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16th February 1987

(Translation)

GROUP OF EXPERTS UNDER THE CHAIRMANSHIP OF M. RAYMOND

The aim of the following text is to list the subjects which might be discussed at the Group's meeting on 25th February and in the preliminary note to be submitted to the Governors on 10th March. The experts will be asked to comment briefly on the various points and to add to the list all those which ought likewise to receive attention at this preliminary stage.

I. TECHNICAL CONSIDERATIONS

Without a doubt, it is the experts' role par excellence to specify the technical content of the measures planned prior to opening the (quasi-theological) debate on the autonomy of monetary policies.

1. Procedures for financial integration

1.1 There exist degrees of financial integration:

- The first consists in granting residents the liberty to diversify their assets freely, whether monetary or in the form of securities, and to choose the currency in which they borrow, but not to allow them to hold assets abroad. This stage already means that capital movements are determined by a comparison between exchange rate expectations and each currency's particular interest conditions.

- A further step is taken once residents are permitted to hold their savings abroad. In this case, their monetary assets and their portfolios escape their national authorities' (necessarily territorial) jurisdiction, be it in matters of statistical records, tax rules or a wide range of other regulations. The differences between the constraints which each country imposes on its banking system and its financial markets constitute an additional factor in capital transfers.

- The third degree of integration renders it total by enabling each country's institutions to pursue their activities, in compliance with their national regulations, in the other member countries. This freedom in respect of financial services ought, in theory, to lead ultimately to a standardisation of transactions and a harmonisation of the rules governing the operation of financial institutions and markets; any government which imposed special rules, whether these represent subsidies or obstacles, would be violating the "level playing-field" principle.

1.2 The question is whether barriers are to be lowered solely between member countries or, at the same time and to the same extent, vis-à-vis countries outside the European Community. It only needs one member country to be equally open to non-member countries and to its partners for the latter to be unable to differentiate between their intra and extra-Community relations. Since several member countries have already attained the second degree mentioned above, it will, no doubt, have to be adopted by all concerned. The third degree is debatable: while some countries are certainly more liberal than others, none is, perhaps, totally open vis-à-vis non-EEC countries in the field of financial services. A common position would thus have to be worked out concerning the acceptance of financial services from outside the EEC.

2. Technical consequences for the monetary authorities

The reforms mentioned above have a number of immediate consequences for the monetary authorities insofar as they call into question some of their techniques and will oblige them to endeavour to harmonise certain of their rules.

2.1 Knowledge of residents' wealth will be made much more difficult once the second degree of integration mentioned above is embarked upon, especially if exchange control is abolished across the board. The monetary aggregates defined according to each country's banking system will only give an incomplete picture of residents' holdings. Several member countries which do not have exchange control are already encountering this difficulty, which can only become more acute and more widespread. One might envisage mutual declarations between member countries, on condition that unreserved agreement is obtained from all. Assets held outside the EEC will still have to be estimated. The usual quantitative guides of monetary policy are thus in danger of becoming even less relevant and clear-cut.

2.2 The instruments of monetary policy, it seems, cannot but evolve progressively towards a predominant recourse to the open market. The development already outlined in the Group's special report of autumn 1986 is thus bound to become increasingly pronounced.

2.3 The harmonisation of regulations will become indispensable, the more so as progress is made along the path of integration. It will affect the tax status of interest and capital gains and the conditions governing the declaration of the one and the other, certain rules relating to monetary policy such as compulsory reserves (which, by imposing constraints on the banking system, influence its borrowing and lending rates) and, finally, the banks' supervisory ratios. Perhaps even the particular statuses of certain financial institutions might pose a problem, as might financing mechanisms.

3. Summary of the preceding remarks

It will undoubtedly be the pressure of events which will lead the central banks to develop their money market techniques.

However, it would certainly be useful for experts to draw up a sort of table setting the stages of integration, on the one hand, against the difficulties relating to statistics and to the rules requiring harmonisation, on the other, so that each country is aware of the reforms involved in each stage of liberalisation. It would be in everyone's interest for progress towards total integration to be accompanied by the elimination of the chief sources of distortions likely to set off large-scale arbitrage activity. One might, for example, demonstrate that it is, in general, profitable for tax reasons to invest one's financial savings abroad.

II. EXCHANGE RATE MANAGEMENT AND MONETARY POLICY

Even if it is assumed that all the technical precautions which have just been recommended have been taken, the total abolition of exchange control will radically alter the conditions under which member countries' monetary policies are implemented. In fact, several of these countries, even within the exchange rate mechanism, use exchange control to attenuate or hold off fluctuations in their exchange rates. This brake will no longer function. Monetary policy and, more generally, economic and fiscal policy will have to be geared to the prime task of maintaining parity. It is in this sense that they will lose their autonomy.

If, in the absence of restrictions on capital movements and on the provision of financial services, a member country wanted to pursue a different objective, it would have to abandon fixed exchange rates.

These statements are almost tautological, but they have to be set in a practical context. There are few exchange controls which today constitute hermetic barriers between the countries participating in the exchange rate mechanism. What one must expect, therefore, is a greater degree of difficulty rather than a really fundamental change.

1. Perfect example of fixed exchange rate

Hypotheses: absence of restrictions on capital movements;
absolute priority given to stabilising the exchange rate very close to a declared parity.

Concrete example: country in the exchange rate system with narrow limits.

1.1 The stabilisation of exchange rates would prove more difficult both for the country or countries losing capital and for the country or countries to which it flows.

- It would require more substantial interventions. Countries which lost capital would, therefore, have to be able to rely on appropriate reciprocal loans. Interventions would be more effective if they took place simultaneously in the countries losing and in those receiving capital; at present this only occurs at the limits. These would, admittedly, be reached more quickly.

- Domestic interest rates would have to be shifted earlier and more strongly. Their fluctuations would have to be triggered by exchange rate movements and interventions. The risk of a deflationary bias has been mentioned given the danger of overshooting which is normally involved in a system where very short-term capital movements occur and which, in the case of a floating currency, is reflected in phases of marked overvaluation or undervaluation. The issue should be examined from the perspective of the days leading up to the realignments since 1979. One may ask, with good reason, what interest rate differentials would have been necessary to avoid parity adjustments.

- This shows how important it is not to let oneself be forced into a crisis situation. For that reason it is necessary to lend greater credibility to the co-ordination of the policies pursued. This does not concern monetary policy alone but affects economic policy generally and taxation and revenue in particular. That is the cost of achieving adequate convergence.

1.2 The convergence of fundamentals is recognised as the precondition for combining exchange rate freedom and fixed parities.

- While it is certainly necessary, one must not be deluded into expecting too much from it. It cannot last for ever, nor can it cover all the economic data. In its Report No. 29, the Group stressed the importance of nominal (price) convergence for exchange rate stability. Further progress is required before a common retail price and unit cost (or selling price) index can be arrived at. With regard to current payments and budget deficits, the countries participating in the exchange rate mechanism have different points of departure.

- However beneficial it may be, convergence does not provide an absolute guarantee, as operators will probably consider that, over time, the risk is not the same for all the currencies concerned. They will base their judgements on domestic political events, which are frequent in democracies, and on external shocks, which differently structured economies cannot react to in an identical fashion.

- Finally, convergence can only be the product of a co-ordinated effort. As long as inflation was high, the natural functioning of the EMS led the member countries to bring their rate of inflation closer to the lowest rate in the EEC. At present, replacing this asymmetry with a goal based more on negotiated consensus would appear a matter of some delicacy: Germany certainly does not wish to let its rate of inflation climb to the Community average, and other countries may not want to lower theirs even further. However, the stability of the system necessitates an agreement on a common objective formulated on such terms that it appears credible to general opinion.

2. <u>The choice of a certain degree of autonomy</u>

Hypotheses:

- transitional phase starting from an excessively divergent position;
- deviation due to a new event whose effects cannot be immediately offset;
- the wish to give priority to a variable other than the exchange rate.

In these circumstances, the lifting of exchange restrictions would mean that exchange rate changes became unavoidable more quickly.

. Within the exchange rate mechanism, the difficulty of defending parity, whatever the direction of pressure (upward or downward), would be likely to lead to more frequent realignments, which are the logical consequence of any attempt at autonomy.

. Another approach would consist in advocating the widening of fluctuation margins. Some people consider today that this has become necessary in any case.

. It is a truism to say that floating ensures the autonomy of monetary policy. This must be mentioned to the extent that not all EEC currencies participate in the exchange rate mechanism. The liberation of capital would not be a cause for satisfaction, however, if it had to be achieved at the cost of withdrawals from the exchange rate mechanism.

3. <u>Impact of dollar and yen exchange rates</u>

To the extent that exchange controls were also removed vis-à-vis non-EEC countries, capital flows into (or out of) Europe would be increased and heighten the tensions between European currencies all the more. This argues in favour of pursuing efforts towards an overall stabilisation of exchange rate relationships (even if there can be no return to a Bretton Woods type of system).