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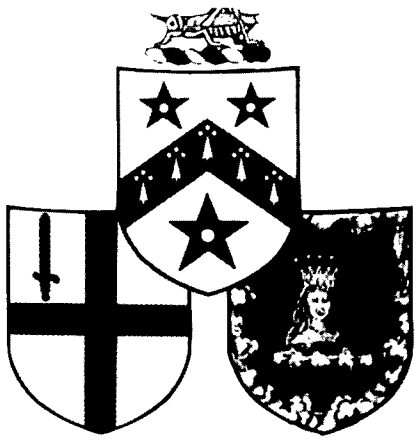

UK MONETARY ECONOMICS: THE INTERNATIONAL DIMENSION

Three lectures given by

PROFESSOR WALTER ELTIS MA DLitt
Mercers' School Memorial Professor of Commerce

Lecture 1 – 5 February 1996
THE MONEY SUPPLY AND THE EXCHANGE RATE

Lecture 2 – 12 February 1996
INTEREST AND EXCHANGE RATE POLICY
AND THE CONTROL OF INFLATION

Lecture 3 – 19 February 1996
MONETARY UNION

GRESHAM COLLEGE

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- to foster academic consideration of contemporary problems;

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Economic Advisers and UK Exchange Rates

Lord Kaldor and theorists of export led growth made a falling pound predictable when Labour won the 1974 election. The Exchange rate index was 124.8 in 1975, (perhaps 135 in 1974), and 107 in 1979. The Exchange rate can always be reduced by holding interest rates down which will produce extra monetary growth. Interest rates were 11% in 1974 and 1975, and 14% in 1976. Inflation was 16% in 1974 and 25% in 1975. After that money supply tightened and exchange rates rose from 1978 to 1979.

Ball and Burns Now Sir James Ball and Sir Terence Burns were very influential after 1979. Their article "The Inflationary Mechanism in the UK Economy", *American Economic Review,* September 1976, was extremely powerful and it was predictable that, under their influence, sterling would rise sharply. The exchange rate index rose from 107 in 1979 to 127 in 1981. The real exchange rate rose about 25% more than this because comparative inflation was also faster in Britain by about 25% in 1979-1981.

The Ball and Burns explanation of inflation is as follows. Extra monetary expansion lowers exchange rate. Then

1. Prices of tradables (exports and import substitutes) rise with exchange rate to keep in line with prices of similar goods overseas. If exchange rate falls 20% prices of tradables rise 20%.

2. Companies producing tradables raise wages in line with the higher prices they can charge.

3. Workers producing non-tradables obtain pay increases in line with workers in tradable sector because of principles of fair comparison.

4. Prices rise 20% in whole economy once wages throughout economy have risen 20%, and competitive advantage from devaluation disappear.

5. The whole process takes about three years. Advantage from devaluation comes because it stimulates supply.

Sterling prices are raised with devaluation and they remain unchanged in D Marks.

Costs of production are reduced 20% by devaluation at first when they are measured in D Marks which lowers supply curve. Devaluation is exploited because incentive to export is increased which raises profits and not by cutting prices in foreign markets. But the advantage only last three years.

The implications of the Ball-Burns theory is that revaluations will cut inflation at a cost of just three years of competitiveness loss.

Exchange rate goes up, prices come down, wages come down, inflation comes down.

To put exchange rate up, interest rates must be relatively high internationally and this constrains monetary growth.

Those who held sterling from 1979 to 1981 gained 20% on the exchange rate and about 10% through higher London interest rates. This is such a bargain that sterling must rise to the point where it is expected to fall. Otherwise everyone would want to hold it. Sterling therefore rise to the point where it is expected to fall, so it rises too far.

It therefore OVERSHOOTS.

From 1981 to 1987 it fell from 127 to 100.

A country cannot control both the money supply and the exchange rate.

When interest rates are such as to produce a low exchange rate money expands over-rapidly. When interest rates are high to produce a high exchange rate monetary growth slows or stops. A country with exchange rate targets will get its money supply wrong.

This underlines the volatility of actual exchange rate movements and the dangers of exchange rate targeting which may seek to control forces that are unpredictable.

Exchange rate targeting proved disastrous in 1987-88 (Shadowing the D Mark) and in 1990-92 (ERM Membership).

Situation exacerbated by impact of Dollar/D Mark volatility.

Sterling cannot shadow both, but a low dollar undermines competitiveness of UK high-tech industries like aircraft and pharmaceuticals.

Shadowing a continental currency therefore leaves high-tech industry vulnerable. Shadowing the dollar would leave us vulnerable in European markets.

Markets take such influences into account.

There is not a precise Money-Exchange rate equation. Hacche and Townend, 'Modelling Sterling's Effective Exchange Rate', *Oxford Economic Papers*, 1981. These Bank of England economists tried to show that monetary policy was loose from 1972-76 when sterling fell and higher after 1976 when sterling rose.

They found:

> The predominant impression left by our results is one of failure; we have not succeeded in finding regularities in the data to help explain the fundamental determinants of sterling's exchange rate. Our research has failed to yield empirical support for any of the theories tested, including most notably the monetary model. Looking positively at our results, it is true that we have identified an auto-regressive process which provides some support for the proposition that the exchange rate will not follow a random walk. p.243

> Whatever unpredictable factors have wrecked the Bank of England's equations will also produce unwanted monetary effects if a fixed exchange rate target is pursued and therefore serious damage to the stability of the real economy.

UK MONETARY ECONOMICS: THE INTERNATIONAL DIMENSION

INTEREST AND EXCHANGE RATE POLICY AND THE CONTROL OF INFLATION

Lecture by

PROFESSOR WALTER ELTIS

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12 February 1996

It has been shown in previous lectures that the exchange rate influences inflation. A lower exchange rate increases the prices which can be charged for tradables, exports and goods and services which compete with imports. This increases the prices which companies that produce tradables can afford to charge both at home and overseas and the wages and salaries they can afford to pay. That will be inflationary.

Lower interest rates will increase the attraction of borrowing and enhance the security of loans, and the liquidity of financial institutions. They will also raise asset prices. Lower interest rates will therefore raise effective demand and the rate of growth of the money supply. The impact of these will also be inflationary.

If lower interest rates and a lower exchange rate both have an inflationary tendency, it is possible to offset the inflationary impact of **lower** interest rates with a **higher** exchange rate, and vice versa. There should always be a combination of **lower** interest rates and **higher** exchange rates which has a neutral long-term impact on inflation.

In Figure 1, the AA line sets out that combination. At the left, the exchange rate is very strong, but the interest rate is low. Moving up the AA line to the right, as the exchange rate becomes lower, the rate of interest rises. Every point on AA supposedly has the same long-term inflation rate.

Figure 1 also has the line FF which shows the impact of the foreign exchange market on a country's interest rates. There when a country's interest rates are high, its exchange rate

will be strong. As the interest rate falls, the exchange rate becomes weaker. At the right when the interest rate is very low, the exchange rate is very weak.

If the Government wishes to maintain the inflation rate shown by AA it must also satisfy the foreign exchange market. That means it will also have to be on FF. The only way of maintaining the inflation rate determined by AA will be to hold its interest rate at r where AA and FF intersect. That will produce an exchange rate of E.

The actual interest rate will be determined by the foreign exchange market. If the government maintains a higher interest rate than r the exchange rate will be stronger than E and the economy will be above AA. That means that inflation will fall below the target level shown by AA. If the interest rate the government maintains is below r, the exchange rate will fall below E, the economy will be below AA and inflation will rise.

The interest rate which produces stable inflation at the inflation target will vary with economic circumstances. Figure 2 shows the impact of a growing wave of portfolio investment into the UK because future prospects are more highly regarded. This lowers the FF line to F'F' which raises the exchange rate. Achieving the inflation target is now compatible with the lower interest rate, r'.

Figure 3 illustrates the impact of a deterioration in trade prospects which raises FF to F'F' because the foreign exchange market now takes a less favourable view of sterling. This lowers the exchange rate, so interest rates have to be raisesd

to r'r' to maintain the inflation target, and counteract the inflationary impact of a weaker exchange rate.

Figure 4 shows the effect of a simultaneous fall in raw material prices and deterioration in trade prospects. The lower raw material prices lower AA: maintaining the inflation target is compatible with lower interest rates, but deteriorating trade prospects raise FF. The two together sharply reduce the exchange rate, but interest rates can remain nearly unchanged because the two effects on inflation counteract each other.

Figure 5 shows the effect of lower wage inflation which lowers AA and improving trade prospects which lower FF. The two together allow interest rates to be sharply reduced without an adverse impact on inflation.

The business community often pleads with government for lower interest rates. These can only be reduced without causing an acceleration of inflation if the pace of wage inflation is at the same time slower as in the 1990s, and the foreign exchange market has confidence in sterling. Otherwise lower interest rates will take the economy below AA and inflation will accelerate.

Finally Figures 6 and 7 illustrate the impact of an increasing tendency for a country's government debt to grow. This will weaken its attractiveness as an international portfolio asset and so push the FF line up to F'F', F"F", etc. That would require ever higher interest rates to keep the country on AA and maintain the inflation target. The exchange rate would at the same time have a continual tendency to fall.

If the country declines to raise interest rates as in Figure 7, the economy would fall below AA so inflation would accelerate, and the exchange rate would fall all the faster.

The essence of the argument is that a government can compensate for having too low an exchange rate by having too high an interest rate and vice versa.

There will all the time be changes in sentiment in foreign exchange markets which are far more powerful than the resources of governments. When the waves of money go in or out from the foreign exchange market governments have to ride with them. If the wave is favourable as in Figure 2 the Government has to allow the exchange rate to be bid upwards, but because this will cut inflation, it can afford to reduce the rate of interest which will be a popular move and still keep a lid on inflation.

If there is an unfavourable movement from the foreign exchange market as in Figure 3 the Government must allow the exchange rate to fall, but it will now have to raise interest rates if this fall is not to be inflationary.

If the Government is locked into a particular exchange rate as Lawson when he shadowed the D Mark in 1987-89 the economy is likely to be forced off the AA line with strong inflationary or deflationary consequences because the interest rate will not be able to stay on AA. In 1987-89 it fell below AA with vast inflationary consequences.

If interest rate decisions are influenced by the political short-term they will all too easily allow the economy to slip below AA and push up inflation.

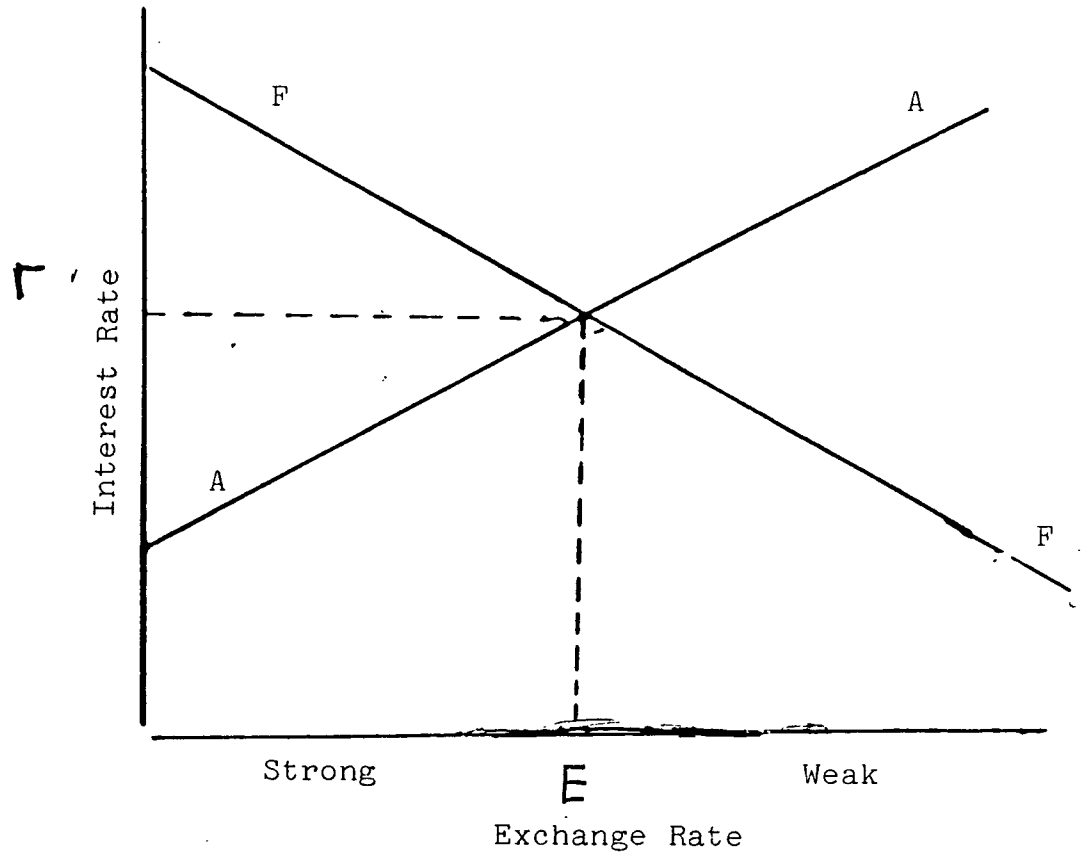
The difficulty with this approach which is perhaps the best available is that the impacts of the interest rate and the exchange rate on inflation have very different time dimensions.

Higher interest rates must reduce inflation in the long-term but in the short-term they will raise mortgage rates and the cost of living and the pace of wage increases. Therefore for about a year higher interest rates may raise inflation and not reduce it. After that, once they influence the rate of growth of the broad money supply, their impact will become overwhelming, after say three to four years.

A higher exchange rate has some immediate negative impact on prices, and this will grow.

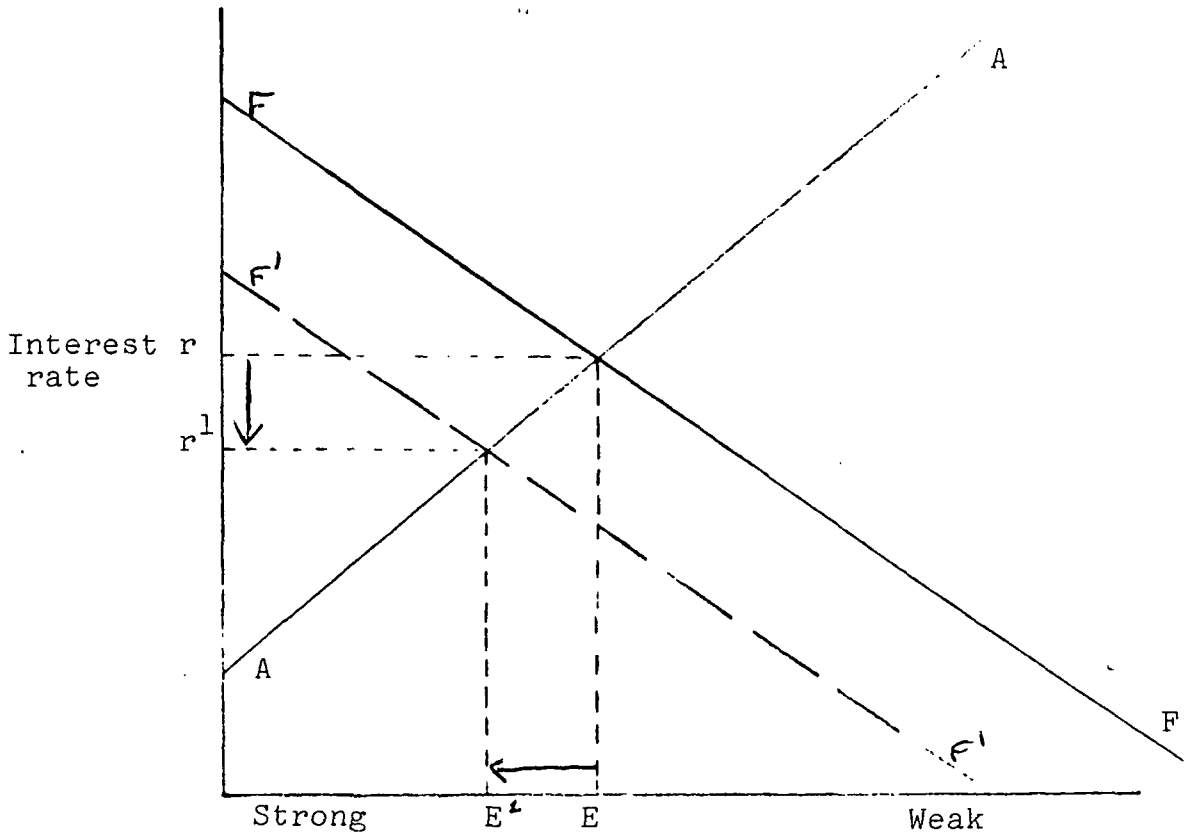
There is therefore no sense in which this approach to inflation control can become automatic. Government must take a view of what inflation will be two or three years in advance and fix interest rates with these medium term effects in mind. This is what the Bank of England and the Treasury both seek to do and they constantly compare their analyses. But inflation can only be controlled if interest rates and the exchange rate are both free to vary.

Figure 1



The economy must be on AA to satisfy the inflation target. It must be on FF to satisfy the foreign exchange market. It must maintain an interest rate of r to satisfy both conditions.

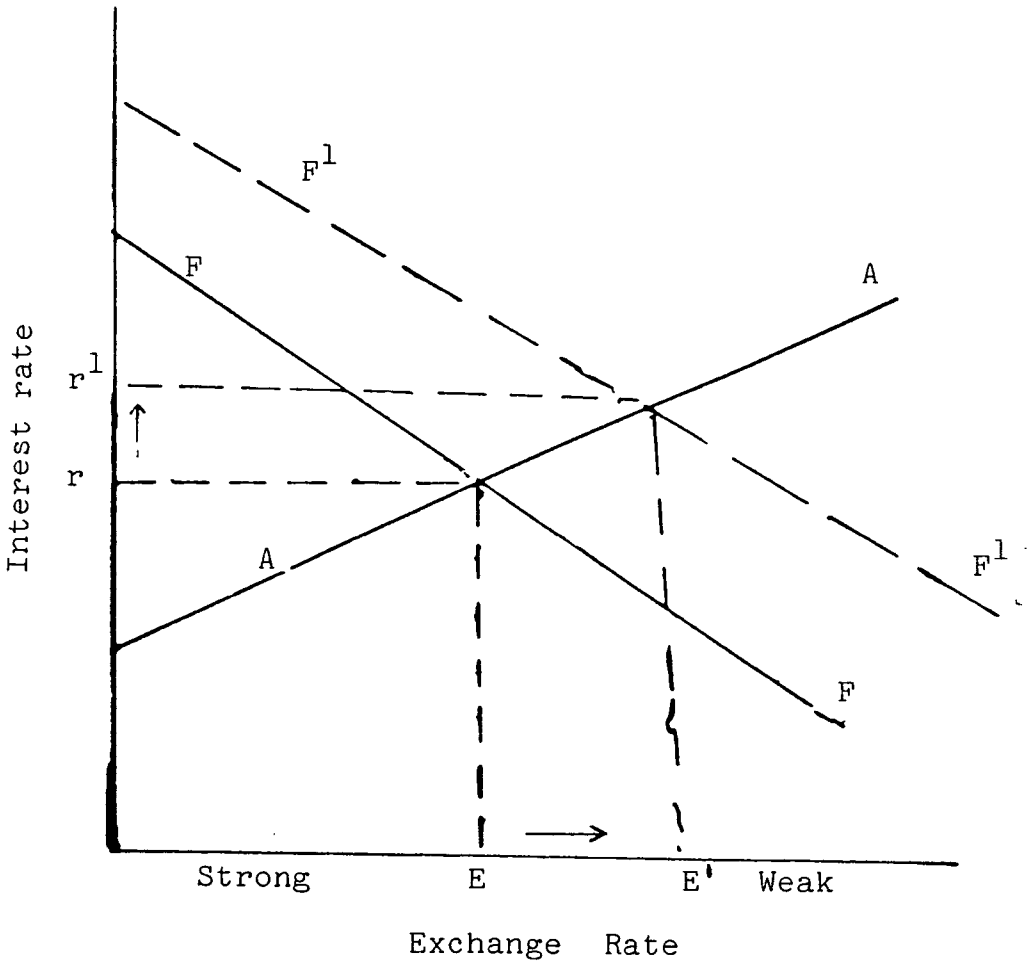
Figure 2



Improvement in relative international assessment of sterling portfolio assets.

This reduced interest rate to r' and raised exchange rate to E'

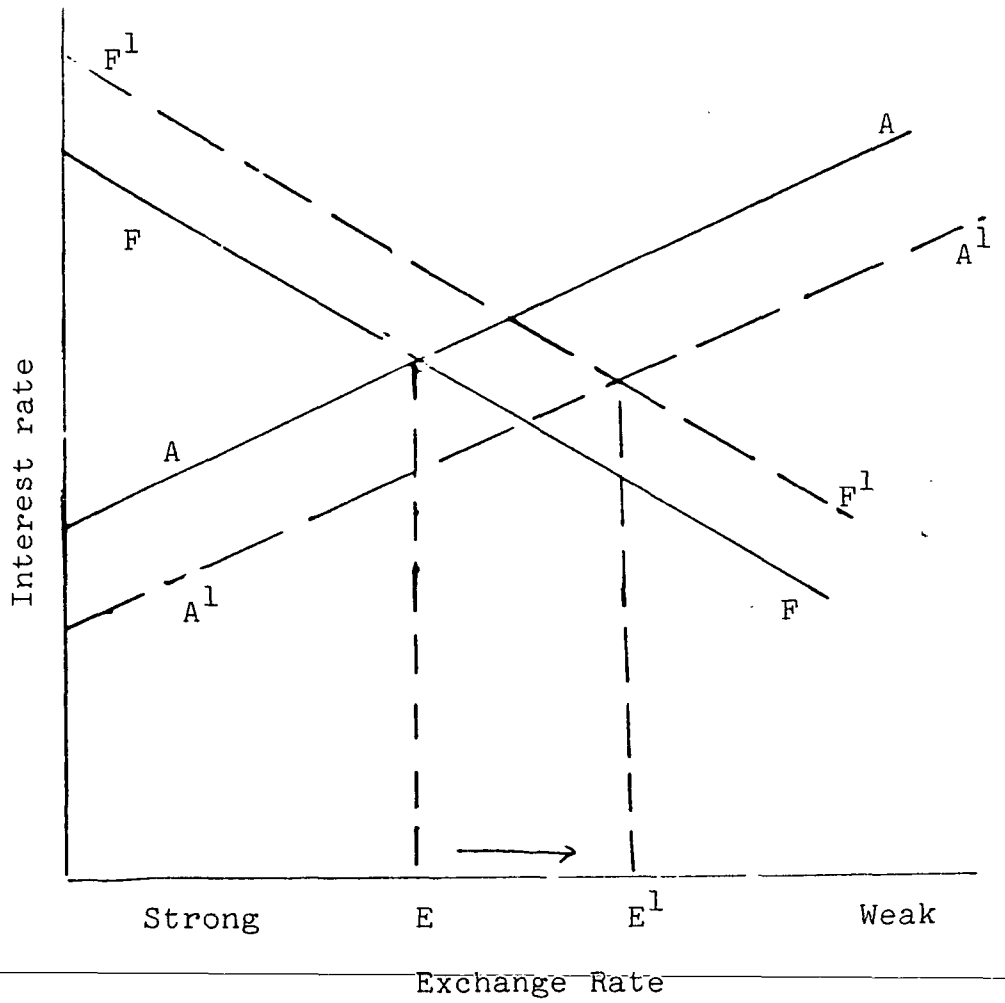
Figure 3



Deterioration in UK Trade Prospects.

This raises interest rate to r' and reduces exchange rate to E'

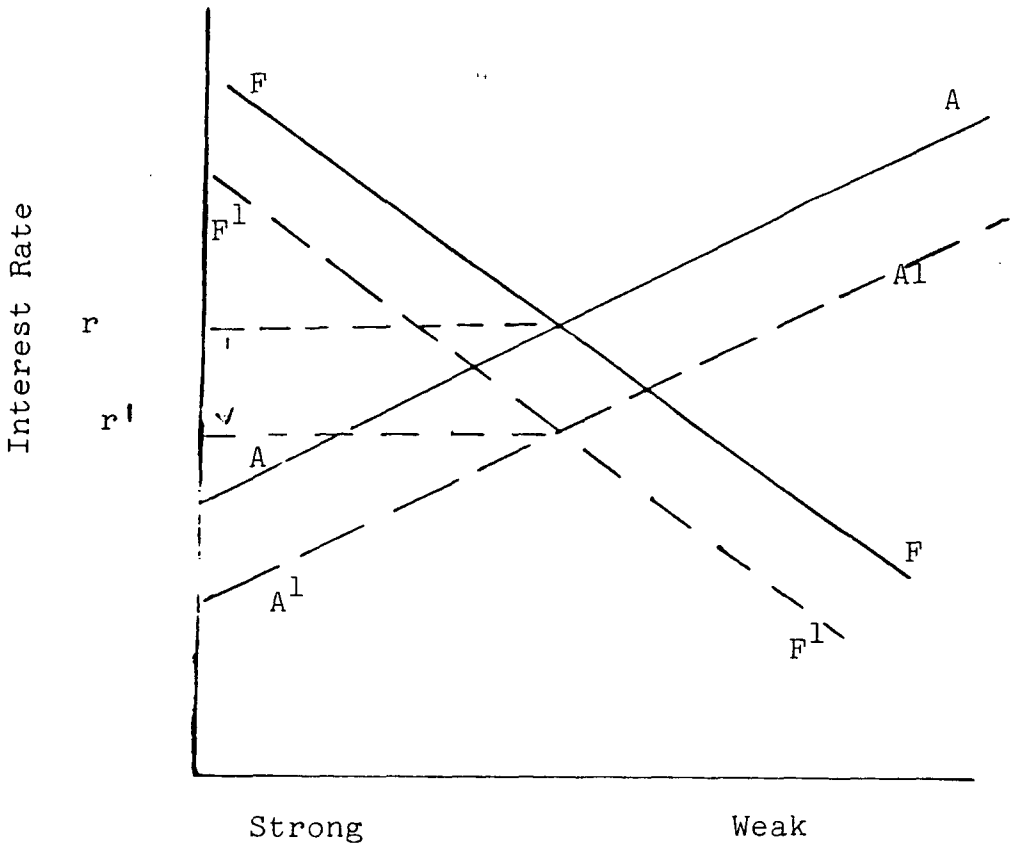
Figure 4



Deterioration in UK trade prospects and Fall in raw material prices.

Lower raw material prices lower AA to A_1A_1. Weaker trade prospects raise FF to F'F'. Exchange rate falls sharply

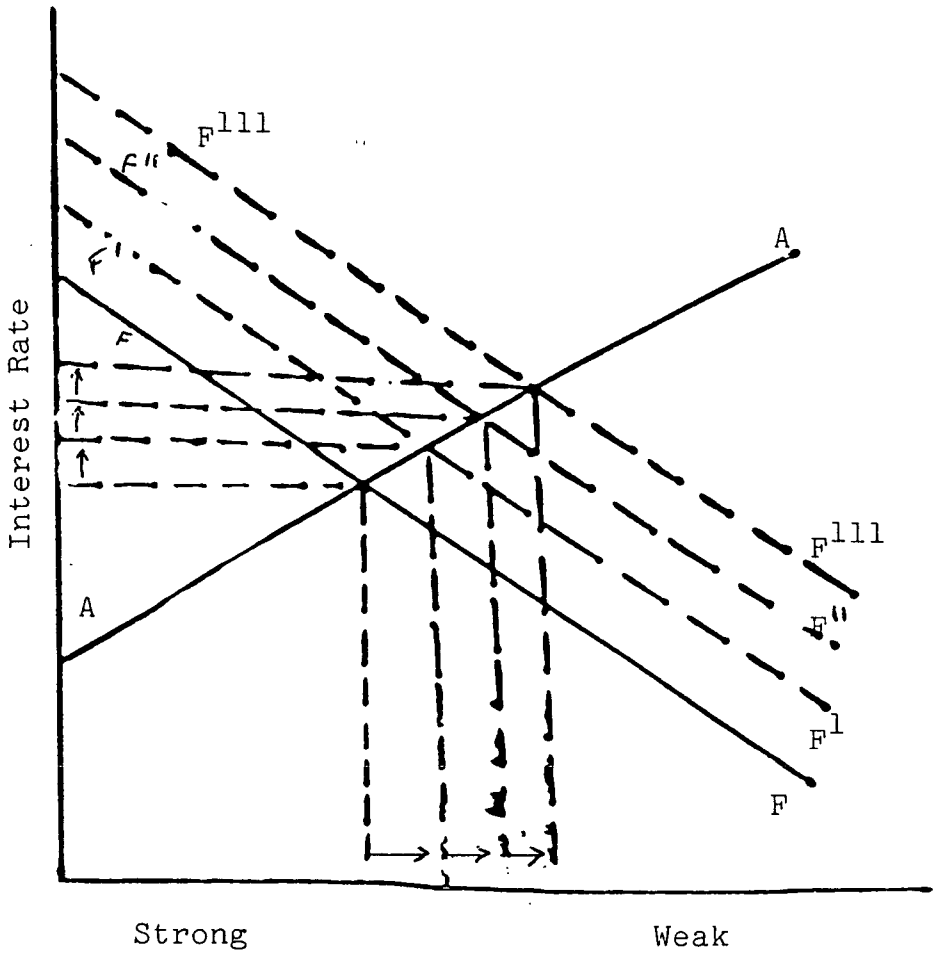
Figure 5



Fall in UK wage inflation
Improvement in expected balance of payments

Lower inflation lowers AA to A'A'
Improvement in trade prospects lowers FF to F'F'
Interest rate falls.

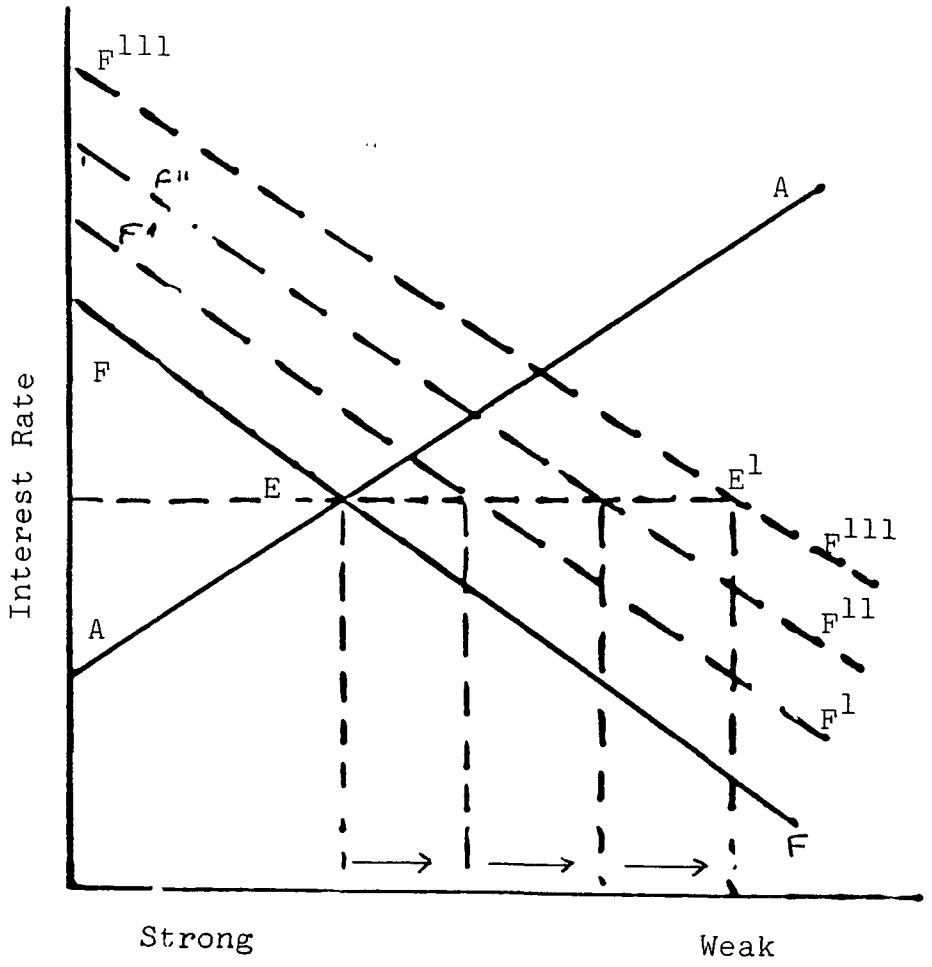
Figure 6



A rising ratio of Debt to GNP makes that country increasingly unattractive to portfolio investment

Increasing debt to GNP raises FF to F'F', F''F'' F'''F''' etc. Interest rate rises and exchange rate falls.

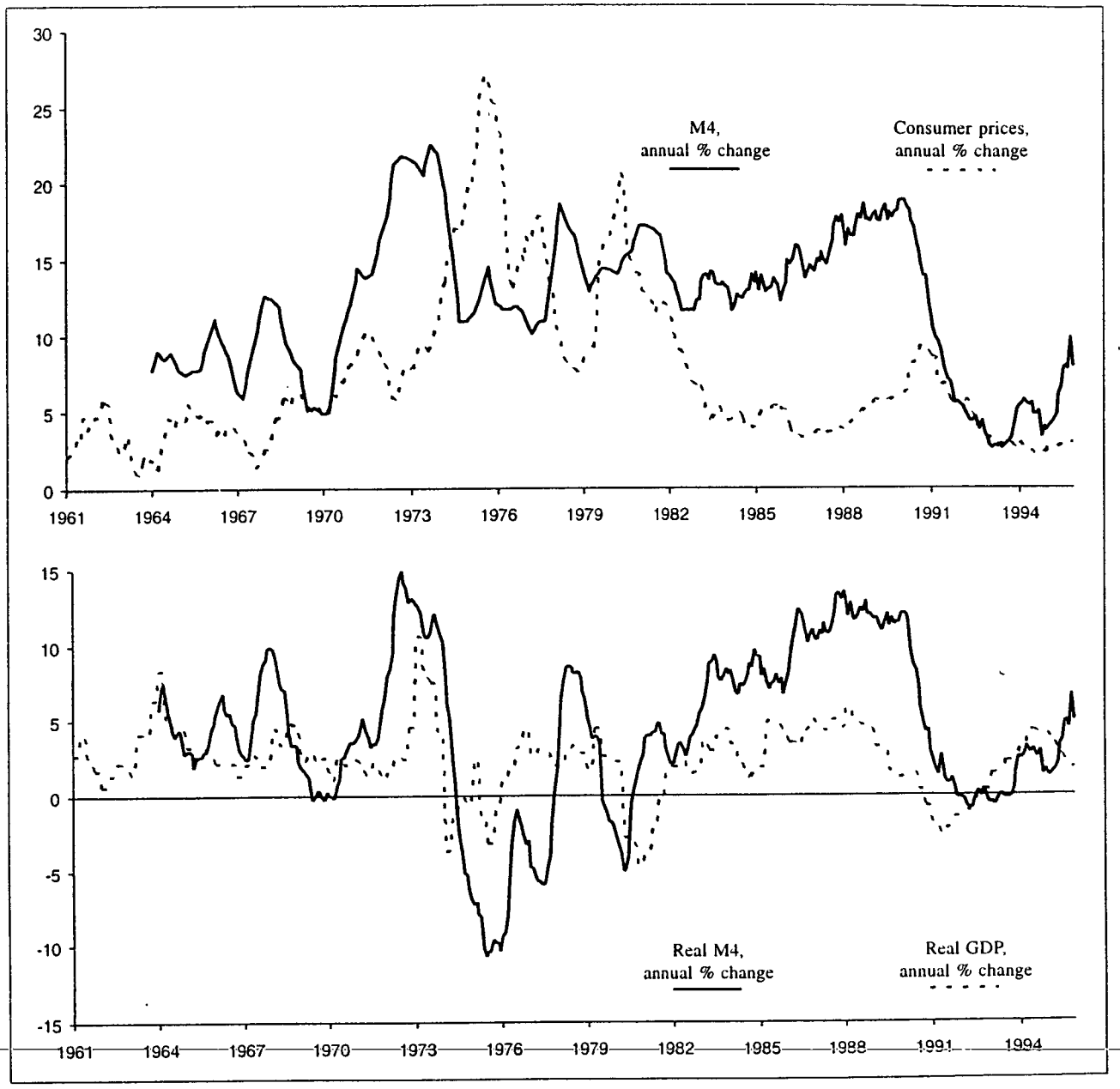
Figure 7



Ratio of debt to GNP rises which reduces attractiveness of bonds to international portfolio holders. Government declines to raise interest rates.

If the government will not raise interest rates, the exchange rate keeps falling and inflation accelerates because economy falls below AA.

United Kingdom



As so often in the past, the UK has the highest growth rate of broad money among the G7 countries. The banks have overcome the trauma of the recession of the early 1990s, their bad debt provisions are behind them and arguably they now have too much capital instead of too little. In their chase for new business, they have driven down margins on new loans and stimulated a dramatic surge in take-over activity. Lending to the corporate sector has revived, and broad money growth has accelerated. It appears still to be accelerating. This trend is unlikely to be reversed before the general election, which will probably be in the spring of 1997. The behaviour of the UK's monetary aggregates, while hardly encouraging for its own long-term inflation prospects, is one (rather minor) reason that the current world slowdown will not become a recession.

UK MONETARY ECONOMICS: THE INTERNATIONAL DIMENSION

WILL THERE BE MONETARY UNION AND SHOULD BRITAIN JOIN?

Lecture by

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Gresham College, London

5.30pm Monday February 19 1996

1. THE OBSTACLES TO THE ESTABLISHMENT OF EMU

These are principally the need to overcome German reservations and whether the excluded will acquiesce in their marginalisation.

The Bundesbank and the German electorate have, on many occasions, underlined their opposition to the replacement of the D Mark by a new European currency. German opinion polls repeatedly show a majority which varies between three-to-two and two-to-one against the replacement of the D Mark. Hans Tietmeyer the Bundesbank President has drawn attention to the 40 per cent decline in the basket ECU relative to the D Mark from 3.08 DM in 1974 to 1.90 DM in 1994, with the result that the inflation of prices in Germany would have been 2 per cent per annum faster if the basket ECU had been the German money of account instead of the D Mark. Interest rates would correspondingly have had to be 2 per cent higher. Dr Tietmeyer has also insisted that it would undermine Europe if there was a tension between economic-Europe with a First and a Second Division and political-Europe where each country particpates in European Institutions with near-equal voting rights.

The replacement of the D Mark by the Euro Mark has had the total support of Helmut Kohl and those close to him. Chancellor Kohl demonstrated in 1989 and in 1990 that the power to determine economic questions which went beyond the determination of interest rates and the detailed implementation of monetary policy belonged to the Federal Government and not the Bundesbank.

But a decision for Germany to replace the D Mark with a new Euro must be ratified by the Bundestag in which the Christian Democrats have a majority and the Bundesrat in which the SPD has a majority, and these must both confirm that the list of countries which joins with Germany conforms to the Maastricht treaty obligations. This means that any weakening of the Maastricht conditions to admit Europe's more inflationary economies may not be approved, even if this has Chancellor Kohl's support.

France is bound to join with Germany if EMU is to be established at all in 1999. Which countries could then join France and Germany is unclear, but there are several which cannot possibly fulfil the Maastricht conditions of a 3 per cent budget deficit, a 60 per cent public debt to GDP ratio, and inflation and interest rates which are within 1½ to 2 percentage points of the European Union's leading performers. Greece's inflation of 8.4 per cent is more than 6 percentage points too high, its long term interest rate of 19.5 per cent is 13 percentage points too high, its government deficit is 11.5 per cent of GDP and its debt to GDP ratio is 123 per cent and rising. Italy's debt to GDP ratio is as high as Greece's, its inflation rate has risen to 6 per cent, and its long-term interest rate of 11.5 per cent is 5 percentage points above Germany's. Spain's long-term interest rate of 11 per cent is only half a percentage point below Italy's and its budget deficit and inflation are a little too high, while with 22.8 per cent unemployment there is a lack of international confidence that it will take the necessary deflationary actions to fulfil the Maastricht conditions. It is because

the next Spanish government is likely to be tempted to loosen macroeconomic conditions to reduce intolerable unemployment that Spanish real interest rates are so high. Portugal's long term interest rates are equally high, while Sweden has a government deficit of 10.1 per cent of GDP and a public debt to GDP ratio of 99 per cent. These five countries and Belgium with its public debt to GDP ratio of 134 per cent cannot possibly pass German scrutiny, whatever steps they may take to move towards a fulfilment of the conditions between now and 1997. Therefore at least six of the European fifteen will be excluded, while Denmark and Britain will be under no obligation to participate.

Article 109j (paragraph 4) of the Treaty of Maastricht includes the statement that, '**the third stage shall start on 1 January 1999. Before 1 July 1999, the Council,** meeting in the composition of Heads of State or of Government, ... shall, acting by a qualified majority and on the basis of the recommendations of the Council ... **confirm which Member States fulfil the necessary conditions for the adoption of a single currency.**' The reference to 'acting by a qualified majority' confirms that the drafters of the Maastricht Treaty accepted that the Heads of Government of Member States were entitled to confirm or not confirm the list of participating countries proposed on the 'recommendations of the Council' and that a qualified majority was required to confirm the Commission's list. In qualified majority voting, Italy and Spain count as large countries and therefore enjoy more voting strength, and if they decline to accept the Commission's list, at least initially as a prelude to further bargaining, they would

merely need to be joined by two smaller countries to interrupt the Maastricht procedure.

The outcome of such a tactic could be the offer of large sums of European money from suddenly expanded solidarity funds to expedite the transformation of the rejected economies to the standards required by the successful. That is what the Greek and Spanish technique of holding up agreements well into the night has achieved when it has been used in the past. Alternatively the Heads of Government might in desperation agree to dilute the conditions required for entry to EMU. If that occurred, the final decision would fall to the Bundestag and the Bundesrat, which would be under domestic pressure to accept the outcome of the negotiations as the best achievable deal for Germany. Britain might therefore be invited to join a broad EMU into which Europe's weaker economies had forced their way, or a strong EMU with a limited membership confined to the countries which had actually achieved convergence.

2. THE DECISION FOR BRITAIN IN 1998

There would be no attraction in joining a weak and broadly based EMU. Several of the countries which are bound to fail the Maastricht conditions have unemployment which far exceeds that in the rest of Europe. Spain's unemployment is 22.8 per cent, Italy's is 11.9 per cent and Greece's is 10.1 per cent. Their participation in a fixed exchange rate régime while their inflation had failed to converge would destroy the competitiveness of some of their surviving industry, so their

unemployment would rise further, and there would be corresponding growth in their need for solidarity funds. They would each have a Director and therefore a vote in the European Central Bank which determined European monetary policy and their preoccupation with short-term considerations in the face of desperate economic circumstances could often lead them to vote for reflation, while the Bundesbank would only have a single vote (the same as Greece's) in favour of monetary integrity. Fear of such conditions has already produced a flood of German money into Switzerland.

The opt-out Britain secured at Maastricht leaves it under no obligation to join a potentially inflationary European currency together with additional obligations to provide further solidarity funds. European decisions have not always proved correct. The Common Agricultural Policy has proved a millstone, and if Britain could have opted out in 1973, we should now enjoy the benefits from lower food prices and less public expenditure. A European currency union with the same Mediterranean-wide membership as the CAP would produce higher United Kingdom interest rates, more inflation and higher public expenditure, and the United Kingdom actually has the right to keep well clear of it. It should certainly avoid participation in a broad-membership EMU.

The more interesting potential option where the balance between advantage and disadvantage is far less clear is what the reaction should be to an opportunity to join a small group of macroeconomically well run economies. These could potentially achieve an inflation performance far superior to the United Kingdom's from 1979 to 1995 when control of

inflation was a central objective of government policy. In these years the United Kingdom achieved acceptable inflation from 1983 to 1988 and again from 1991 to 1995 but it allowed inflation to reach 9½ per cent in 1990. Because of Germany's superior counter-inflation credentials, a United Kingdom decision to join a narrowly based hard EMU might well reduce inflationary expectations and therefore United Kingdom interest rates.

But there are significant questions about a decision to join a narrow base hard EMU. Previous lectures have shown that the UK has only had sufficient means to control inflation when it has been able to vary both the interest rate and the exchange rate. If Britain was a member of EMU it would have no independent influence over either the interest rate or the exchange rate. Interest rates would be determined in the European Central Bank in which Britain had only one vote (and we have rarely had sufficient influence in any European Institution to determine the outcome of a decision). The exchange rate with our European partners would be fixed, and we would have virtually no influence on the exchange rate of the new Euro with the dollar and the yen. Again our influence wouldb be that of one director out of several.

The loss of freedom to vary the exchange rate has been much discussed. In 1965 sterling was worth 11.25 D Marks and after that the pound was devalued time after time and it has now (at 2.26 D Marks) reached one-fifth of its 1965 value. In that time Germany's share of world trade has risen markedly, while in most years Britain's has fallen. In addition, Germany's unemployment has been below Britain's in most of the last

thirty years. Unemployment and shares of world trade depend on far more than exchange rate flexibility or the lack of it, but it would be surprising if the repeated acquiescence by the British authorities in the medium-term inflationary consequences of a falling pound has benefited British industry and commerce. It is certainly arguable that United Kingdom governments exercised the devaluation option over-loosely to the detriment of the real economy. Hence the loss of the devaluation option against European currencies could indeed prove advantageous.

But there is a more serious objection to tying the United Kingdom exchange rate to that of Germany and France and other macroeconomically 'sound' European economies. The foreign exchange market brackets sterling quite closely with the dollar: during 1995 sterling and the dollar have moved almost in parallel againt the D Mark, and in 1993 and 1994 the sterling-dollar rate absorbed approximately one-half of rises and falls in the D Mark-dollar rate. When the dollar fell against the mark, the pound fell approximately half as much. This may reflect the greater ratio of high-tech production such as aircraft in United Kingdom trade than in French and German trade. Britain's ratio of high-tech products in total exports is between one-and-a-half and twice that of France and Germany, and its principal high-tech competitors are the United States and Japan rather than the leading European economies. To force sterling into a fixed rate with France and Germany would prevent foreign exchange markets from reflecting this difference in trade patterns. In consequence, whenever the D Mark rose in relation to the dollar, the

competitiveness of Britain's high-tech industry would be more severely undermined than if sterling could continue to move to some degree with the dollar as it does at present.

A forced alignment of United Kingdom with French and German interest rates could be still more damaging. Nigel Lawson's famous decision to shadow the D Mark in 1987-89 produced a monetary explosion in Britain. In order to prevent sterling from rising, British interest rates were set at a lower level than domestic monetary conditions required. The consequent escalation of bank and building society lending caused the broad money supply (M3 and M4) to grow explosively which produced the housing boom (that created today's negative equity) and an acceleration of inflation to 9½ per cent by 1990.

An inappropriately high level of interest rates forced on London from outside (such as the rates determined by the Bundesbank in 1992 in Britain's final months of ERM membership which Norman Lamont was unable to persuade Helmut Schlessinger to reduce) will conversely impose inappropriately tight monetary conditions in Britain, including unduly slow growth in bank and building society lending and the broad money aggregates.

Yves-Thibault de Silguy, the European Commissioner for Economic and Monetary Affairs told The Times on November 27 1995 that 'The European Central Bank would have overall control of a single money supply in the European Currency. The concept of money supply in national banking systems would no longer have any relevance'. This would be true of M0, the European monetary base, but not M3 and M4, measures of the

money supply which include bank and building society deposits which are also influential. It is a little surprising that the European Monetary Commissioner should overlook M3 when this is actually the measure of the money supply which the Bundesbank targets with such success.

In 1987 United Kingdom M0, the only kind of money Commissioner de Silguy takes into account, grew at less than 5 per cent per annum and its growth accelerated to a maximum of 8 per cent in 1988. The growth of United Kingdom M0 exceeded 6 per cent from April 1994 until June 1995 and it actually reached 7 per cent in September to December 1994 and in March 1995 so the inflationary signals from M0 in 1987-89 were quite similar to those experienced in the last fifteen months, when it is now quite widely agreed that inflation is set to fall.

The damage in the Lawson boom came from M3 (which includes all bank deposits) which grew at more than 20 per cent per annum and M4 (which includes both bank and building society deposits) which grew at a rate of almost 20 per cent. The Bank of England would have no power to control these unless the Governor could persuade his seven or eight fellow Directors in Frankfurt to raise the level of interest rates throughout Northern Europe. The Bank could seek to introduce a corset and suchlike, but that would not prevent those in Britain who regard interest rates as low from borrowing from offshore banks in London, which was their reaction to Denis Healey's corset.

This would matter crucially to the ability to manage the British economy because the rate of interest has a greater impact on lending and borrowing in Britain than in the other

leading European economies. This is partly because almost all British housing loans are on variable interest rate contracts. A fall in interest rates therefore redistributes income immediately and on a large scale from low-spending lenders to high-spending borrowers. The deposits required from house purchasers in Britain's highly competitive loan market are near to zero when they are close to 50 per cent in much of Europe. There is therefore a flood of demand for new loans in Britain whenever short-term interest rates are judged to be at bargain levels.

The City of London has enormously more international financial activity than Frankfurt, Paris or Zurich. In 1995 daily foreign exchange market turnover exceeded $450 billion in the United Kingdom when it was less than $100 billion in Switzerland and Germany.[1] In 1995 derivatives turnover was almost twice as great in Britain as in France and Germany combined.[2] In 1992 marine insurance was almost twice as great in Britain as in France and Germany combined while aviation insurance was more than seven times as great.[3] In 1995 cross-border bank-lending was greater in London than in France and Germany combined, and equity turnover was one-and-a-half times as great while turnover in foreign equities was almost thirty times as great: markets for these scarcely exist in Frankfurt

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1 Bank of England Quarterly Bulletin, November 1995, p.363.

2 'Key Statistics on Financial Ativity in UK, France and Germany', City Competitiveness Group, Bank of England.

3 Corporation of Lloyds.

and Paris.[4] Because of London's far greater level and variety of financuial activity than Frankfurt and Paris, sustaining a level of sterling interest rates which avoids overheating and consequent unpredictable market instability matters more. With London financial markets of such size and sophistication, severe damage could result from inapproporiate interest rates in a manner which may only be understood after the event.

Because broad money lending and borrowing is more sensitive to the rate of interest in Britain than in other European financial centres while financial activity is so much more extensive in London, it is vital that the Bank of England (in cooperation with the Chancellor or independently) should retain control of the level of London interest rates. This is a consideration which could outweigh all others, especially when the Lawson boom effects of inappropriate interest rates are considered with their legacy of negative equity from which the economy has still not entirely recovered.

There is a good deal of apprehension in the City that its present high share of global financial activity will be undermined and Frankfurt's enhanced if London has to face competition from the heart of a far larger currency-bloc. This will be no kind of competition if financially weak economies are admitted to EMU, and even if they are not, Britain will retain the financial trading opportunities of Switzerland.

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4 'Country Shares in Selected International Financial Markets, City Competitiveness Group', Bank of England.

The challenge to Britain will be to create a sound macroeconomic framework without help from French and German bankers and economists which should certainly be attainable. If Britain does after all enter EMU it will suffer the consequences of an exchange rate structure and domestic interest rates which are often inappropriate to British conditions.

There is a country which has achieved outstanding economic success with high employment, competitive manufacturing companies and a prosperous financial sector which does not maintain exchange rate stability with any other currency. If Britain remains outside EMU, the model for the maintenance of the market share of the City of London is surely Switzerland?