Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

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(Translation)

Group of experts under the
Chairmanship of M. Raymond

MONETARY POLICY IMPLICATIONS OF THE LIBERALISATION OF CAPITAL MOVEMENTS WITHIN THE COMMUNITY

PRELIMINARY NOTE BY THE CHAIRMAN

This note is concerned with the implications of the liberalisation of capital movements for the monetary policies of the countries participating in the European exchange rate mechanism. Because of the very limited time available the Group was only able to hold one meeting and could not prepare a report in the normal way. The present note has been drafted by the Chairman, on his own responsibility, and, while based on the discussions of the Group, it does not commit its members.

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The progressive abolition of exchange controls, to the point of the complete freedom of capital movements, is an objective actively pursued by the authorities of the European Community. This process is a vehicle of progress, in that it must lead to the optimum allocation of financial resources, reduce the cost of the financial system by heightening competition, and create a market which is broad, efficient and consequently attractive to operators in all countries.

At the same time, it is a European project which ought not to be taken out of the context of the long-term perspectives opened up by the Treaty of Rome and subsequent texts. The measures under study would have no meaning if they did not mark a step in this direction. Their effect must, therefore, not be to divide member countries, but to bring them closer together. This means both that possible risks should not be regarded as a priori obstacles and that the necessary basis must be created to avoid setbacks.

Taking a pragmatic approach, let us, with this in mind, recall a number of principles or basic premises and take note of some technical issues before going on to discuss the application of monetary policies.

I. PRELIMINARY REMARKS

1. Compass of the subject

A few simple, general ideas seem to need to be borne in mind.

1.1 The abolition of exchange controls and the free provision of financial services have implications the one for the other. The latter, however, is less directly linked than the former with monetary policy, and it has a logic of its own.

1.2 The removal of foreign exchange restrictions between member countries cannot be divorced from an opening-up vis-à-vis countries outside the Community. As soon as just one country has no exchange controls, all the others will be obliged to remove their own. It is necessary to see capital flows in this wider context in order to measure their impact on countries linked by special exchange rate commitments.

1.3 The significance of the technical factors should not be ignored. They may be a source of disturbances but, given the present disparity in conditions among member countries, they certainly lend themselves to considerable improvement.

2. Examination of the facts

2.1 An examination of the facts reveals that, even within the group of countries belonging to the exchange rate mechanism, there is a wide diversity of situations. Some are entirely without exchange controls. Where restrictions do exist, they apply only to residents, generally do not limit their borrowing abroad, and may be circumvented by fraud and by economic behaviour such as leads and lags. The compartmentalisation of the European markets is not total, far though we may still be from perfect substitutability between assets denominated in different currencies.

2.2 The process of integration is already underway. Financial innovation has been contributing to it for several years. The national authorities have deliberately accelerated and guided it. We are therefore speaking not of effecting a transformation tomorrow, but of continuing to live through a transition. The longer a country's road, and the more quickly it has to be travelled, the greater the risk of shocks to the exchange rate. And, given

the differences in their size and openness, not all economies are approaching these reforms from the same starting-point.

2.3 With these reservations, we must expect a greater degree of difficulty, rather than a change in the nature of the difficulties. It is, therefore, important not to dramatise the consequences of liberalising capital movements. Liberalisation will only reinforce an external constraint which already exists in exchange rate and interest rate management for all the countries in the European exchange rate mechanism.

2.4 This is not to say that the world of capital movements does not also contain unknown territory. Our knowledge of the operators' expectations and of the causal links remains imperfect. Model-making and forecasting are risky exercises. It is therefore still of value to develop the analysis as far as possible.

II. <u>TECHNICAL CONSIDERATIONS</u>

It is, without doubt, the experts' rôle par excellence to specify the technical content of the measures planned before opening the (quasi-theological) debate on the autonomy of monetary policies.

1. <u>Ways and means of financial integration</u>

1.1 There are <u>degrees</u> of financial integration:

- The first consists in permitting residents to incur debt, and repay debt, in foreign currencies or with non-residents.

- The second consists in allowing residents freely to acquire foreign currency and foreign securities. The authorities in certain countries still require that such assets remain domiciled on national territory. Where this is no longer the case, removal to another locality poses specific problems. In fact, assets held abroad escape the necessarily territorial jurisdiction of national authorities, be it in matters of statistical records, tax rules or a wide range of other regulations. Differences between the constraints which each country imposes on its banking system and its financial markets constitute an additional factor in transfers of funds.

- 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 represented subsidies or obstacles, would be violating the "level playing-field" principle.

2. Technical consequences for the monetary authorities

The reforms mentioned above have 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 For a knowledge of residents' wealth it may be necessary to have, in addition to the statistics provided by the national banking system, information concerning residents' positions abroad. Data supplied by the BIS, balance-of-payments analysis or other sources may be of service here. For the moment, residents' liquid assets held abroad are generally considered to be of little importance - and changes in them of little significance - for purposes of domestic monetary regulation.

2.2 The instruments of monetary policy cannot but evolve progressively towards an increased rôle for money market rates, along the lines indicated in the Group of Experts' Special Report of November 1986.

2.3 The harmonisation of regulations may prove to be necessary in regard to 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 statuses of certain financial institutions may pose a problem, as may particular financing mechanisms. This does not mean that it is necessary to reach a state of complete identity in every field. Stable exchange rates may be maintained between countries with different administrative regimes. Nevertheless,

certain disparities may lead the residents of a country abandoning exchange control to transfer their savings as soon as they are free to do so to a market where they would receive better treatment than at home.

It would therefore 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 the rules requiring harmonisation, on the other, in order to highlight the reforms entailed by each stage of liberalisation with a view to eliminating the chief sources of distortions likely to set off large-scale arbitrage activity.

III. 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 the monetary policies of the countries participating in the exchange rate mechanism are implemented. In fact, several of these countries still 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 give greater attention to maintaining parity. In this sense they will lose, at any rate, a certain degree of autonomy.

However, the issue that arises today is more fundamental and relates to the theoretical impossibility of combining more than two of the following three characteristics:

- complete freedom of capital movements;
- fixed exchange rates;
- autonomous, that is to say discretionary, monetary policy.

Taking the first of these terms as a working hypothesis, it is useful to examine in turn how it can be combined with each of the other two before turning to practical considerations.

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 (European exchange rate mechanism with no realignment).

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 receiving it.

- 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 moved up or down earlier and more strongly. Their fluctuations would have to be triggered as soon as exchange rate movements and interventions took place.

One may well ask what interest rate differentials would have been necessary to avoid parity adjustments in the weeks leading up to the "crisis" realignments that have been made since 1979. In other circumstances, however, very sharp rises in money market rates effectively discouraged speculation and, since they lasted only a short time, had no destabilising effect on the economy.

- Certain countries with highly open economies which are already very exposed to external constraints fear the deflationary risk entailed by the necessity of raising domestic interest rates still further in order to stifle capital outflows.

Conversely, those countries which have eliminated inflation and whose currencies are candidates for revaluation fear being unable to control their monetary aggregates, in particular their monetary base. A decline in nominal interest rates would, in fact, reach a natural limit as they approached zero, whereas speculators would only be discouraged by negative yields.

These opposing fears as regards the risk of an inflationary or deflationary bias show that it is important not to let oneself be forced into a crisis situation and, to this end, to make a constant effort towards a sufficient degree of convergence.

- The increased variability of interest rates and the impact of international operations might, finally, alter certain of the transmission mechanisms of monetary policy, or at least their relative importance; it

would be useful to examine the circumstances in which this would take place more closely. Each country would become more sensitive to the measures taken by its partners.

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 fundamentals. In its Report No. 29, the Group stressed the importance of nominal (price) convergence for exchange rate stability. Substantial progress has been made in the area of retail prices and unit costs, but divergences still exist. With regard to current payments and budget deficits, by contrast, 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 may nevertheless consider that, over time, the risk is not the same for all the currencies concerned. They will be influenced by domestic political events, which are frequent in democracies, and on external shocks, which differently structured economies cannot react to in an identical fashion.

1.3 Convergence can only be achieved and maintained through a close co-ordination of policies, especially fiscal and monetary policies.

The co-ordination of monetary policies, which are the focus of this note, could be based on two different approaches.

The countries participating in the exchange rate mechanism could align themselves - to comply with the restraint imposed by the exchange rate - with the policy of one of their number, whether because it is judged to be the best or because it is that of the dominant economy.

On the other hand, the countries as a group, without any one taking on the appearance of leader, might agree to set a common objective for prices (whereby the type of index to be used as a reference would doubtless also have to be decided on) and to gear their macro-economic policy, and in particular its monetary components, towards convergence on this common goal. This so-called symmetrical solution would, naturally, require a rule of play as regards the consultation and decision-making process.

2. The choice of a certain degree of autonomy

2.1 Several lines of argument may lead a country participating in the exchange rate mechanism to wish to preserve a certain degree of autonomy as regards the choice of internal monetary policy objectives.

- It may regard the current stance of this policy as the best for itself and consider that any concession in the interests of achieving a different, Community objective would destabilise its internal equilibria. Here the dilemma between the deflationary bias (with a refusal to apply an even more restrictive policy) and the inflationary bias (with a refusal to adopt as a target an average inflation rate higher than that achieved at home) reappears.

- A country starting from a divergent position when capital movements are freed may wish to take its time in attaining the degree of convergence necessary for the defence of parity.

- Finally, a country may suffer a sudden deviation under the impact either of an internal shock (wages, tax reforms, etc.) or of an external shock that has greater - or smaller - repercussions than in other countries.

2.2 In such situations, the lifting of capital transfer restrictions would mean that exchange rate changes became unavoidable more quickly. Within the European exchange rate mechanism, this might engender the idea of accepting more frequent realignments and/or widening the fluctuation margins.

3. EMS practice

3.1 As has already been noted, the EMS exchange rate mechanism was conceived as a set of rules whose purpose was to create a zone of monetary stability. It has undoubtedly helped to steer member countries' policies in the direction of convergence towards low inflation. National authorities have defended their currencies' parities so as to make realignments less frequent and avoid competitive devaluations. A certain amount of flexibility has, however, had to be accepted in practice, so that for the present the EMS cannot be compared to scenario 1 examined above, i.e. firmly fixed exchange rates.

3.2 On the one hand, the recent improvement in convergence makes it less difficult to move closer to scenario 1. On the other hand, complete freedom of capital movements makes it more difficult to the extent that co-ordination of monetary policies, in their formulation and in their daily management, is imperfect. Should we adhere to the pragmatic system of co-ordination now practised, at the risk of larger capital movements in the event forcing a relaxation of the exchange rate mechanism? Or should the liberalisation of capital movements, which is a specific decision, be accompanied by closer co-ordination of monetary policies in the form of new procedures which are both more developed and more constraining. An unambiguous reply must be a matter of policy.

3.3 The experts, however, are right in recommending a number of precautions which they consider to be of value in any event.

- Firstly, it is important not to ignore the environment in which monetary policies operate, and it would be unwise to impose all the pressures on them if aberrations in interest rates are to be avoided. It would for this reason be advisable to reduce structural disparities (see Section II) and strengthen convergence of fiscal policies.

- It would seem unwise, given the negative impact it would have on expectations, to impair the credibility of the exchange rate mechanism at a stroke by announcing that the margins will be widened and/or realignments made easier.

Most members of the Group consider it futile to expect added comfort from wider margins which speculation will never stop trying to reach. The present margins of $\pm$2.25 per cent. offer a flexibility which can be utilised to the full.

Realignments for their part must continue to be accompanied by flanking measures. They should be avoided as far as possible - and parities should be defended energetically - when convergence is satisfactory. It cannot, however, be ruled out that some realignments would become necessary solely as a result of capital movements, all the more so as these are not exclusively European but also involve relations with the dollar and the yen.