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Prof. Baffi looks back on the negotiations leading to the establishment of the EMS, with particular reference to the wide band and UK membership English translation of a speech given by the Honorary Governor of the Bank of Italy and Vice-Chairman of the Board of Directors of the Bank for International Settlements, Prof. Paolo Baffi, in Rome on 5/12/88 on the occasion of the tenth anniversary of the Brussels agreement on the establishment of the European Monetary System.

1. My purpose today is to re-examine, in the light of subsequent events, the validity of some of the arguments we adopted in the course of the negotiations which led to the establishment of the EMS. I will limit my examination to two areas: the width of the fluctuation band and UK participation in the exchange rate arrangements.

2. In the two-and-a-half years from July 1976 to the end of 1978, inflation in Italy had slowed down considerably, but the major achievement of monetary policy was on the external front. A balance-of-payments surplus after years of deficits had made it possible to pay back debts abroad, recover the gold given as security, rebuild foreign exchange reserves and restore Italy's creditworthiness, as demonstrated by the insistency with which we were offered new loans. I was very concerned lest such positive results be compromised through participation in a strict exchange rate agreement tying the lira tightly to the Deutsche Mark area, and hence forcing a systematic appreciation of its real exchange rate, with negative effects on Italian exports. This concern was at the root of our insistence on obtaining a wide band which would ease the dilemma of either accepting recurrent periods of overvaluation of the real exchange rate or asking for frequent changes in the central rate, each of which could have caused frictions and prompted speculation waves.

In the negotiations on the fluctuation band I had three able collaborators in Messrs. Magnifico, Sarcinelli and Masera. At the meetings in Brussels, in the course of bilateral discussions which I attended at the request of the President and the Finance Minister, and finally in Basle, we hammered away at Governors and experts with a tenacity which might have been irritating were it not, perhaps, for the quality of our contributions. Our task was made somewhat easier by the position adopted by the President of the Deutsche Bundesbank, Dr. Otmar Emminger, a man who owed his authority to that of his country and to his own ability, as well as to the constitutional autonomy of the Bundesbank.

In his memoirs, published in 1986, Dr. Emminger claims that he, rather than Prof. Röpke, was responsible for introducing the concept of "imported inflation" due to a surplus in the balance of payments, and describes how even in 1956, in the context of the overheating caused by the Suez crisis, he had suggested to Dr. Vocke, the then President of the Bundesbank's predecessor, i.e. the Bank deutscher Länder, that Germany be defended against the contagion of inflation by widening the exchange rate fluctuation band to around ± 6 or 8% from parity. The fluctuation band which Dr. Magnifico and I initially proposed to our fellow EMS negotiators was of exactly the same dimensions. Neither of us knew of Dr. Emminger's confidential proposal of 1956. In fact, in the twenty-two years which had elapsed in the meantime, his vision of the role of exchange rate flexibility in the defence of price stability in Germany had not changed in the slightest. He had again put forward his idea of a wide fluctuation band at the beginning of 1961, but was unable to convince Chancellor Adenauer, who opted instead for straight revaluation.

The request for a wide band was put to the UK side during the visit which the Minister and I made to London on 25/7/78, repeated at our meeting with the French at Bergamo on 8/9/78, and kept on the agenda during the meeting of the EC Council of Ministers for Economic and Financial Affairs held on 18/9/78 and at the various bilateral meetings which followed. On 26/10/78, in particular, at the Villa Madama in Rome, in the presence of the President and the Minister, I made the case for a band of $\pm 6\%$ to President Giscard d'Estaing, who seemed impressed by the technical arguments I put forward; and if unconvinced by the arguments, the importance the French attached to our presence in the system, whether to prevent it becoming another

version of the snake, which they had had to leave on two occasions, or because of the negative effect on the Giscard-Schmidt initiative of Italy's absence, did the trick.

We had a more difficult time of it at our meeting with the German Chancellor, which took place in Siena on 1/11/78. The Chancellor stressed the role of money in the process of political unification, giving as an example the history of Italy in the nineteenth century, and expressed satisfaction at Ireland's imminent abandonment of parity with sterling. Contradicting the statement of his own central bank President, he declared that to obtain the narrow band, i.e. that used in the snake, he was prepared to pay the price of higher inflation in Germany.

But I did not lose heart. I see from the entry in my diary for 12/11/78 that I took part in a breakneck round of meetings in Basle with the individual EC central bank Governors - Messrs. de Strycker, Richardson, Zijlstra, Clappier and Emminger - noting finally that "the wide band has been accepted".

3. On 20/11/78 a meeting of the EC Council of Ministers for Economic and Financial Affairs took place in Brussels. At the September meeting UK Chancellor of the Exchequer Healey had expressed strong dissatisfaction at not having been informed of the Aachen Franco-German meeting and of its results. On this occasion he produced a series of somewhat contrived arguments against the agreement which was then taking shape, and which, in his opinion, amounted to a departure from the spirit of the Bremen conference. What was involved, he observed, was an expanded snake which (1) failed to observe the reciprocity of obligations implied by the use of the divergence indicator, (2) did not give the ECU the central role in the financing system, which in turn (3) had simply been expanded in proportion to the increased participation in the exchange rate agreements. Finally, (4) no definition had been provided of how settlements of credits extended under the system were to be carried out and (5) an adequate system of assistance to less developed countries and regions had not been established.

On 22/11/78, the President and the Minister arrived in London. At the airport I welcomed them with a paper I had written in the Embassy the previous day, replying to Mr. Healey's first four points, but not to the fifth, since it coincided with the Italian position. The paper concluded with the following observations:

"The situation following the Ecofin meeting of 20/11/78 is a singular one: the fact is that the United Kingdom is heading in the direction of withdrawal from the exchange rate agreement, for reasons based, in reality, neither on insufficient breadth of the system, a lack of symmetry in the obligations it imposes or on unsatisfactory financing provisions, but rather on the insufficient progress made in the parallel studies on the reduction of regional imbalances within the Community. Italy, too, can see the point of this argument, even if it is being made indirectly. It is nevertheless unclear whether the United Kingdom is convinced by its own objections to the exchange rate agreements, or whether they constitute a negotiating tactic or a smokescreen to cover withdrawal from the system. An important acquis of the Brussels meeting is the commitment to review the exchange rate agreement in the light of the experience gained after the first six months of operation. For countries which had initially remained outside the system this could be a good time to join."

I put forward the idea of a review after six months with implicit reference to Italy also. While I thought the challenge of EMS membership might help reduce inflation, I felt that proof of the seriousness of our intentions would have to be given by starting that process even before we committed ourselves. Among the questions to be answered were those of the treatment of involuntary debtors and of the weight to be given to the individual currencies in the ECU basket, which for the lira was, and still is, ridiculously low.

4. From the Brussels meeting of 5/12/78 I recall two little episodes which illustrate the two constant factors of German obstinacy and UK reluctance. The first

concerns a proposal I made for the automatic renewal of short and very short-term financing for involuntary debtors. This proposal had been accepted by the French, the Belgians, and by the Germans, in the person of Junior Minister Lahnstein, but when the Bundesbank was phoned to give its views it vetoed the project. The protagonist of the second episode was the permanent Undersecretary at the UK Treasury, Couzens, who along with Messrs. Clappier and Schulmann had been one of the "three wise men" before Bremen, at the time when Messrs. Giscard and Schmidt were cultivating their relationship with UK Prime Minister Callaghan. Cornered by our demands, Mr. Couzens fell back on a series of structural reasons why the United Kingdom should not join a European system, such as the importance of its trade in dollars, the question of oil, and so on. "But in that case when will they join?" I noted disconsolately in my diary.

5. What value do the arguments made then have today?

In 1977-78, the inflation differential between Italy and Germany, measured by wholesale prices, was of the order of 8%; in 1979 it rose to 14%, and in 1980-81 it stabilised at 10%. Allowing for one change per year in the central rate to restore equilibrium, the lira would on average have been overvalued in relation to the Deutsche Mark by 5 to 7% between two successive realignments.

What actually happened was that in the first four years realignments took place more frequently than assumed above: there were seven of them in all, and the lira could, when it suited, fall in with the other currencies. I had not expected such an accommodating policy in an area which aimed at monetary stability and in a system which, according to the Bremen declaration, was to be "at least as rigorous as the snake". In the eight years up to January 1987, it was in fact possible for the lira to fall against the Deutsche Mark by 36.5%, while the French franc fell by 32.2%. This permissiveness did not prevent the French and Italian currencies appreciating in real terms against the Deutsche Mark, thus conferring on Germany a competitive advantage which contributed to the growth of its trade surplus with the rest of the Community.

In the numerous realignments, and especially those of 1981-83, the wide band did an excellent job in ensuring a smooth transition, without the sudden movements and the volatility of market rates which encourage destabilising speculation, and which frequently constitute a source of fat profits. The realignments of the French franc, on the other hand, limited as it is to the 2.25% band, necessarily took place in a more discontinuous way, and were sometimes accompanied by serious turbulence on the money market.

This said, we have to recognise that the appreciable downward convergence of inflation rates, achieved within the framework of the EMS, has created a favourable environment for narrowing the Italian band. On the other hand, however, the liberalisation of capital movements makes the parity system more vulnerable. The equilibrium point could be found in a band somewhat wider than the current 2.25%, which would be common to all member currencies. Italy's entry to the new band could take place subsequent to an initial examination of the effects of the liberalisation of capital movements. At the same time negotiations should be set in train on doubling the weight of the lira in the ECU, from 9 to 18%, on the basis of the relevant indicators (trade, national income, population).

6. The argument in favour of the wide band carries less weight if a range of positive effects is attributed to a rise in the real exchange rate. The view which is now dominant in Italy credits the strict exchange rate policy - the pressure of the high real exchange rate - with the twin advantages of having helped tame inflation and promote industrial restructuring. I have my doubts as to the propriety and the effectiveness of using the exchange rate to attain this second objective.

First of all, one can make a methodological objection. Every economic policy instrument should be used for the purpose for which it is designed, that of

the exchange rate being to help bring the balance of payments into equilibrium. If used as a scourge, its blows fall upon companies already exposed to the stimulus of international competition and leave untouched the sluggish domestic sectors which provide non-tradable goods and services.

One is, moreover, faced with the question of consistency in the interdependence pattern. A high real exchange rate reduces exporters' receipts in lire terms; the upward wage pressure in the 1970s raised costs; reduced receipts and rising costs both have negative effects on company earnings. It is difficult to see why compressing receipts by using exchange rates should trigger a virtuous circle of restructuring, while the upward wage pressure should produce a vicious circle of inflation. Nor can it be said that this second effect followed because an accommodating monetary policy allowed companies to pass higher costs on to the customer; on the contrary, at that time companies' profit performance was much worse than it is today. Furthermore, recent studies have shown that during the 1980s the speed of restructuring of German industry was no lower than ours, despite the opposite effects which the supposed effects of exchange rates should have produced in the two countries. In looking for the real connections between economic phenomena, one should not forget the time it takes the economic agents to react to their experiences and to events; some adjustments are likely to have spanned the two decades.

7. The United Kingdom's participation in the exchange rate arrangements seemed to me to be useful for a number of reasons in the technical monetary field, for which I was empowered to negotiate. At that time sterling was considered a weak currency; so far as Italy was concerned, sterling's presence within the system could have lightened our burden as to speculation waves and exchange rate realignments. It would also have improved the functioning of the divergence indicator. It would have counteracted the hegemony of the German line on economic policy, which was less open to the requirements of development and the reduction of regional imbalances favoured, on the UK side, by Messrs. Jenkins, Callaghan and MacDougall. It would have reinforced transatlantic links, in line with the suggestion, supported by us among others, for a common policy towards the dollar, a policy which was entirely ignored until September 1985 (the Plaza agreement). The years which followed saw the relative importance of UK trade with other Community countries grow in relation to its trade with the rest of the world, while the special relationship with the United States became less significant, and the experience of floating exchange rates was negative so far as sterling was concerned too. As a result, the United Kingdom is now firmly integrated into the EC economy, as are some non-member states - such as Switzerland and Austria - which have de facto placed themselves within the Deutsche Mark area.

These are the technical arguments. But not even an expert, try though he may to be objective, reaches his conclusions uninfluenced by deeper motivations; and in this respect I am culturally attracted by a country whose writers, institutes and markets have supplied economists with the widest possible range of sources and objects of study.

8. In my opinion, UK membership with the wide fluctuation band as applied to Italy could have been fruitful. This was not to be, but the idea had authoritative supporters in the United Kingdom itself. I will conclude by quoting two.

In 1986 the Public Policy Centre published the text of a study carried out by a committee chaired by Lord Croham (Sir Douglas Allen), entitled "Exchange rate policy for sterling", which contained the following conclusions:

"Although adopting a narrow band would be an earnest of intent, on balance we are in favour of entry with the wide band (+6%)... We wish to see sterling enter with wide intervention margins like those of the Italian lira."

The second quotation comes from an article by Samuel Brittan, published in the Financial Times under the heading "The case for the Italian band", on 16/11/78, immediately after the Basle meeting referred to above.

- 5 -

"The Italian transitional formula... would serve UK interests extremely well. Even at this late hour the British Government should be asked to think again about its outright rejection of the idea, for a wider band could provide a formula by which the UK and Italy could both join the EMS... There is now a common Anglo-Italian economic sickness. When there is just as big a question-mark over whether an aircraft will be allowed to take off from Rome and whether it will be allowed to land at Heathrow, neither country can afford superiority feelings at the expense of the other. To the post-war British generation the British Empire is as much a thing of the past as the Roman Empire to present day Italians."