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Commentary on the economic situation

Is there a case for more candour about official interest-rate assumptions?

Cut in base rates to 14% amply justified One of Mrs. Thatcher's last initiatives as Prime Minister was to persuade Mr. Major, then her Chancellor of the Exchequer, that clearing bank base rates had to be cut. At the time the move to 14% was widely criticised as political opportunism. But it has been amply justified by events. The CBI now warns that national output will fall in 1991, basing its view on survey evidence and the financial difficulties of the corporate sector.

In his first Question Time as Prime Minister Mr. Major expressed remarkable complacency about the recession, perhaps because he really believes the Treasury forecast in the Autumn Statement of 1/2% growth in 1991. But all Treasury forecasts suffer from the defect that their interest-rate assumptions are kept secret. It should surely be uncontroversial that next year's growth rate, and the quarterly profile of GDP, will be very different if base rates average 11% rather than 14%. Mr. Major may be right in his complacency if base rates average 11%; he will certainly be wrong if they average 14%. The private sector cannot know how to assess the official forecast if it is left in the dark about this key variable. Perhaps there is a case for the Treasury including its interest-rate assumption with its macroeconomic forecast. Of course, it would be market-sensitive, but so are the other contents of official policy statements.

Another cut is needed soon

Many signs of a coming slump argue for further early and significant cuts in interest rates. Newspaper comment on the monetary aggregates concentrates on M0, merely because there is an official target for it. But, as is well-known, it is a coincident rather than a leading indicator. Broad money is more interesting, because it measures all money balances in private-sector hands, and is therefore crucial to balance-sheet strength and spending decisions. In the six months to October 1989 M4 (i.e., notes and coin, and bank and building society deposits) rose at an annualised rate of 19.0%, while retail prices went up (on the same basis) by 5.7%, implying that real money growth was well into double figures. By contrast, in the six months to October 1990 M4 increased at an annualised rate of 10.7% and retail prices of 8.3%, leaving real money growth at almost nothing. Since changes in broad money growth normally lead economic activity by at least six months, the adverse change in monetary conditions implies that the earliest date for an upturn is late 1991.

"Golden scenario" vs. "nightmare scenario"

If the constraint of the ERM hinders the Government from cutting interest rates, it could be caught in a "nightmare scenario", where financial confidence is lost because the exchange markets believe that a devaluation is inevitable and so require a highly attractive interest rate differential if they are to be persuaded to hold sterling. (The accompanying research paper contrasts the "nightmare scenario" with the more familiar "golden scenario".)

Summary of paper on

'The nature of the exchange rate constraint in the ERM'

Purpose of the paper Now that Britain is a full member of the European Monetary System, it is important to understand precisely how domestic monetary policy is constrained by the exchange-rate commitment. Before entry many City commentators thought that it would lead to a "golden scenario" for the economy, because the markets would trust the commitment absolutely and this would require a narrowing of the interest rate differential between sterling and other European currencies. The purpose of this paper is to show that a very different outcome, a "nightmare scenario", is possible, if the markets expect a devaluation.

Main points

- * The sharp slowdown in UK economic activity argues for a large and early cut in interest rates, but this is constrained by our membership of the exchange rate mechanism of the EMS. As so often in the past, there is a conflict between domestic and external pressures on sterling interest rates.
- * ERM entry at a central DM/£ rate of 2.95 was close to the actual spot rate at the time. But it implied a large rise in the future value of the pound. It meant that the spot DM/£ rate could not fall beneath 2.778 at any future date, but this was higher than the forward rates (for 15 months and beyond) which prevailed before entry.
- * The interest parity theorem (which determines the relationship between exchange rates and interest rates) required a cut in interest rates after ERM entry. But the need to tighten policy, because of the appreciation of forward rates, argued for higher interest rates.
- * If the foreign exchanges do not believe that the Government is in earnest about the exchange rate commitment in the ERM, it is harder to reduce interest rates. In an extreme case - the "nightmare scenario" - lack of financial confidence makes it impossible to cut interest rates. This worsens the recession, aggravates the loss of financial confidence, makes interest-rate cuts yet more remote, and so leads to a self-reinforcing downward spiral of deteriorating economic activity and financial disintegration.

This paper was written by Professor Tim Congdon.

The nature of the exchange rate constraint in the ERM

“Golden scenario” or “nightmare scenario”?

Domestic vs. external in British monetary policy

Conflict between domestic and external pressures is an ancient theme in British monetary policy. For much of the time the state of the currency and the state of the economy give the same message for interest rates. This is indeed quite logical, as weak domestic demand and low inflation ought to be accompanied by a strong exchange rate and both domestic and external considerations then argue for lower interest rates. But from time to time weak domestic demand is associated with a depreciating currency and policy-makers have to decide which has priority. Should they raise interest rates to bolster the currency or cut interest rates to stimulate more domestic spending? There may be no clear-cut answer. Policy-makers and their advisers may squabble endlessly, without there being an obvious “right” or “wrong” answer.

One of the most celebrated debates of this kind occurred in 1925, when Britain returned to the gold standard at the pre-1914 parity. As Keynes had warned beforehand in *The Economic Consequences of Mr. Churchill*, the pound was overvalued at this exchange rate. The result was a fall in exports (particularly, of price-sensitive coal), a downturn in economic activity and the general strike of 1926. Thereafter British economists have generally been averse to exchange rate overvaluation and professed a bias in favour of domestic objectives, notably low unemployment, over external. Ironically, however, they have been rather keen on fixed exchange rates. The strong support among a wide range of economists for UK participation in the exchange rate mechanism of the European Monetary System reflects this preference. Not surprisingly, the original title of Sir Alan Walters’ recent book criticising the ERM was *The Economic Consequences of Mr. Lawson*, although the publishers in the end opted for the more prosaic *Sterling in Danger*.

The “Walters critique”

A central idea in *Sterling in Danger* is the so-called “Walters critique”. According to this critique, the ERM suffers from a serious structural weakness. The foreign exchange markets are given to understand that a currency cannot move outside a particular band, which defines the maximum depreciation from the present exchange rate. If a currency yields an interest rate much higher than in other ERM currencies because of rapid inflation, the favourable interest rate differential may exceed the maximum possible depreciation. As a result, the currency is irresistibly attractive to speculators and moves to the top of the ERM band, even though it comes from a high-inflation country. Perversely, the ERM can cause high-inflation countries to have strong currencies and low-inflation countries to have weak currencies.

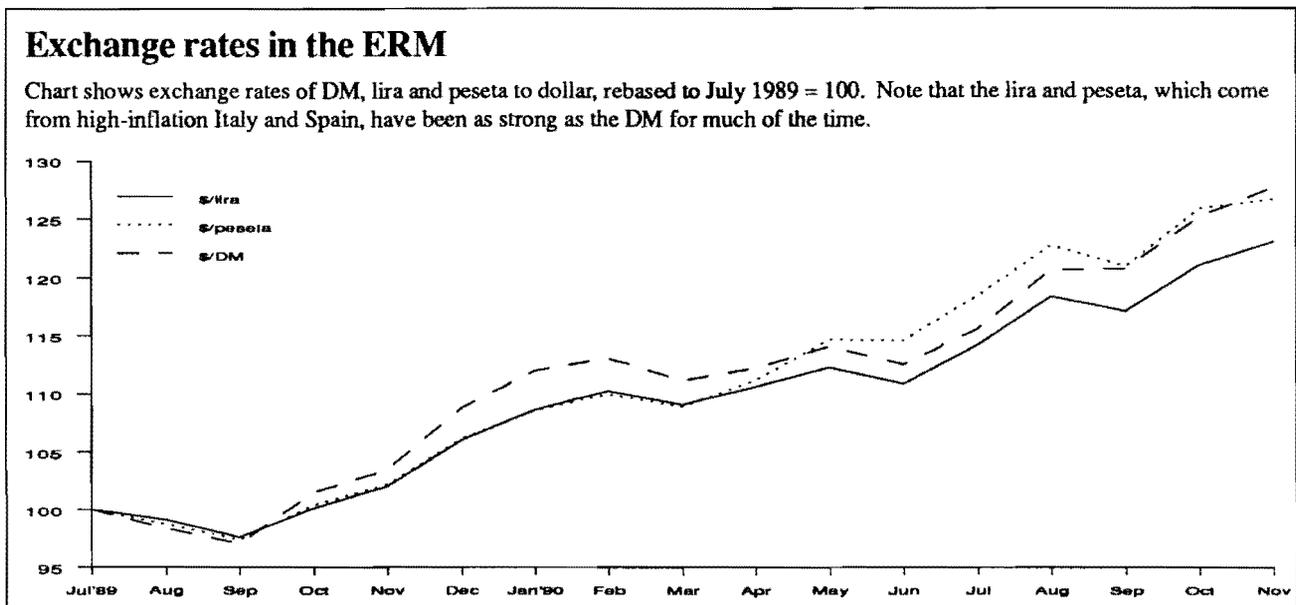
Economic fundamentals vs. market psychology

Of course, the anomaly should unwind in the end. Sooner or later the foreign exchanges will realize that the currency from the high-inflation country is becoming overvalued and will dump it. So it will plunge to the bottom of the ERM band despite its high interest rates. Indeed, the annualised interest rate required to offset the risk of a 3% or 5% re-alignment in one day is unthinkable. It follows that the ERM will be associated with peculiar patterns of short-term exchange rate variation, in which the volatile psychology of the foreign exchange markets interrupts the gradual evolution of economic fundamentals. (ERM governments have a way of discouraging this speculation, which is to restrict re-alignments of a currency's central rate to less than the width of its permitted band of fluctuation. The problem here is that the re-alignments may be too small to offset changes in the fundamentals. An annual rate of depreciation of 1 1/2% - which is within the 2 1/4% band - is not much help in the long run to a country with an inflation rate 3% above the European average.)

The Walters critique is a telling indictment of the ERM and has been validated by recent events. The widening gap in 1990 between the economic performance of Germany and the Mediterranean countries argues that a re-alignment will be essential sometime next year. The high inflation rates in Italy and Spain have been associated with high interest rates and strong currencies in recent quarters, but their widening payments deficits and the onset of recession will eventually require that their currencies be devalued. Far from providing a model of exchange rate stability, the ERM has led to a rather peculiar game in which speculators try to out-guess each other about their own intentions.

Why has the pound been weak since ERM entry?

But the Walters critique by no means exhausts the paradoxes of the ERM. The purpose of this paper is to identify another puzzle in the dynamics of semi-fixed exchange rates (or "pseudo-fixed exchange rates", as Walters calls them) and so to throw light on the disappointing behaviour of the pound since UK entry



on 8th October. As is well-known, the domestic argument for lower interest rates has become increasingly persuasive because of the slide in economic activity. But, with the pound's weakness within the ERM a crucial obstacle to early and large interest-rate reductions, external and domestic influences on monetary policy are in conflict. Sterling's poor performance since 8th October has been a surprise. Most analysts (including the author of this paper) thought that the pattern of early 1988, when a semi-fixed exchange rate between the pound and the deutschemark stimulated capital inflows into high-interest-bearing sterling, would be repeated in late 1990. It is important to compare the two situations and to attempt an explanation for the pound's poor performance.

Before ERM entry there was an active debate about the "right" exchange rate. Economists at the National Institute of Economic and Social Research judged that an exchange rate for the pound under 2.5 DM was appropriate, while other observers (notably Samuel Brittan of *The Financial Times* and Giles Keating of Credit Suisse First Boston) favoured a high rate, perhaps over 3 DM. In the event the Government chose a middle rate of 2.95 DM, very close to that prevailing at the time of entry. The justification was largely that the 2.95 DM rate was determined by market forces and was deemed to be as close to neutrality as possible. On the face of it, central expectations about the path of the exchange rate after ERM entry ought to have been roughly the same as beforehand.

Because of implied rise in future spot rates, ERM entry meant large sterling appreciation

But, as we shall see, in one vital respect ERM entry implied a much different level for the exchange rate. Contrary to appearances, the decision was far from neutral and involved a sharp appreciation of the pound relative to previous expectations. The central ERM rate on 8th October may have been much the same as the spot rate on 7th October. But the spot rate is not the only "exchange rate" for a currency. For every widely-traded currency forward exchange rates are available for a large number of future dates. Our key point is that - because of ERM entry - the foreign exchange markets were required to alter their expectations about these forward rates.

Relationships between currencies' forward rates are governed by the interest parity theorem. This theorem states that the forward discount (or premium) between the exchange rate today and in x months' time equals the difference between the interest rates (for x months) in the two countries concerned. (Of course, the currency which bears a high interest rate relative to the other is at a forward discount, that with a low interest rate is at a premium.)

The interest parity theorem and its workings

If this theorem is violated, it pays arbitragers to carry out banking and foreign exchange transactions until the hypothesized relationship holds. For example, suppose that sterling yields 10% more than the Swiss franc, but the one-year forward discount is 5%. Then an arbitrageur simultaneously carries out two transactions:

1. He borrows Swiss francs for a year, converts the proceeds into sterling and holds it in a one-year interest-bearing account. At the end of the one-year period he has 10% more sterling than at the start.

2. He sells sterling one-year forward against the Swiss franc, promising to deliver 5% more sterling for each unit of Swiss francs than implied by the spot exchange rate today.

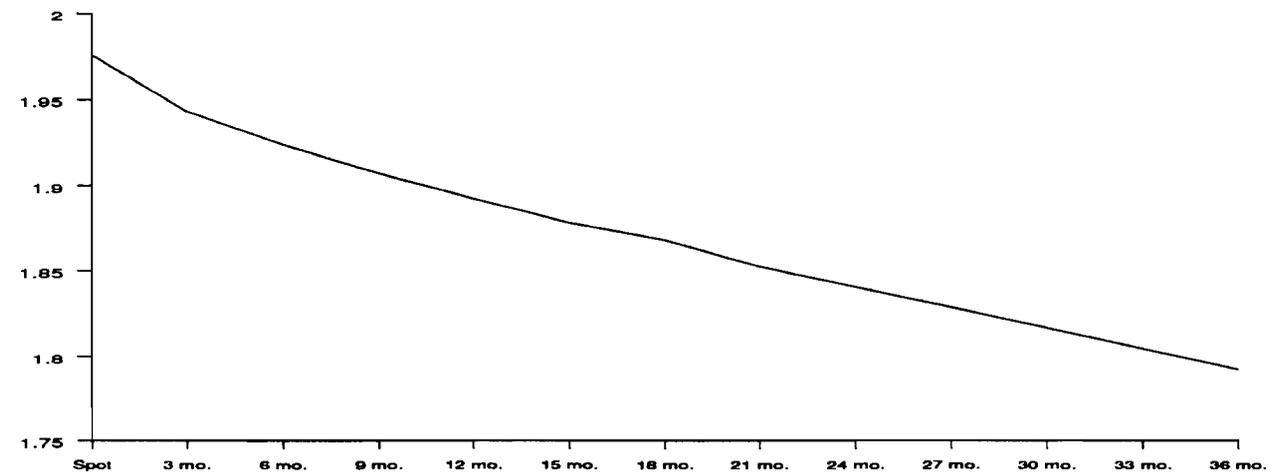
Clearly, the arbitrageur makes 5% profit (minus expenses) on this set of transactions. Since these profits involve little risk, the markets keep on transacting until the forward discount equals the excess of sterling over Swiss franc interest rates.

Forward and spot rates for a currency can diverge substantially

UK interest rates were appreciably higher than in most other European countries before 8th October (and remain so). As a result the forward rates were at significant discounts, with the discounts widening the more distant the dates. Thus, with the one-year interest rate differential compared to the DM at approaching 6%, the one-year forward rate associated with a 2.95 spot rate was about 2.77. Although the interest rate differential was narrower further down the yield curve (at two, three and four years, and so on), the two-year, three-year and four-year forward rates were even lower. (With the two-year differential at, say, 4 1/2% the two-year forward rate would have been 2.69; the three-year differential at 3 1/2%, the three-year forward rate would have been 2.65; and so on. These numbers are not supposed to be the quotations prevailing on any particular day, but just an indication of rough orders of magnitude. Of course, the market thins out the more it looks into the future. Indeed, quotations two or three years out on the pound/DM can be difficult to find. But the basic determinants of such quotations are as we have described them.)

The difference between spot and forward rates

Chart shows forward rates for \$/£, for dates at quarterly intervals up to three years, on afternoon of 29th November 1990. Note that three-year forward rate is 8.9% lower than spot rate, reflecting interest rate differentials.



In summary, just before ERM entry the foreign exchange markets' expectation of the future value of the spot pound/DM rate on 7th October 1991 was roughly 2.77, on 7th October 1992 2.69, on 7th October 1993 2.65 and so on. Despite the increasingly notional nature of distant forward quotations, these forward rates were just as much part of the foreign exchanges' thinking about the pound as the spot rate of a little less than 2.95.

ERM entry radically changed prospects for spot rates in future

After ERM entry the situation was, at least officially, very different. With the maximum 6% band of variation around the 2.95 figure, the future value of the spot DM/pound rate was constrained within a band of 2.778 to 3.132 indefinitely into the future. Beyond a year out the future value of the pound implied by ERM participation was therefore systematically higher than that implied by financial markets' thinking before entry. Entry into the ERM at 2.95 may have been neutral for the spot rate, but - if ERM membership is meaningful - it signalled substantial appreciation for the forward rates.

Is the rise in future spot rates credible?

The question then arises, "why should the foreign exchanges (and other financial markets) attach the same degree of credibility to the new, officially-endorsed limits on future spot rates (i.e., 2.778 - 3.132 for ever) as they did to the old, market-determined forward rates (2.77 on 7th October 1991, 2.69 on 7th October 1992, etc.?)". Since ERM entry actually implies a large revaluation of sterling, the new exchange rate ought to be credible only if inflation is to be lower than before. One key requirement for reduction in inflation on these lines is surely that domestic monetary policy be tightened.

It is here that we come to the paradox. A standard argument before ERM entry was that in a genuine fixed-exchange-rate zone interest rates ought to be the same in all participant countries. If this were not so, it would pay economic agents to borrow in the low-interest currencies and re-deposit the proceeds in the high-interest currencies. After all, that is essential for the interest parity theorem to be satisfied. The implication of British entry into the ERM is that sterling interest rates ought to move closer to the lower level prevailing in most European countries. The cut in base rates to 14% on 8th October was very logically interpreted in these terms.

Did ERM entry require a tightening or easing of monetary policy?

However, our argument about the need for a tightening of policy to bridge the gap between exchange rate expectations before 8th October and the ERM commitment thereafter argues that interest rates ought to have been raised. It is difficult to see why, in the absence of some policy tightening, the foreign exchanges should be persuaded that the outlook now is for a stronger pound. Numerous suggestions have been made that ERM entry would have beneficial psychological effects on pay bargaining and that this would dampen underlying inflationary pressures. But the evidence of pay settlements since 8th October hardly supports this view.

How is our problem to be resolved? The interest parity theorem implies that ERM entry should be accompanied by lower interest rates. But the effective revaluation of sterling associated with ERM entry implies that interest rates need to be raised to bring British inflation down to European levels. Contrary to the consensus of City economists in the summer, ERM entry does not contain an unambiguous message for interest rates. Which set of considerations will be dominant in practice?

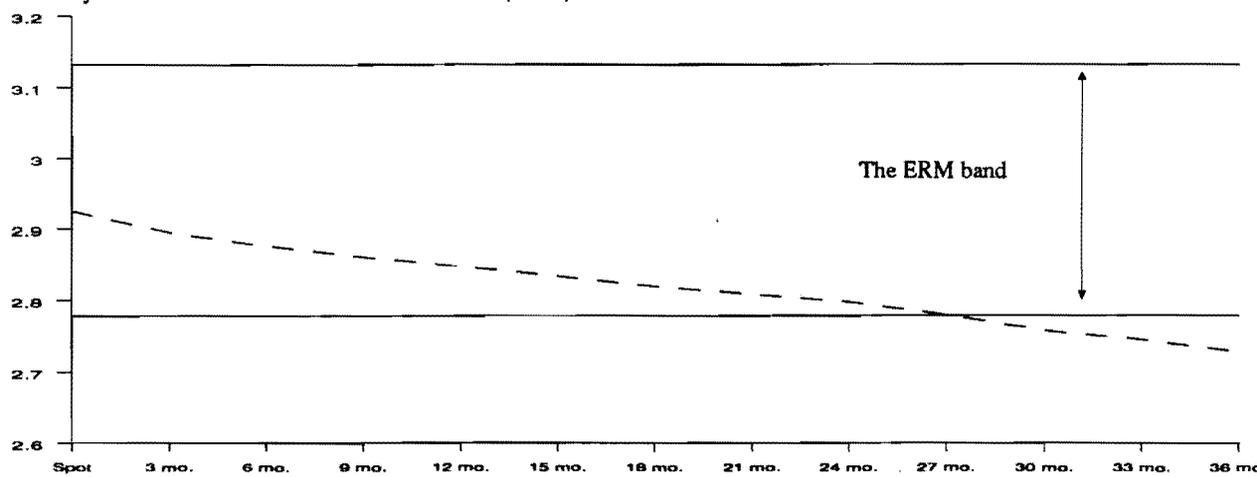
Direction of monetary policy depends on foreign exchange market expectations

The answer turns on expectations. In broad terms, if the foreign exchanges believe that the ERM commitment is genuine and long-lasting, and so expect that the lowest possible level for the DM/pound rate at any time in, say, the next 10 or 20 years is 2.778, the interest parity theorem must lead to a strong pound (i.e., a spot rate above its central rate in the ERM grid) while British interest rates are above those in the rest of Europe. If the Government is happy to have only a moderately strong pound (i.e., close to the central rate), it can cut interest rates without worrying about the exchange-rate consequences. When City economists predicted in the summer that ERM entry would be followed by a "golden scenario" for the Conservative Government, with interest rates falling and a consumer boomlet ahead of the next general election, their implicit assumption was that the foreign exchanges would believe the ERM commitment.

But this outcome was not inevitable. As we have argued, the foreign exchanges would have been inconsistent if they had not had some doubts about the strength of the British Government's commitment to the ERM. Since there was a case for saying that interest rates ought to have been raised at ERM entry to buttress the exchange-rate commitment, but interest rates were in fact cut, these doubts had - and continue to have - obvious force. If the foreign exchanges believe that a realignment is possible, and that the 2.778 figure therefore does not define

Are the foreign exchanges expecting sterling to be realigned in the ERM?

Chart shows forward rates for DM/£, at quarterly intervals, for periods up to three years on afternoon of 29th November. Note that rates beyond 27 months are beneath the lowest rate (2.778) consistent with the UK's commitment to the ERM.



the lower DM/pound rate in coming quarters, the spot DM/pound rate could fall beneath the central 2.95 figure even with sterling interest rates above those in DM.

Our argument may seem rather ponderous. Perhaps it merely reduces to the claim that, when the foreign exchanges believe that a currency is too high, the currency must fall irrespective of the actions of the sponsoring government and central bank. But it has a vital and disturbing conclusion. The prevailing view in financial markets before ERM entry - that entry would lead to a "golden scenario" - may be wrong. It is easy to put together a very different story, of a "nightmare scenario", in which participation in the ERM obstructs interest-rate cuts. Far from helping the Government win the next general election, full membership of the European Monetary System could be a political disaster.

The "nightmare scenario"

Suppose that the foreign exchanges do not fully believe the Government's ERM commitment. Suppose, instead, that they think the Conservative Government wants to stimulate industry before the election and would engineer a 5% or 10% devaluation in early 1991. Suppose also that they expect the Conservatives to be defeated at the election and to be replaced by a Labour Government which would immediately devalue once more, by another 5% or 10%. In such circumstances, where the markets regard a fall of over 10% in the exchange rate in the next year as likely, sterling's favourable interest rate differential may not be sufficient to keep the currency in the top half of the ERM band. In fact, the pound could be both the highest-yielding currency in the EMS and permanently at the bottom of the ERM band.

Indeed, a potentially ghastly sequence of events is easy to describe. The markets become anxious that the recession will result in a Labour victory at the general election and be followed by a large devaluation. Interest rates therefore have to be maintained at a high level in (what may be) the closing months of the Conservative administration. In consequence, the recession cannot be relieved by cheaper money and it worsens markedly. The slide into deeper recession makes the markets even more nervous about a Labour victory and devaluation, the pound drops to the bottom of the ERM band and stays there, and interest rates cannot be cut despite the deteriorating economic environment. Because financial confidence has disintegrated, the real economy is plunged into depression. This makes it even more likely that the Labour Party will secure a majority of votes in the general election. And so on. Confidence, economic activity and the exchange rate interact in a suicidal downward spiral.

"Golden scenario" or "nightmare scenario"?

A nightmare scenario of this kind would be the worst imaginable outcome of ERM entry. Both it and the golden scenario are possible in early 1991. We have seen that the state of expectations in the foreign exchange markets is crucial to determining what happens. If the foreign exchanges regard a devaluation/realignment within the ERM as highly improbable, the economy could enjoy the golden scenario. But, if they think a devaluation/realignment

is certain, the economy would be more likely to suffer from the nightmare scenario. In short, in a system of semi-fixed exchange rates the psychology of foreign exchange traders can determine the welfare of nations.

Fundamentals determine exchange rates in the long run

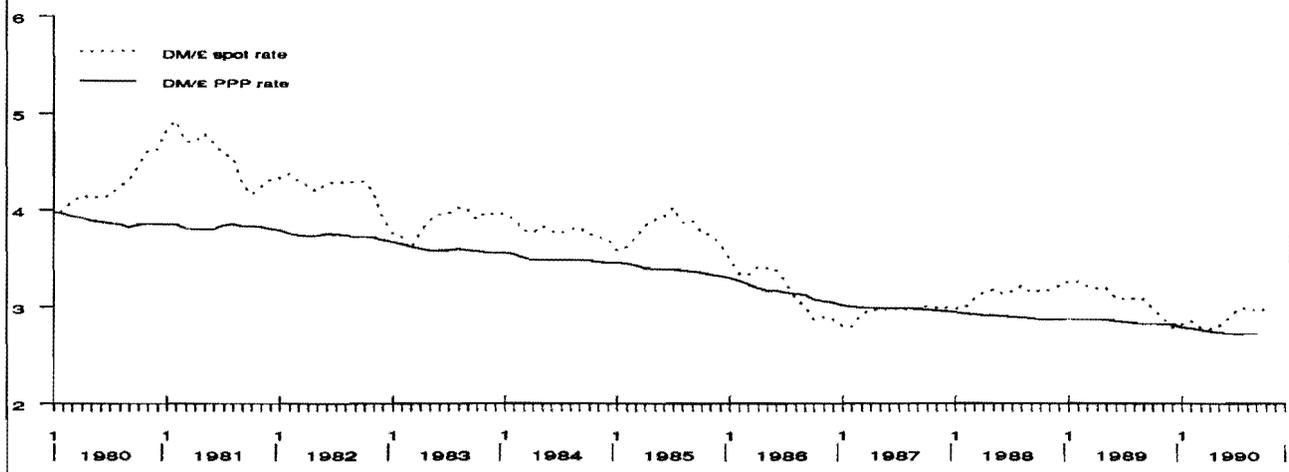
Of course, the power of foreign exchange traders is not unlimited. In the long run the fundamentals must come to the fore. Perhaps the most important fundamental is the balance between the demand for a currency and its supply. The antics of foreign exchange traders may cause the investment and speculative demand for a currency to jump up and down erratically in the short term, but over periods of several years the more stable transactions demand should dominate. As long as the quantity of a currency is restricted (relative to the quantities of other currencies) by a sensible monetary policy, its exchange rate cannot fall for ever. In summary, over the short and medium runs, changes in foreign exchange psychology towards a currency - acting in conjunction with wide and fluctuating interest rate differentials - can cause spectacular divergences from the "correct" exchange rates. But in the long run exchange rates are determined by purchasing power parity and relative rates of monetary growth.

But in short run exchange market expectations can be very powerful

The advocates of ERM entry thought that it would iron out the short- and medium-run anomalies so often thrown up by foreign exchange markets, by protecting the pound against the wild swings in speculative sentiment which sometimes seem to occur. They have overlooked that these swings may still have important effects, but instead of being absorbed by exchange rate movements they impact on interest rates. As we have shown, the difference between the golden and nightmare scenarios arises essentially because of a difference in foreign exchange expectations. The golden scenario might result in base rates of under 11% by mid-1991, the nightmare scenario in base rates

Sterling's valuation against the DM in the last decade

The chart compares the actual value of the DM/£ exchange rate (dotted line) in the last decade with the exchange rate consistent with purchasing power parity (continuous line). Note quite large departures from PPP.



still at 14%. The ERM therefore makes foreign exchange expectations very important as determinants of sterling interest rates.

By entering the ERM the British Government decided that an external consideration should be the main influence on sterling interest rates. Domestic monetary variables, particularly the growth rate of broad money, are now of little interest to policy-makers. (They may nevertheless have immense significance for economic activity and inflation.) When the practice of basing interest rates on domestic monetary conditions was the leading theme of British monetary policy in the early 1980s, it was much criticised because of its technical complexity and the instability of certain key relationships. For example, it was widely argued that there was no reliable relationship between broad money and money GDP. But our argument on the ERM shows that it too is subject to serious instabilities.

Sharp changes in such expectations can affect interest rates, whatever the state of the domestic economy

We have seen that, in a system of semi-fixed exchange rates, expectations about future exchange rates can exert strong influence over interest rates. It follows that sharp changes in such expectations can precipitate erratic interest-rate movements altogether unconnected to the fortunes of the domestic economy and wholly inappropriate in their macroeconomic effects. The strong pressure for lower sterling interest rates in early 1988 was one example of the ERM disrupting the sensible conduct of domestic monetary policy. A nightmare scenario in early 1991, when the ERM commitment could obstruct interest rate cuts even though these were vital on domestic criteria, could be another illustration of the point.

The nightmare scenario arises essentially because of (what might be termed) perverse or cantankerous expectations. Specifically, the foreign exchanges do not believe the Government when it says it intends to keep the pound within the announced ERM band. Once credibility is established, and expectations become benign (i.e., the markets do believe the Government's commitment to the ERM band), sterling interest rates may move down to the European average. It may take a few years to establish credibility in the required way. Unhappily, another problem may intrude over this medium-term time-horizon. While interest rates converge across Europe as expectations become more benign, growth rates of domestic credit and money may diverge because of structural differences in financial markets.

Further problem of conflict between interest parity theorem and need for convergent credit conditions

This sort of difficulty is particularly difficult in the British case, as private-sector credit demand appears more tolerant of high real interest rates than in other European countries. If credit and broad money growth is higher in Britain than elsewhere at the same nominal interest rate, the pound suffers from a deep-seated incompatibility with the ERM. The interest parity theorem requires that nominal interest rates be the same, more or less, in Britain and other ERM countries. But differences in credit and money growth at the same nominal interest rates will ultimately impel differences in inflation between the

countries, and differences in inflation cannot be reconciled with fixed exchange rates.

There is much more to be said about the puzzles and paradoxes of exchange rate dynamics in a semi-fixed-exchange-rate zone. But enough has been said to question the view that the ERM involves fewer problems for policy-makers than domestic monetary targeting. At present the ERM is causing a severe headache for French and Italian policy-makers, because they are being forced to hold interest rates higher than is appropriate on domestic grounds in order to keep their currencies stable within the ERM. For them, as for Britain on so many occasions in the past, domestic pressures on interest rates are in conflict with external. Recent developments suggest that tension between domestic and external considerations is likely to be endemic in European monetary policies for many years to come.

**Greater European
monetary
integration will not
end puzzles of
exchange rate
dynamics**

One reaction is to press for closer European monetary integration, including a European central banking system in which the Bundesbank would be a subordinate member. French and Italian enthusiasm for EMU is best explained in this way. But the result could be a leap from the frying-pan of semi-fixed exchange rates to the fire of a single European currency. In practice, stage two of the Delors process will probably amount to nothing more ambitious than a tightening of currencies' permitted band of variation around central ERM rates. Instead of a permitted band of 2 1/4%, the figure might become 1%, 1/2% or whatever, declining gradually over time. The arguments in this paper suggest that European governments and central banks are naive if they think that this tightening of the external constraint over interest rates will reduce conflicts between different countries' monetary policies.