
Economic Perspective

UK MEMBERSHIP OF THE EMS - TIME FOR ANOTHER LOOK?

by Bill Stewart, Department of Economics

The UK is a member of the EMS but does not participate in its most important element, the exchange rate regime. The UK expressed a willingness to join when "conditions were appropriate" but so far has never found any set of conditions to be appropriate.

Should the UK now join the EMS in the expectation of enjoying greater exchange rate stability against a group of countries which form its major trading partner by far - accounting for 43% of its visible trade in 1980. The independent pound sterling has shown greater variability than EMS currencies. It has been argued that as a member of EMS the pound would have avoided the excessive appreciation of 1980 and the subsequent depreciation of 1981-82, to the benefit particularly of UK manufacturing industry.

The UK has argued for retaining independence from the EMS exchange rate regime on a number of grounds. The pound sterling it is argued is a petro-currency subject to the vagaries of capital flows determined by changing expectations with regard to oil output and price from both her own and OPEC sources and requiring greater flexibility in exchange rate than would be available in the EMS. This argument would carry less weight if the UK was to enter the EMS with a margin of plus or minus 6% from the central rate, a provision currently enjoyed by Italy.

Germany also has a currency which is extensively used internationally and has managed to operate satisfactorily within the narrower plus or minus 2.25% margins. However, uncertainties regarding the equilibrium exchange rate between the dollar and the Deutschmark introduce pressures into the EMS which would be heightened if the UK was also a member. The relatively relaxed approach of the UK authorities to the dollar appreciation in early August this year is in marked contrast to the heavy intervention undertaken by the Bundesbanks and other central banks. Such a relaxed approach would not have been possible in the EMS.

Perhaps of more serious concern is the appropriate exchange rate at which the UK should enter the system. Most commentators agree that the £ is seriously over-valued in relation to many of its major competitors (see Table 1) and that to enter at an over-valued rate would place the UK at a serious competitive disadvantage for an extended period. There is, however, no agreement as to what an appropriate exchange rate would be and rapid agreement in the EMS is unlikely.

Although the UK is increasingly dependent on EEC countries for trade, her trade with non-members is equally important, and it is argued that an effective exchange rate target allowing for the influence of non-EMS trading partners is more appropriate in these circumstances. However, to the extent that UK trade with other EMS countries grows and other countries join

the EEC the UK case for retaining an independently flexible exchange rate is weakened.

TABLE 1 PRICE DEFLATORS AND EFFECTIVE EXCHANGE RATES FROM 1978 TO 1982 IN RELATION TO 17 MAJOR PARTNERS

	Relative* Prices 1	Effective** Exchange Rate Indices 2	Real Exchange Rate Indices 3 = 1x2
	1982 in Relation to 1978		
Belgium	89.7	87.8	78.7
Denmark	100.3	81.0	81.3
Germany	84.2	107.2	90.3
France	111.8	87.1	97.4
Ireland	119.7	86.9	104.5
Italy	139.8	76.9	107.5
Netherland	91.5	104.2	95.3
UK	118.8	116.0	137.8

* Individual countries GDP price deflators, measured against 17 major partners, export weighted, variable from year to year till 1977

** 1982 Effective exchange rate using June 1982 central rate for for EMS countries.

Source: European Economy June 1982

Another argument employed is that the UK has made better progress towards meeting certain of the targets necessary for policy convergence - control of the money supply, reduction in the level of inflation, reduction in the budget deficit - outside the EMS than many countries have inside it and that therefore the arguments for membership based on ensuring greater policy discipline are reduced. On the other hand the overall performance of the UK economy is still inferior to that of other members of the EMS and progress by the UK could be regarded as establishing conditions which would make the transition to EMS membership easier. In these circumstances does retention of freedom to adjust the exchange rate lose some of its appeal and might not the acceptance of an exchange rate target as a full member of the EMS not have an important psychological impact regarding the seriousness of the intent to pursue the appropriate economic policies necessary to sustain EMS membership?

Given the ultimately political nature of the EMS, the UK cannot indefinitely postpone membership of the EMS and remain in the EEC, particularly if further integrative advances are proposed in the system. As UK trade with the EEC expands, particularly as new members are admitted, the attractions of EMS membership will be enhanced. In the field of international monetary relations the UK may find a more persuasive outlet for her interests through the EEC and the EMS than by pursuing an independent approach in negotiations with the USA and Japan and other members of the IMF.

The UK is being pushed towards EMS membership both by economic and political factors. The major question is when the economic factors would be regarded as sufficiently attractive to enhance the expected, if more tenuous, political benefits.