slightly more favourable terms than those available to investors in D-mark issues.

I realize that such measures would at this stage be regarded as extreme, and even other-worldly, by German officials at the moment. I mention them in order to make the point that there is no want for practical devices by which the diversion of international pressure on the D-mark could provide a particularly powerful means for building up the ECU as an alternative international currency. The logic of what the Germans originally wanted to achieve through the establishment of the ECU requires them to take a new and radical view of their own existing administrative habits. I think it is this implication, which underlies Padoa-Schioppa's arguments, that requires to be given a special prominence.