

PREM 19/3438/1

Raddible Report on Ministerial Memoirs

MEMOIRS

Policy on Ministerial Memoirs

PT1: August 1979

[An attached folder just draft of Li'dan Walters' book "Steady and Inflation in the Eighties".

PT2: September 1988

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
16.7.88							
3.10.88							
3.2.89							
1.3.90							
8.3.90							
27.3.90							
30.3.90							
9.4.90							
18.4.90							
30.4.90							
16.7.90							
7.9.90							
PT2							
ENDS							

PA PREM 19/3438

● PART 2 ends:-

AT to Doe 6. 2. 91

PART 3 begins:-

EXTRACT OF INGHAMS BOOK UID



File in
bc F&B

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

6 February 1991

Dear Philip,

THE CHALLENGE OF EUROPE - CAN BRITAIN WIN?

The Prime Minister has seen your letter to me of 5 February. He accepts that the paperback version, using the same text as appeared in hardback, should be allowed to go ahead. He would not object to Mr. Heseltine undertaking "a modest amount of post-launch publicity" provided what he said defends current Government policy and observes the principles of collective responsibility. There are a number of points at which the book advocates ideas which are at variance with Government policy and the Prime Minister recommends that Mr. Heseltine consults the Foreign Office for advice on this. I understand the Foreign Office are ready to provide a brief identifying points of difficulty and setting out current Government policy, particularly the negotiating position in the two IGCs.

I am copying this letter to Richard Gozney in the Foreign Office.

Yours sincerely

Andrew Turnbull

ANDREW TURNBULL

Phillip Ward, Esq.,
Department of the Environment.

fm

PRIME MINISTER

MR. HESELTINE'S BOOK

In the attached letter Mr. Heseltine's Private Office report that a paperback version of Mr. Heseltine's book is to be published on Friday. As this is the same version as was published in hardback there can be no objection to this.

More troublesome, however, is Mr. Heseltine's request that he should "do a modest amount of post-launch publicity". There are two difficulties here. First, the views in it, as I remember from a hasty reading during the leadership campaign, are not the same as current Government policy, and these differences would be exposed by a skillful interviewer. Secondly, I am not happy about one Minister speaking specifically about matters in the portfolio of another.

One cannot take this doctrine too far as, under collective responsibility, all Ministers are expected to defend Government policies, even those for which they do not have direct responsibility. For example, on Question Time, a Minister is expected to defend the Government's position on whatever issue is raised. But that is not the same as appearing on a platform devoted to a specific policy when it is not strictly necessary to do so.

Agree Mr. Heseltine should be asked not to give any publicity to the book?

AT

ANDREW TURNBULL
5 FEBRUARY 1991

c:\wpdocs\pps\Heseltine.MRM

*In not case, why not
(yes... subject to collective responsibility?)
The problem here is M.H.'s. The Press
will point out difficult date anyway.*

*What does
the For. Sec. think?*

4/5.2



2 MARSHAM STREET
LONDON SW1P 3EB
071-276 3000

My ref:

Your ref:

Andrew Turnbull Esq
Principal Private Secretary
10 Downing Street
LONDON
SW1A 2AA

5 February 1991

Dear Andrew,

THE CHALLENGE OF EUROPE - CAN BRITAIN WIN?

You are probably aware that Mr Heseltine - while on the back benches - wrote a book with the above title which was published in hardback just before the last European elections.

The publishers of the hardback version have sold their paperback rights to Pan who have only just informed Mr Heseltine that they intend to publish the paperback version next Friday. The original plan had been to publish a revised and updated version in the autumn of this year.

Since the book itself will be printed in an unaltered form, I imagine there is no difficulty about the production of a paperback version. However, Pan are ~~know~~ asking Mr Heseltine to help with the launch of the book by appearing on radio and television to discuss it and European policy generally.

Mr Heseltine is quite content to do this subject to the Prime Minister and Foreign Secretary being happy for him to do so. He has no anxiety about any differences between the views in his book and those of the Government on European policy and is confident that he could handle the interviews without difficulty.

I would be grateful to know whether you see any problem with him in accepting invitations to do a modest amount of post launch publicity.

I have written separately on similar lines to Richard Gozney in Douglas Hurd's office.

*Yours
Phillip*

PHILLIP WARD
Private Secretary

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RETAINED UNDER SECTION 3 (4)
OF THE PUBLIC RECORDS ACT.

9th January 1991

Dear Andrew,

Thank you for your letter dated 3rd January 1991. I have read the letter carefully together with the extracts from the Civil Service Code and fully understand my position.

I truly apologise for the great embarrassment I must have caused you: it was never my intention to upset or betray anyone and I shall always regret the distress the proposal for this book obviously caused Mrs Thatcher.

I realize that there are many more important things happening and worrying everyone at No. 10 than my insignificant book and shall wait until you have the time to discuss this matter further. Please be assured that I shall not do anything without first consulting you.

Yours
Shery

Andrew Turnbull, Esq., C.B.



10 DOWNING STREET

From the Principal Private Secretary

Note for the Record

I spoke to Stangham about the draft (Earlier in the day Mr Crawford had also spoken to Mr Gray that Mrs Thatcher was most unhappy - feeling the book was most intrusive. She also felt it oversteered Stangham's role - No 10)

I said

(i) I always felt the book would need careful drafting to be acceptable. Having seen the proposed I agreed that it went beyond that was acceptable. I had warned against using recipes / menus to particular people and occasions yet less was pressed what was being done.

(ii) The five meals mentioned were each written up in a way which ~~the~~ objects could be made

(iii) The introduction was an invitation, soapspeak Stangham's point and consistently drawing attention to the ~~book's~~ intrusiveness.

(iv) I told Mr Thatcher was very upset and for the good of their future relations Stangham should reconsider

(v) The formal position was Stangham need to formal points permitted to be there at least in the before shall could publish a book drawing on official information and experience. I could not authorize it.

Stangham asked whether there was anybody else she could publish I said that if it concentrated on the recipes / menus is what Stangham brought to No 10 rather than the occasions on which served that would be less problem. It would of course make the book less interesting. Stangham agreed to reflect.

- ① Been out. Thought you were going to see me a couple.
Always felt a bit raw to bone. Need to be written carefully
- ② Not happy & when we spoke I went against (with) d. receipts
→ names to public people on occasions yet less of
precisely what has been done.
- ③ For exact. support the general election
fund for industrialists & charities.
draw by A.S.C.
this theme.
Troops Paul Part
- ④ (who) available. do the nature & area, be cook
recall quite readily upon d. occasion.
evoked a Dutch era. parallel, sent, is ...
already meant the kitchen and dining room
But he it might for certain still to write - was still
- ⑤ Mrs T v. upset 'impersonal' into private life.
- ⑥ Not sort of book I would not you to publish



10 DOWNING STREET

Sherry

I'm sorry to write you
a rather stuffy letter but I
don't want through some
mis understanding to wake up
one morning to find something
has been published and I have
an apoplectic Mrs Thatcher
on the phone.

Andrew

PERSONAL



KW
c/warner

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

3 January 1991

YOUR BOOK

Could I record some of the points I made to you when we spoke on the phone.

When you mentioned the idea of a book to me, I always felt that it would need careful drafting. Having seen the proposal, I share Mrs Thatcher's view that it goes beyond what is acceptable. I had warned against linking recipes/menus with particular people and occasions yet this is precisely what part of the book would do. There was, in my view, something in each of the way the five meals mentioned were written up to which objection could be made. I also feel that the introduction is over-written and consciously draws attention to the intrusive nature of the text. You will be aware from Crawfie that Mrs Thatcher was very upset, feeling that the privacy of occasions in No 10 had been invaded. I do not think Crawfie was exaggerating.

Could I also record the formal position so that there is no misunderstanding, though I would hope to resolve this amicably between us. As you will see from the attached extract from the Civil Service Code, a Civil Servant who wishes to undertake private work involving the use of official information or official experience, needs permission from the Head of the Department (I assume that means me) before doing so. I do not think I could give that approval on the basis of the present proposal.

You asked me whether there was any book which could be published. If it concentrated on the recipes and menus, i.e. highlights what you bring to No 10, rather than the occasions on which those meals are served, there would be less problem. I recognise, of course, that this could make it more difficult to write the book in an interesting way.

You agreed to reflect on this. Can we have a word when we are next both in No 10.

ANDREW TURNBULL

Mrs Sherry Warner MBE

Part I
paragraphs 4083 to 4094

4083 A civil servant should be required to obtain permission from the Permanent Head of his Department before undertaking any private work involving the use of official information or his official experience. If possible permission should be sought before the activity is actually begun, on the basis of an outline of what is proposed. It is, however, essential that a civil servant should apply for permission before attempting to dispose of the product of his private work. The department should consider, in consultation with any other department which may be concerned, whether the department itself should acquire or take over responsibility for the activity (or for its product or any part of its product) see Guide paragraphs 4133 to 4136. If the department decides to take over, the officer has no appeal against that decision, and the financial arrangements should be those appropriate to payments by departments for work outside the scope of normal duties see Guide paragraphs 4089 and 4090. If, however, permission is given to dispose of the product of his private work in the outside market, the officer should be allowed to make his own terms. The payment which a civil servant receives from an outside source for his private work should not be restricted by his department on the sole ground that official information or official experience is involved.

RL pa

SIR ALAN WALTERS'S BOOK

1. Q. Is he expressing the Government's view on ERM?
A. No. Government is committed to joining ERM, and has set out the conditions for this. In recent interview AW endorsed those conditions.
2. Q. Will the arguments AW produces trigger a reappraisal?
A. No. His arguments are familiar. Book simply expands on lecture to City University in April.
3. Q. But AW argues that those conditions must be fully achieved. Would not be so long as inflation remains near 10% and interest rates at 15%. Entry in these circumstances would be damaging.
A. Nothing new to say on Madrid conditions. Not going to be drawn into providing a gloss on them.
4. Q. Has the Prime Minister read the book?
A. No, but she is familiar with the arguments in it.
5. Q. Does the Prime Minister agree with arguments in the book?
A. Since the Prime Minister reaffirmed the commitment to join the ERM in House on 12 July, clearly not.
6. Q. What do you think of his ECOM idea?
A. Is a sophisticated presentation of how a commitment to low inflation might be entrenched. Government has recently tabled an alternative proposal, the hard ECU, which is seeking the same objective in a different way.
7. Q. Is it true that you demanded extensive re-writing?
A. Sir Alan submitted text of his book, as is customary with all books by recently retired Ministers and officials. Some amendments were sought, most of which were adopted.

8. Q. What amendments do you insist on? What amendments were not accepted?

A. That is a matter between us and Sir Alan.

[Note: The conventions governing memoirs, etc. are set out in the Radcliffe Report on Ministerial Memoirs which also governs those by officials. Its guiding principle is that no one should publish information "which would be destructive of the confidential relationships which may subsist between Minister and Minister, Minister and their advisers ..." Its procedures are not backed by statute and the ultimate responsibility for what to publish rests with the author. In the case of this book the tone to get across is that there has been no great wrangle. The text was handled very much in the same way as his previous book "The British Economic Renaissance", 1986.]

9. Q. Is it true that the 3DM shadowing was cooked up by Mr. Lawson and Sir Terence Burns and that other Treasury officials were kept in the dark? (Footnote 17 on page 137.)

A. No.

10. Q. Sir Alan says (Footnote 17 on page 134) that in July 1988 he was asked to shut up and did. Who muzzled him and why?

A. At that time negotiations were in hand for him to return to No.10 as an adviser. Once agreement was reached it was appropriate for him to limit his comment on public policy in the UK, which he did.

11. Q. The implied, if unstated, theme of the book is that the economic consequences of Mr. Lawson were as disastrous as those of Mr. Churchill, and that he personally is to blame for much of what has happened. Do you accept that?

A. No. In any case economic policy is a collective responsibility. Attaching the label of a particular Minister may be a convenient journalistic shorthand but it ignores the reality of how policy is formed.

Thursday 20th December 1990

Dear Mrs Thatcher

I am sending the attached to you for your information. Please delete anything you do not like as naturally I would not wish to offend you in any way. I have also sent a copy to the Press Office at No. 10 which had been passed.

I am sorry to ask you to do this as I know you are tremendously busy at the moment.

My best wishes to you & Mr Thatcher

Sherry

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DOWNING STREET COOK

Recipes from the Thatcher years

by

SHERRY WARNER

DOWNING STREET COOK

Recipes from the Thatcher Years

Sherry Warner has been the cook at No 10 Downing Street since 1981, and has witnessed all the victories and crises of Margaret Thatcher's premiership from behind the scenes. She has baked exquisite pastries for Eduard Shevardnadze and the Reagans, fed the War Cabinet during the Falklands Conflict, cooked delicious lunches for important Downing Street guests, prepared feasts to mark Trooping the Colour and celebration suppers after Mrs Thatcher's 1983 and 1987 general election victories, and made weekly working lunches for the Prime Minister and her Cabinet.

DOWNING STREET COOK contains Margaret Thatcher's favourite recipes - the simple yet superbly conceived dishes she has requested time and time again, from egg, cucumber and watercress mousse, chicken cooked with lime and tarragon and veal braised with oranges and watercress to summer pudding and gooseberry soufflé with elderflowers.

In these recipes Sherry Warner imaginatively reworks many of the forgotten glories of British food, displays the lightness of touch that characterizes her cooking and emphasizes the importance of using the freshest possible ingredients - qualities that brought her to the attention of Downing Street initially and led to membership of the most exclusive association of chefs in the world, Le Club des Chefs des Chefs. She lists many of the menus she has created in Downing

Street during the Thatcher era, recalling the guests and recording her impressions of the occasion, as well as explaining the workings of the kitchens.

More than a book of recipes, DOWNING STREET COOK is a revealing insight into the kitchens and dining rooms of one of the most famous addresses in the world.

Sherry Warner's book is an evocation of the Thatcher era - the personalities, the events, the power and politics, the clatter of pots and pans, the clink of crystal and, above all, the simple but stylish food that graced the Prime Minister's

table.

CONTENTS

INTRODUCTION

Sherry Warner describes her life cooking for the Prime Minister, her love of cooking, how she became a professional cook, 'discovery' by Downing Street, the satisfaction - and stresses - of cooking for politicians and statesmen, and membership of the exclusive Club des Chefs des Chefs.

THE DOWNING STREET KITCHENS

Life 'downstairs' in the Prime Minister's residence and how it has changed over the decades; the kitchens and how they are organized.

CUSTOMS OF THE HOUSE

The traditions of No 10 Downing Street: the menu, inside the dining room, laying the table, serving the food and wines, the cheeses.

MENUS

30 memorable menus of lunches, dinners, suppers and teas served during the Thatcher era.

RECIPES

Over 150 recipes of dishes that the Prime Minister, Cabinet and visitors to Downing Street have enjoyed - including a tempting selection of first courses,

many of which may be served on their own for lunch; poultry, meat and fish dishes distinguished by Sherry Warner's original approach; irresistible desserts, and the exquisite pastries and cakes that are eaten at *téatime*. The recipes for each course are grouped together: first courses and light lunch dishes (mousses and terrines, eggs, tarts and quiches, salads, soups); main courses (fish, poultry, beef, veal, lamb, pork and ham); puddings, and cakes and pastries.

INDEX

THE AUTHORS

SHERRY WARNER trained at the Cordon Bleu School in London. In 1979 she started her own cooking business, which she ran until Andrew Duguid recommended her to No 10 Downing Street. Sherry started cooking for the Prime Minister on Budget Day in 1981, and continues to prepare working lunches and teas as well as occasional suppers and dinners during parliamentary sessions. In 1990 Sherry was invited to join the exclusive Club des Chefs des Chefs, membership of which is restricted to those who cook for the world's monarchs and heads of state. Sherry commutes to Downing Street from the Isle of Wight, where she lives with her family.

MARY TREWBY, an experienced editor and writer, is the author of A Gourmet's Book of Herbs & Spices. She has edited and contributed to a number of books on food and wine, including The Wine Lover's Guide to France and Antonio Carluccio's Invitation to Italian Food, and has written the Time Out New York Guide and several other travel books.

CELEBRATION SUPPER AFTER THE 1987 GENERAL ELECTION

Friday 11 June 1987

Cold salmon mayonnaise

Mangetout & French bean salad

Tomato, mozzarella & avocado salad with basil dressing

Hot new potatoes vinaigrette

Fresh fruit with cream

Cheese

The night after Mrs Thatcher lead the Conservatives to a third general election victory I prepared an impromptu supper to celebrate. The Thatchers invited Norman Tebbit, who was then party chairman, Willie Whitelaw, John Wakeham and her PPS, Nigel Wicks. Because it was mid-summer and an informal occasion, I kept the food very simple - cold poached salmon with mayonnaise, several salads and tiny new potatoes. The Prime Minister always insisted on serving British cheeses and I usually included her favourite blue Lymeswold, which is at its best when soft and creamy, as well as a mature farmhouse Cheddar and, perhaps, a soft Welsh goat's cheese.

LUNCH FOR INDUSTRIALISTS

6 December 1989

Egg, cucumber & watercress mousse

Melba toast

Rack of lamb with mint, orange & redcurrant sauce

Potatoes dauphinoise

Selection of vegetables

Raspberry syllabub

Cheese

Mrs Thatcher often invited industrialists and financiers to lunch - there were usually twelve people present. The egg mousse is very light and refreshing and was a particular favourite of the Prime Minister's. On this occasion I garnished it with anchovy fillets - it is also excellent served with a garlicky tomato sauce, although I never use garlic at No 10.

DINNER GIVEN BY THE CHANCELLOR OF THE EXCHEQUER

11 April 1983

Salad Nicoise

Lamb Wellington with mint hollandaise

Selection of vegetables

Pineapple mousse

Cheese

I cooked this dinner for the then Chancellor of the Exchequer, Sir Geoffrey Howe, in his official residence at No 11 Downing Street. It was held in the ground-floor dining room, off which is a butlers' pantry. But I had to work in a small kitchen down in the basement - it was extremely hot and not very well ventilated. I remember vowing never to cook at No 11 again.

TEA FOR KING HUSSEIN OF JORDAN

22 July 1982

Cucumber sandwiches

Strawberry, grape & peach tartlets

Tiny coffee eclairs

Shortbread

Chocolate gateau

Indian & China teas

I was rather nervous the day I made this tea, my first ever for a king. One thing I soon learnt was that the Prime Minister and her guest would eat very little. These teas are good opportunities for talking informally and so it is important that all the food is very small and easy to handle. I had decorated the chocolate gateau with caraque chocolate and it looked beautiful, but was just too big and was not touched. After that, I scaled everything down. Even the cucumber sandwiches, made with very thinly sliced wholemeal bread, are cut into tiny triangles. The tea service is Royal Minton - fine white bone china edged with gold.

LUNCH AFTER TROOPING THE COLOUR

17 June 1989

Coronation chicken

Sirloin of beef

Tomato & avocado salad with basil dressing

Mixed leaf salad

Rice salad

Hot new potatoes with coriander butter

Raspberries & strawberries

Peach & lemon pavlova

Chocolate marquise with mocha sauce

Tiny meringues

Cheese

Every year, following a formal reception for foreign dignitaries who attended the Trooping the Colour ceremony, the Prime Minister held a private buffet lunch for about 30 guests. It was always a very happy occasion. I prepared the food in the Thatchers' top-floor flat - caterers cooking for the reception were using

the downstairs kitchens - and so had a perfect view of the ceremony in Horseguards Parade. Invariably, the sun was shining and the building humming - people invited to watch the Trooping from the official stand left their children at the house and Downing Street staff always tried unsuccessfully to keep them in order. After the reception and several of the special-recipe Pimms that are always served, those who had been invited to stay for lunch were ushered into the main dining room, where they sat around the large table and helped themselves to food.

EXAMPLES OF RECIPES

FIRST COURSES & LIGHT LUNCH DISHES

Egg, cucumber & watercress mousse

Warm chicken liver mousseline with cranberry sauce

Stuffed mushrooms with basil mayonnaise

Spinach roulade with smoked salmon & dill sauce

Wild mushroom tart

Ratatouille quiche

Parma ham & celeriac salad

Avocado & smoked chicken salad with hazelnut dressing

Artichoke & baby mushroom salad

Spinach salad with bacon, avocado & stilton

Chilled cucumber soup

Crab & corn bisque with coriander

Leek & watercress soup

Stilton & port soup

Spiced parsnip & apple soup

MAIN COURSES

Fillets of sole stuffed with salmon with a saffron sauce

Fillets of sole in whisky sauce

Haddock & watercress roulade

Smoked haddock & broccoli with cheese sauce

Plaice stuffed with mushrooms

Salmon kouloubiac

Poached salmon cutlets with pink & green peppercorns

Grilled salmon with bearnaise tomatoes

Poached turbot with champagne

Chicken with lime & tarragon sauce

Hazelnut chicken en papillote

Chicken, leek & cream pie

Baked chicken with sour cream & mushrooms

Summer chicken fricasse with cucumber

Coronation chicken

Honeyed chicken with mint & lime

Crisp chicken with celery in almond sauce

Fillet of beef with bearnaise & red wine sauces

Tournedos Rossini

Veal braised with orange & watercress

Lamb Ratatouille with coriander

Rack of lamb with mint, orange & redcurrant sauce

Noisettes of lamb Shrewsbury

Lamb Wellington with mint hollandaise

Pork tenderloin with red wine, mushrooms & cream

Honey baked ham with white onion sauce

PUDDINGS

Summer pudding

Cranachan

Tulip brandy snaps with orange ice-cream

Peach & lemon pavlova

Burnt cream with Cointreau

Rich chocolate mousse

Chocolate marquise with mocha sauce

Orange & chocolate roulade

Butterscotch tart with pecans

Brown sugar meringues

Orange syllabub

Lime & lemon soufflé

Gooseberry soufflé with elderflowers

TEAS

Tiny scones with clotted cream & strawberries

Fruit cake

Walnut fruit cake

Tiny coffee eclairs

Hazelnut tartlets with raspberries

Chocolate macaroons

Petits fours

PUTNAM, HAYES & BARTLETT, INC.
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Washington, DC

Putnam, Hayes & Bartlett Ltd
London, England

Dear Terry,

I do apologise for the footnote. Together with a list of other amendments, I instructed that it be deleted. But for some reason, still not clear, the managers of the manuscript never received the instruction. Sackcloth and ashes for us all !

In any case it is clear from the context that I am reporting not from any direct knowledge but from "reliable sources", which of course may well be wrong. I was not in Downing Street in 1987, as everyone knows, so I have recourse only to the usual leaks and (second hand) briefings.

I had no intention of writing anything other than an account of the issues and the outcomes. As you know, in my book I did not touch upon the behaviour of Lawson, Howe, the treasury leaks and briefings etc. I know that this is not your responsibility, but I was misrepresented scandalously and this was taken up, duly distorted for their own political agenda, by the FT and Independent (although the latter, in part, recanted.) Although sorely tempted, I thought it wise to maintain as much silence as possible: that I think I did.

And it appears that, in spite of my silence and submitting to official editing, I have been officially shafted. So I doubt if I will be any more trouble to you. If I do get around to doing a second edition of my book, I will make it clear that there was no evidence for the footnote in the first edition.

I must also congratulate you, if the reports of the imminent entry into the ERM are correct, on winning the policy decision.

Yours sincerely,

Alan

Sept 7 1990

 HM Treasury



Fy
Parliament Street
London SW1P 3AG
Telephone 01 270

bc IC Jumbull - No 10

Sir Terence Burns
Second Permanent Secretary
Chief Economic Adviser

Sir Alan Walters
Putnam, Hayes & Bartlett Inc
1776 Eye Street NW
Suite 600
WASHINGTON DC 20006
USA

3 September 1990

Dear Alan,

I was very surprised and shocked to read footnote 17 on page 137 of your book 'Sterling in Danger'. I understand that you had agreed to remove this reference but that it was one of a batch of changes that, in error, were not made by the publishers.

2. Unfortunately the reference is wrong in a number of respects. For example:

- the 1987 IMF speech did not say that exchange rates were the main guide for monetary (interest rate) policy;
- as you would expect, the speech was widely discussed by senior officials in the Treasury before delivery;
- the decision to "shadow" the Deutschmark was not the consequence of a number of discussions between Mr Lawson and myself.

3. You quote Keegan as a source. He does not make the first or third errors in his book, although he does make the second error.

4. I am particularly surprised that you should have wished to join in such malicious gossip - even in draft - without first consulting me about its accuracy.

Yours,

Terry
T BURNS

PR



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Andrew Turnbull Esq
No. 10 Downing Street
London SW1A 2AA

16 July 1990

Dear Andrew,

has - what?

Thank you for your letter of 12 July. I trust that you have now received mine of 13 July.

When we spoke on the telephone again I mentioned that it had become clear that footnote 17 had been revised independently of the missing note. At a review meeting our people were unhappy with the way the footnote read and revised it themselves. They advised me that it had stood out from the text in the way some of the other points did not.

Once again, we are all in sackcloth and ashes about the mistake.

G - Mather

Graham Mather
General Director

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7. Q. What amendments do you insist on? What amendments were not accepted?

A. That is a matter between us and Sir Alan.

[Note: The conventions governing memoirs, etc. are set out in the Radcliffe Report on Ministerial Memoirs which also governs those by officials. Its guiding principle is that no one should publish information "which would be destructive of the confidential relationships which may subsist between Minister and Minister, Minister and their advisers ..." Its procedures are not backed by statute and the ultimate responsibility for what to publish rests with the author. In the case of this book the tone to get across is that there has been no great wrangle. The text was handled very much in the same way as his previous book "The British Economic Renaissance", 1986.]

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A. No.

9. Q. Sir Alan says (Footnote 17 on page 134) that in July 1988 he was asked to shut up and did. Who muzzled him and why?

A. At that time negotiations were in hand for him to return to No.10 as an adviser. Once agreement was reached it was appropriate for him to limit his comment on public policy in the UK, which he did.

10. Q. The implied, if unstated, theme of the book is that the economic consequences of Mr. Lawson were as disastrous as those of Mr. Churchill, and that he personally is to blame for much of what has happened. Do you accept that?

A. No. In any case economic policy is a collective responsibility. Attaching the label of a particular Minister may be a convenient journalistic shorthand but it ignores the reality of how policy is formed.



FILE

TW

a: / Question

10 DOWNING STREET

From the Principal Private Secretary

13 July 1990

Dear Gus,

SIR ALAN WALTERS'S BOOK

Although publication of this book is scheduled for 27 July, the publishers seem to be failing to enforce the embargo and copies are beginning to leak out. This ragged presentation may, of course, help to defuse its impact. I attach some Q & A briefing. If you have any comments on it or points you wish to add, please could you let me know.

I am copying this letter to Sir Robin Butler, Sir Peter Middleton, Sir Terence Burns and John Gieve (H.M. Treasury).

Your sincerely

Andrew

ANDREW TURNBULL

A.T. O'Donnell, Esq.,
H.M. Treasury.

K

SIR ALAN WALTERS'S BOOK

1. Q. Is he expressing the Government's view on ERM?
A. No. Government is committed to joining ERM, and has set out the conditions for this. In recent interview AW endorsed those conditions.

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A. No. His arguments are familiar. Book simply expands on lecture to City University in April.

3. Q. But AW argues that those conditions must be fully achieved. Would not be so long as inflation remains near 10% and interest rates at 15%. Entry in these circumstances would be damaging.
A. Nothing new to say on Madrid conditions. Not going to be drawn into providing a gloss on them.

4. Q. Doesn't this represent Prime Minister's views?
A. No. Prime Minister reaffirmed commitment in House on 12 July.

5. Q. What do you think of his ECOM idea?
A. Is a sophisticated presentation of how a commitment to low inflation might be entrenched. Government has recently tabled an alternative proposal, the hard ECU, which is seeking the same objective in a different way.

6. Q. Is it true that you demanded extensive re-writing?
A. Sir Alan submitted text of his book, as is customary with all books by recently retired Ministers and officials. Some amendments were sought, most of which were adopted.

010



GR
despatching

cc Sir Robin Acheson
Sir Peter Middleton
Sir Terence Burns

The Institute of Economic Affairs

Registered No. 755502 England Charity No. CC/235 351 Limited by Guarantee

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Director of Finance and Administration: Keith C Miles FCA, MBIM Publishing Director: Walter Allan

Andrew Turnbull Esq
No. 10 Downing Street
London SW1A 2AA

13 July 1990

Dear Andrew,

I was very alarmed by your telephone call. Inquiries have confirmed that the last batch of changes agreed with you to Alan Walters' book were unfortunately not made, and are not included in the final printed copies.

I do apologise for this error. The changes had been passed to our Publishing Department and the failure to reflect them in the text was an oversight which causes me considerable concern.

I have apologised to Alan Walters. If there is anything we can do to correct the position please let me know.

Graham Mather
General Director

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10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

C:\WPDOCS\PPS\
WALTERS (MEM)
bcc Peter Middleton, HMT
Robin Butler, CO
Trevor Burns, HMT

12 July 1990

On 21 May I wrote to Alan Walters seeking half a dozen further amendments to the text of the book. Some of these amendments were seeking the deletion of points which Alan had himself deleted at an earlier stage, but which had re-appeared in the text. You replied on 25 May informing me that Alan was able to accept all of the points made and that these would be incorporated into the final version.

I was therefore very annoyed to discover that in the version of the book to be published these deletions had not been made. The result is that there is a footnote in Chapter 6 which purports to convey the views of a named official and does so erroneously. Also, I had sought the deletion of "by hook or by crook" in line 12 of page 104 as it wrongly implied that those advocating ERM entry were acting by subterfuge. I would be grateful if you would investigate how this came about and let me know what happened.

When we spoke on the telephone you suggested that there might have been an administrative error in that the note of amendments sought was not passed to those responsible for finalising the text. One mystery with this explanation is that had the deletions sought simply not been acted upon, the whole of footnote 17 as it appeared in the draft would have carried through to the published version when in fact, the final sentence was deleted.

I am copying this letter to Sir Alan Walters.

ANDREW TURNBULL

Graham Mather, Esq.,
Institute of Economic Affairs

MR O'DONNELL

11 JUL '90 17:49 TREASURY PRESS OFFICE

P.1



H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 071-270 5238
Facsimile: 270 5244
Telex: 9413704

OUTGOING FAX

FROM: *Judith Simpson* DATE: *11/7/90*
TO: *Gus O'Donnell* TIME: *17:45 BST*

Number of pages following: *4*

*This is the transcript of Sir A Valls on World At One.
Apparently PM have seen it with comments from John Seigand.
(They tried to get a Treasury Minister as, but we couldn't play)*

J.

Prime Minister

You could get a question such as
 "Do you agree with AW that it would be damaging
 to join ERM with Madrid conditions as more clearly
 fulfilled i.e. the interests have come down from 15% and inflation
 from 10%." You will want to avoid being drawn
 on what Madrid conditions mean.

TRANSCRIPT FROM THE WORLD AT ONE, BBC RADIO 4, 11 JULY 1990

PRESENTER: It was reported in today's FT that Sir Alan Walters, the former Economic Adviser to the Prime Minister, is about to launch a stinging attack in his book called "Sterling in Danger" on the proposals to take up full membership of the EMS of the ERM. Now, the growing strength of sterling in the past week or so has arisen out of a belief that the Government is only a few weeks away from joining the ERM, which has been so heavily resisted by Sir Alan over the years. Now, the question is, is Sir Alan trying to scupper these plans at the last minutes, that is what is being said. Fortunately for us, Sir Alan is on the line now from Washington to tell us. Is it true that you are resuming your long-held opposition to the ERM in the book, and that you hope that at the last minute, perhaps, you might stop Britain going in?

WALTERS: I don't know where that idea comes from. For Britain is committed to go in under the full Madrid conditions. Those full conditions are that inflation is suitably low, that the other countries, particularly Germany and France and Italy, get rid of exchange controls, which they have done substantially, and thirdly, that they get free capital markets, which they have not done yet, and fourthly, of course, there really is a Common market. Now, those are the Madrid conditions to which the Government, I think, has put its name about a year ago.

NAUGHTIE: The question is whether the Government is now prepared to go in before the conditions were met in a way in which you would accept as a proper meeting of those conditions. Don't you fear that the Prime Minister has shifted the ground that she once shared with you?

WALTERS: I don't know what ground the Prime Minister stands on. You must ask her. But the formal position is that you have got to wait for inflation to come down and all the other things to be delivered on those Madrid conditions. I should point out also that when Herr Pohl gave his speech in London a week or two ago, he said things that I entirely admit virtually all his speech I entirely agreed with. Those are the conditions I think he would wish to see us in the EMS, that is if we have low inflation and relatively low interest rates. If we go in with high inflation and high interest rates, we won't do any good to our partners in the EMS, not a bit.

NAUGHTIE: Are you still offering advice formally or informally to Mrs Thatcher?

WALTERS: No, I am not an adviser. I ceased to be an adviser in October last year.

NAUGHTIE: But when you talk, it would be odd not to discuss matters which are so close to your heart and to hers.

WALTERS: you can regard that as odd if you like, but formally I am not an adviser. I ceased being an adviser last year, and that is my formal position.

NAUGHTIE: Do you offer informal advice?

WALTERS: That is a matter between friends, not for dissemination over your airwaves.

NAUGHTIE: Your attitude to the ERM is well known. The FT is quoting you assaying in the book "pseudo fixed exchange rates are accompanied by a pseudo monetary policy, both are indeed half-baked." Do you think that Britain is in danger of going into the ERM before the conditions which you think should be adhered to precisely are met, and that will be damaging?

←
WALTERS: There is always the danger, even though accidents happen in politics, I guess. And if we went in with our present interest rates and rate of inflation, then I think we would get a replay of what happened when the Spanish went in just over a year ago. Spain went in, they had an awful time of it, and they are in considerable trouble now, similar to that which we are in, but on a much bigger scale.

NAUGHTIE: Is that a mistake which you fear John Major and the Treasury want to make?

WALTERS: No, as far as I read it, and the FT is, in my view, quite misleading. As far as I read it, John Major has said that you would not wish to join yet, until the Madrid conditions are met, as far as I can see it, that is inflation rate down and interest rates are down. And he has said that time and time again, now he is being pushed by journalists from the FT, and the Independent, and so on, to commit Britain to an earlier entry. I think jhe has stood out very well against that.

NAUGHTIE: It does seem clear though that the Treasury does want to go in sooner, and we are back replaying the old argument sooner than you would want? Sooner than Downing Street wants?

WALTERS: Sooner than the Madrid conditions? You mean they would like to go in if interest rates are still 15% and inflation is near 10%.

NAUGHTIE: I can't put a figure on it, but as you know, the Madrid conditions are things which are open to different interpretations by different politicians. Otherwise, the differences between Mr Lawson and Mrs Thatcher, for example, would have been less obvious, would they not?

WALTERS: I find what Major has said various times is entirely consistent with what Herr Pohl has been saying. And indeed, with what Mr Stiggason has said, one of the Delors Commission economists. They say it would be disrupting in the extreme both for Britain and the EMS. That is a position I fully agree with.

NAUGHTIE: How do you look back on the episode where Nigel Lawson resigned, and how would you describe the relationship between yourself and Lawson at that time?

VERY LONG SILENCE

WALTERS: I think my arguments at that time have had substance, broadly as I thought it would. I don't think anyone won, but at least the ideas I put forward there have been more and more embraced by, I think, thoughtful people anyway in the UK.

NAUGHTIE: Do you think the controversy was wrong?

WALTERS: You must ask Mrs Thatcher about that.

NAUGHTIE: thank you, Sir Alan.

Ref.A090/1644

MR TURNBULL

2ccs being sent out by IEA
on 4/7

Sir Alan Walters' Book

I understand that Sir Alan's book is to be published later this month - probably on 26 or 27 July - and that advance copies are now available. In your letter of 30 April you asked Sir Alan to keep you informed of the timing of publication, so that Ministers could be briefed. I am not sure whether Sir Alan has responded to your request, but copies of the final text will also be necessary in order to brief the Prime Minister and the Chancellor of the Exchequer. Sir Robin would be grateful if you could ask Sir Alan for two advance copies of the book.

Senia Phippard

Miss S C Phippard

10 July 1990

SIR ALAN WALTERS'S BOOK

Copy sent to
O'Donnell
Maddalati
Butler
Barnes
Plan office

1. Q. Is he expressing the Government's view on ERM?
A. No. Government is committed to joining ERM, and has set out the conditions for this. In recent interview AW endorsed those conditions.

2. Q. Will the arguments AW produces trigger a reappraisal?
A. No. His arguments are familiar. Book simply expands on lecture to City University in April.

3. Q. But AW argues that those conditions must be fully achieved. Would not be so long as inflation remains near 10% and interest rates at 15%. Entry in these circumstances would be damaging.
A. Nothing new to say on Madrid conditions. Not going to be drawn into providing a gloss on them.

4. Q. Has the Prime Minister read the book?
A. No, but she is familiar with the arguments in it.

5. Q. Does the Prime Minister agree with arguments in the book?
A. Since the Prime Minister reaffirmed the commitment to join the ERM in House on 12 July, clearly not.

6. Q. What do you think of his ECOM idea?
A. Is a sophisticated presentation of how a commitment to low inflation might be entrenched. Government has recently tabled an alternative proposal, the hard ECU, which is seeking the same objective in a different way.

7. Q. Is it true that you demanded extensive re-writing?
A. Sir Alan submitted text of his book, as is customary with all books by recently retired Ministers and officials. Some amendments were sought, most of which were adopted.

8. Q. What amendments do you insist on? What amendments were not accepted?

A. That is a matter between us and Sir Alan.

[Note: The conventions governing memoirs, etc. are set out in the Radcliffe Report on Ministerial Memoirs which also governs those by officials. Its guiding principle is that no one should publish information "which would be destructive of the confidential relationships which may subsist between Minister and Minister, Minister and their advisers ..." Its procedures are not backed by statute and the ultimate responsibility for what to publish rests with the author. In the case of this book the tone to get across is that there has been no great wrangle. The text was handled very much in the same way as his previous book "The British Economic Renaissance", 1986.]

9. Q. Is it true that the 3DM shadowing was cooked up by Mr. Lawson and Sir Terence Burns and that other Treasury officials were kept in the dark? (Footnote 17 on page 137.)

A. No.

10. Q. Sir Alan says (Footnote 17 on page 134) that in July 1988 he was asked to shut up and did. Who muzzled him and why?

A. At that time negotiations were in hand for him to return to No.10 as an adviser. Once agreement was reached it was appropriate for him to limit his comment on public policy in the UK, which he did.

11. Q. The implied, if unstated, theme of the book is that the economic consequences of Mr. Lawson were as disastrous as those of Mr. Churchill, and that he personally is to blame for much of what has happened. Do you accept that?

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PUTNAM, HAYES & BARTLETT, INC.
ECONOMIC AND MANAGEMENT COUNSEL

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Washington, DC 20006
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Washington, DC

Putnam, Hayes & Bartlett, Ltd.
London, England

*Prime Minister
To note. Thygesen's view that
ERM is unstable leads him forward
to EMU, not back to Hoating*
→ → → *AT 1/6*

1 June 1990

1/6

Andrew Turnbull
Principal Private Secretary
Office of the Prime Minister
Number 10 Downing Street
London SW1 A2AA
UNITED KINGDOM

Dear Andrew:

I am putting the attached addendum in my manuscript. It might however be of interest to the Prime Minister. Thygesen appears to have come around completely to my view of capital movements in the ERM.

Regards,

Alan
Alan A. Walters

INSERT Chap 5 AFTER section entitled "Exchange Controls and the Consequences of Freedom" and BEFORE section entitled "Covert Exchange Controls" a new Section entitled:

Is the "Walters' Critique" now accepted and respected?

I believe that, since I first stressed the problem of capital flows and their perverse influences, most informed observers have ignored the point or have asserted that it was of little importance - even with no exchange controls.¹ Indeed the problem was not mentioned let alone discussed in the Delors Report. There are, however, some signs of change - at least among those whose minds are not closed to the evidence. In January, the Economist suggested that Italy was a working example of the "Walters' critique".² I do not think that the evidence of Italy between January and June 1990 has in any way discredited the critique, and I would expect Italy to come under additional pressure now that overt exchange controls have been removed.

Even more interesting is the case of the peseta. Perhaps it is most revealing if I quote from an article, one of whose authors was a member of the Delors Committee:

"The entry of the Spanish peseta in June 1989 provided a foretaste of what is in store, in case sterling were to join. That step would improve confidence in the UK currency and - provided, as seems likely, that sterling interest rates remain higher than DM rates - lead to sizeable outflows from low inflation EMS-countries to the UK. That would not be welcome in view of the already highly liquid state of the UK economy; at some point the process would be interrupted, as anticipations of realignment arise. Given the British tradition of using monetary policy in a relatively activist way for purposes of domestic stabilization, markets would be justified in assuming that the EMS will be in for a rougher ride than, say, in the 1987-89 period. The system would come to look more like the view of it presented in Walters (1986), which we tended to regard as more of a caricature when it was first put forward at a time when German leadership was more firmly established and some capital controls were still in place, and in other unstable models of economic interaction between countries where inflation and nominal interest rates have not converged closely and discrete realignments are possible.

In such a world capital flows can be destabilising by flowing towards higher inflation countries, perpetuating inflation differentials and, ultimately, generating massive outflows prior to anticipated realignments. The enlargement of membership makes it more, not less urgent to move beyond stage one towards an EMU with more centralised monetary management. Far from causing offense among present EMS-members, labelling stage

¹ A typical example of the attitude appeared in an article by Sarah Hogg, the economics editor of The Independent on July 15th 1988 in response to my criticism in the same newspaper of July 14th.

²See "The EMS without a safety net", Economist, January 27th 1990 p71.

one "a half-baked house" should prompt reflection on how the system could be strengthened to accommodate sterling too.³

As the authors imply, the advent of Spain joining the ERM (albeit with 6 percent limits) sent the peseta to near the top of the band as capital poured in to take advantage of interest rates around 15 percent. The money supply has expanded dramatically and even the most stringent limits imposed on commercial bank lending have not stopped the credit inflation. It has merely driven the expansion into different forms - mainly the pagares de empresa or commercial paper market, where the June interest rates were about 15 percent. The inflation rate has risen (currently in June 1990) to 7 percent, and it is most likely that it will go on rising for some time. The realignment will soon be anticipated. I believe that the authors are right to use the Spanish experience as relevant to a judgement of what would happen if Britain joined the ERM. And, as they infer, the disruption caused by Britain's entry would be much greater than that associated with the peseta. Of course I do not share the conclusion that, necessarily, this increases the urgency of proceeding to EMU. This is a solution, but there are others such as floating. Overall, however, it is gratifying to see that the such authoritative and influential authors agree with my analysis of a "half-baked" system.⁴

³ Daniel Gros and Niels Thygesen, "The Institutional Approach to Monetary Union in Europe", May 4th 1990 Draft Paper, Centre for European Studies, Brussels. Professor Thygesen was a member of the Delors Committee, while Daniel Gros was Adviser, Directorate-General for Economic and Financial Affairs of the Commission of the European Communities.

⁴ It is perhaps appropriate, by analogy, to call the Plaza and Louvre agreements "half-baked" solutions.

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Prime Minister
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AT 1/6

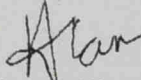
1 June 1990

Andrew Turnbull
Principal Private Secretary
Office of the Prime Minister
Number 10 Downing Street
London SW1 A2AA
UNITED KINGDOM

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PRIVATE AND CONFIDENTIAL



Feb
27
by Sir Robin Butler
Sir Peter
Middleton

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

31 May 1990

STERLING AND INFLATION IN THE 1980s

I have received Graham Mather's letter of 25 May confirming that you will be making the amendments proposed in my letter of 21 May. I can now confirm that the objections to publication of the book have been lifted. I will keep in touch with Graham, to whom I am copying this letter, about the precise date for publication.

ANDREW TURNBULL

Professor Sir Alan Walters

Putnam Hayes and Bartlett Ltd
Lansdowne House
Berkley Sp.
WOK 50H

PRIVATE AND CONFIDENTIAL

Pro

Ref. A090/1303

MR TURNBULL

Sir Alan Walter's Book and Mr Lawson

I told Nigel Lawson at lunch today where we had got to on Alan Walters' book. He expressed his gratitude for the efforts made to remove personal attacks on him and revelations of what had happened inside Government, particularly in connection with his and Sir Alan's resignations. He said that he had refused to comment on Sir Alan's lecture and hoped to take the same line on his book, although this would obviously have to depend on its contents.

2. As regards his own book, he said that he had made very little progress and hoped to start during the summer. His timetable was still to deliver a book by the end of 1991 for publication after the next General Election.

R.F.R.B.

ROBIN BUTLER

31 May 1990

C. Prime Minister
So far so good
AT 31/5
RB

ph

PRIME MINISTER

SIR ALAN WALTERS' BOOK

The first draft of Alan's book was unacceptable on two grounds.

- there was a great deal of invective directed at Nigel Lawson personally
- on a number of points the text identified the positions taken by Ministers and officials in policy discussions.

On both counts the text was inconsistent with the general understanding set out in the 1976 Radcliffe report on Ministerial Memoirs.

Alan has substantially redrafted the text in a way which meets the objections which Robin Butler and I had raised. I will now be confirming to him that no objections will be made to publication. This is likely to take place in July or August.

Robin is having lunch with Nigel Lawson later this week. He will reassure him that the version of the book to be published will be very different from that described in the press and that he should feel no need to rush into print with a rejoinder. There is no reason either for him to depart from his plan to publish his book after the next election.

I mentioned to you earlier today Alan's ideas on European commodity money. This would be introduced either as a parallel currency to the existing national monies in Europe or subsequently as the single currency in a monetary union. His ideas are set out in Chapter 7 of his book, a copy of which I attach.

AT

ANDREW TURNBULL

29 May 1990

c:\wpdocs\pps\alanw (slh)

A Monetary Constitution for Europe ?Introduction

In this final chapter, I try my hand at sketching a monetary system which will ensure stability of the general price level. This, albeit in a wobbly sort of way, Western Europe enjoyed under the gold standard for centuries. The norm for a civilized society was a stable currency and not inflation. After these many decades of depreciating currencies, it seems that the world yearns again for that ancient stability. Anchors are needed. Institutions such as the Federal Reserve Board, the (old) Bank of England, and the Bundesbank have provided such anchors in various periods of the historical record. But all have, at times and to varying degrees, failed to give that that rigidity when under pressure.

Rather than relying on authorities and institutions, one would like to rely on rules. It is rather easier to agree on rules and procedures than to agree on policies and outcomes. Furthermore those rules should be transparent and unavoidable, rather than, as under the gold standard, obscure and escapable. In this chapter I discuss the problems and prospects of basing a European

currency on a commodity basket. Thus one unit of money will always be able to purchase certain quantities of commodities which represent the budgets of consumers. I also consider some paths from the present situation to the commodity currency, and how commodity money may exist side by side with present national moneys and ECUs

Of course this is not a complete monetary plan for Europe. It is merely a mixture of some ingredients of a monetary constitution. It is really half-baked. But it is proposed simply to test the ideas, not to inflict on suffering humanity. The underlying spirit of these ideas is that the people of Europe should be free to choose whatever currency they wish in order to carry out their business. Governments should impose neither restrictions nor penalties. Competition between currencies is the best way of preserving both our freedoms and reliable units of account. But also, in cooperation with the private sector, the governments of the Community should promote a monetary unit which, by virtue of its own operating rules, is free of inflation.

The Need for a Stable Currency

Money performs three basic functions: it serves as (1) a store of value, (2) a unit of account, and (3) the medium of exchange. Inflation erodes all three functions, but to very different degrees. As we know

from many historical inflations, money still serves as an intermediary in exchange even though inflation is very high. For example, in the many Latin American inflations that have occurred in the 1980s, although the increase in the price index may be as much as 30 per cent per month, the currency is still used for the host of small household transactions. But no-one keeps notes as a store of value and virtually all contracts are not in terms of the currency as a unit, but are calculated in US dollars or perhaps in some agreed indexed form of money.¹ The separation of the unit of account from the rapidly depreciating medium of exchange involves considerable costs - as anyone who has lived in Argentina, Brazil, etc can readily testify. One main business is to minimise any currency holdings so that one is not substantially expropriated by the State. And it seems that everyone gives up many a useful employment to become a currency dealer. The main business is getting rid of currency as quickly as possible.

Maintaining a constant unit of account is as important as maintaining constant standards of physical measurement - where a kilogram and a metre are always the same. With money it is more difficult since, unlike

¹. Deflation, it will be noted, increases the attraction of money as a store of value and increases, if anything, its use as an intermediary. As a standard of account, it may suffer somewhat, but not if the deflation is gentle (as in the United States after the Civil War)

distance or weight at sea level, there is no natural and immutable definition of the value of a monetary unit. Money exchanges against a host of goods and services. In the past the definition of money has been in the form of goods, such as ounces of silver or gold of specified purity. Thus there is usually just one particular good, defined and widely used as money. This is ideal only when the price of gold (say) in terms of representative baskets of other goods and services in the economy does not much change. Then gold is good surrogate for all goods. But, over the years, gold has not behaved so well. Gold discoveries and new technologies have reduced the price of gold relative to other goods, and so induced inflation. At other times, the stocks of monetary gold have stagnated and so, as production of other goods increased, given many years of deflation. (See Table 7.1 Wholesale Price Changes under the Gold Standard) The legendary stability of the gold standard is indeed legend. Allan Meltzer has shown that predictability of the price level and GNP was far, far less under the gold standard than under the floating rate system of the 1970s.² Little wonder that Keynes described gold as a "barbarous relic".

²."Some Evidence on the Comparative Uncertainty Experienced under Different Monetary Regimes", in Alternative Monetary Regimes, ed Colin D. Campbell and William R Dougan. Baltimore, Johns Hopkins University Press, 1986

A Broad Commodity Money

The natural question is whether it would be wise to include more goods in the definition of the monetary unit. Other precious metals are obvious candidates. Bimetallism, for example, became an active issue in Britain in the 1850s as people became concerned about the gold discoveries inducing inflation. Bimetallism involves fixing the ratio of the prices of gold and silver at the mint - and both are given the status of legal tender. Under propitious circumstances - in particular where the mint ratio is approximately the same as the free metal price ratio - the bimetal standard can function as such. But if, for example, many new easily accessible silver deposits are discovered, then the price of silver will fall relative to that of gold, and so silver currency will drive out gold; at the fixed mint ratio, Gresham's Law works - bad money drives out good. This is the normal fate of bimetallism.³ Nevertheless, throughout history the periods of bimetallism have exhibited much more stability than those of gold monometallism.⁴

³. The United States went on a bimetallic standard in 1792, but as the price of gold rose relative to that of silver, so silver drove out gold and the United States was on a de facto silver standard for some 40 years.

⁴ See Michael Bordo, "Bimetallism" in The New Palgrave Dictionary of Economics, ed John Eatwell, Murray Milgate and Peter Newman, Macmillan, London 1987.

An obvious way out of the Gresham's Law effect is to avoid fixing the mint ratio. The unit can be defined simply as a basket of the two metals - say one ounce of silver and 0.02 ounces of fine gold. The price ratio could then fluctuate. The coins would be composed of an alloy of gold and silver in the fixed ratio. No doubt there are many technical difficulties in minting and maintaining such coins. But for our modern economies this does not matter since we circulate bits of paper rather than coin. Under this metallic commodity standard, the currency note would be a claim to the 1/0.02 ounce mix of the metals. The monetary authorities would stand ready to convert notes into the metal mix, and vice versa. This requires the authorities to hold stocks of silver and gold sufficient to meet any convertibility demands. Any shortfall of such stocks will be reflected in people's suspicion that the authorities will not honour their obligations and the currency will become inconvertible. There have been too many cases in history where convertibility has been suddenly revoked to allow any monetary authority to get away with small stocks of the precious metals.

A Commodity Money without Commodities

The idea of a commodity money that is not based on the narrow basis of silver or gold stocks, but is

founded on a broad range of representative commodities or services has surfaced periodically in discussions about monetary anchors. The attraction of convertibility into a basket of commodities, or even services, is that one avoids the idiosyncracies of gold or silver supplies and all the political problems associated with the gold producers or owners. Furthermore it seems quite absurd for scarce resources to be devoted to digging a hole in the ground to extract gold, only to return that gold again to the deep vaults of the world's central banks. Convertibility into the ordinary useful commodities of trade appears much more attractive as an anchor in the real economy.

Obviously the commodity basket must be very large to accommodate normal lot sizes of wholesale trade. Similarly the commodities must be readily storable and of identified uniform quality, just as under the gold standard the gold content was of a given purity. And the monetary authority would clearly enter the lists as a major commodity dealer.

The prospects of a monetary authority sitting on large stocks of commodities, and the likelihood that one would add to the present grain mountains, cheese hills and oil lakes has been sufficient to chill the enthusiasm of most of mankind. Although some economists have also been entranced by the prospects of introducing a world

Commodity Reserve Currency to replace the old role of gold and which, in addition, would enable the world authorities to intervene massively in "smoothing" the oscillations in commodity prices and in reducing the variations in the incomes of producers of primary commodities.⁵ (Perhaps the main motive was to foster large intergovernmental transfers from the Western countries to the third world. But as we know from the fortunes of Messrs Mobutu and Marcos, this often takes the form of transfers from the poor consumers in rich countries to the rich rulers of poor countries.)

However it has also occurred to many economists, although I believe that Irving Fisher was the first to enunciate the idea, that one does not really require commodities as the reserve asset.⁶ Instead one could simply redeem the currency by supplying a financial asset which gave the holder sufficient resources to buy the

⁵. See Albert Gailord Hart. "Commodity Reserve Currency" The New Palgrave Dictionary of Economics, ed John Eatwell, Murray Milgate, and Peter Newman, Macmillan, London 1987. Lord Kaldor was the primary force behind these suggestions.

⁶. See Irving Fisher, The Purchasing Power of Money, 2nd edition, New York, Macmillan 1913. Warren L. Coats has developed these ideas in: "In Search of a Monetary Anchor: A New Monetary Standard", IMF Working Paper, October 11, 1989, Washington, DC.

commodities if he so wished.⁷ The point is that the value of the currency will be preserved through its convertibility into a reserve asset which has a value defined as constant in terms of the commodity basket. If, for example, one defined the reserve asset in terms of a fixed fraction of the basket of goods and services that enter into the retail price index, then one unit of the currency, convertible into the reserve asset, would be of a sufficient value to purchase that fraction of a basket.

The indexed reserve asset appears to be closely analogous to an indexed gilt-edged security. But there is a crucial difference. An indexed gilt has a fixed maturity, usually many years, at which time the principal is paid duly enlarged in proportion with the change in the retail price index. The authorities, however, do not guarantee to redeem the gilt at par, duly uprated for the retail price index, at any time. With an indexed gilt, one takes one's chance on whatever price one can get on the market for such bonds. For this commodity money, the authorities always redeem at slightly below the par value of the retail price index. The "slightly below" condition is to ensure that there is some

⁷. The seminal paper is Robert L. Greefield and Leland B. Yaeger. "A Laissez-Faire Approach to Monetary Stability", Journal of Money Credit and Banking, Vol 15 August 1983, p 302-15. See also Irving Fisher, Stabilizing the Dollar, Macmillan, New York, 1920.

disincentive against too ready redemption, and that the issuing authority earns sufficient profits to pay for the costs of operating the system.

A Stable Commodity Money for Europe

How would one provide this alternative of a stable European money? I believe that it should be introduced as a parallel currency to the existing national moneys in Europe. In accordance with the liberal principles nominally embraced by the Community, all citizens should be allowed freely to use what every currency they would wish with no restraints of legal tender or overt and covert exchange controls. Thus they should be able to hold and transact in the commodity money. Thus people could choose to conduct business in any of the national moneys or in the Euro commodity money, the ECOM. With parallel national moneys, the reserve assets, duly indexed, could be denominated in any of the member currencies, or, if desired, in terms of a basket such as the ECU

There are many feasible alternative redemption arrangements, but some principles are fairly clear. First one would restrict redemption operations to wholesale quantities of money. Thus instead of exchanging ECOM against sterling, one would specify that the ECOM would be exchanged only for large treasury bills

(say of 100,000 stg equivalent). On one ECOM note it would promise that "this note is redeemable for a fraction (or number) of treasury bill(s) sufficient to purchase the basket of goods defined as one ECOM".

To see how the system would work, imagine that we begin in a nice equilibrium, but then there is some external shock, such as an increase in the price of oil, which brings inflationary pressure in its wake. Prices in ECOMs would then rise as people got rid of their ECOMs by spending them on goods and services. But the ECOMs are worth more than their value at the inflated prices, since they can be exchanged for an amount of treasury bills equivalent to the base value of the ECOM, and these treasury bills are worth more than the ECOM notes by the amount of the price rise. So people will be induced to redeem their ECOM notes; they will take their ECOMs to the EIB and receive treasury bills in exchange. This will reduce the quantity of ECOMs and so depress the ECOM prices of goods, until equilibrium is again restored with the ECOM value in the market at its original goods value.⁸ Private arbitrage will thus keep restore the value of the ECOM.

As an illustration, suppose that the reserve asset is an ECOM demoninated treasury bill. The private sector

⁸. For a clear account of the process of arbitrage, see Warren Coats 1989 op cit.

will hold both ECOM TBs and ECOM notes. The holdings of notes will depend primarily on transactions demand for money. The TBs, lacking the moneyness of notes (and in large denominations), will command an interest rate determined by market conditions - that is to say the yield on alternative assets, whether nominal or indexed. With the indexed character of the TB one would expect that the market rate of interest would be quite low - perhaps 1 or 2 percent. Let us begin in equilibrium where people are content with their existing holdings of TBs and notes. But then an exogenous inflationary shock occurs, and the ECOM note would tend to decline in value, say by 1 percent. But the indexed TB of 10,000 ECOMs denomination is now worth 10,100 ECOMs and these uprated TBs can still be purchased at a price of 10,000 ECOM notes. Hence the incentive for the private sector to convert their notes into TBs.⁹

Problems with the ECOM

There are obviously a host of problems in setting up an ECOM. Many of them are basic policy issues. For example, I have discussed linking the ECOM to the consumer basket - and obviously I would mean the weighted

⁹ It might be thought that yield on the TB would move to abort such arbitrage. True it may move slightly, but the yield will be constrained by the substitutability into parallel instruments - even ordinary treasury bills or perhaps indexed treasuries which do not have the status of reserve assets.

average consumer basket in the Community. The ECOM would be kept in line with the weighted average of retail price indices. This would have the advantage that no single country would have any incentive, in addition to those they have already, to distort the index. But there would be also the problem of "harmonizing" the indices and, preferably, calculating them more frequently than the present monthly figures. A more substantive issue is whether the retail basket is an appropriate anchor. It is probably better to index to the prices of things produced, rather than consumed, by the Community; then holders of ECOMs (as do indexed gilts) will not be shielded against changes in the terms of trade. But the retail price indices are much used throughout the Community and represent a more accepted unit of standardization of value.

In order to set up the EBI, the various central banks would contribute reserve assets, defined as outlined above, in exchange for shares on a pro-rata GDP basis. Analogous to the introduction of indexed gilts in the UK, it would be best to begin with a relatively modest issue of ECOMs - though there needs to be sufficient to give a sufficient momentum to the market. In its constitution the EBI would have the sole role of issuing and redeeming ECOMs.

It might be efficacious if there were developed

first an external eurocurrency as suggested by Jaques Riboud.¹⁰ This, in M. Riboud's proposal, would be a market in constant-value dollars. The Community could encourage this market and guide it by suggesting that the standard of value should be related to the weighted retail (or producer) price index for the Community. The ECOM could then take over the external unit of account, accepted and even hallowed by use, and then internalise it.

There is no doubt that creating an ECOM would not ease the task of the constituent monetary authorities in dealing with the liberation of financial markets to which all constituent countries are committed. But it is doubtful if it would make the task much more difficult. If, for example, Greeks can transact in Deutschemarks rather than drachmas, the possibility of substituting ECOMs will not be any great change. As people in Greece switch out of depreciating drachmas into either Deutschemarks or ECOMs, the Greek monetary authorities will have to reduce their drachma monetary expansion to keep inflation at its existing rate.

The value of the ECOM is preserved through ECOM currency being expanded or contracted according to demand arbitrageurs. But of course currency is the small change

¹⁰. Op. cit

of any modern monetary system. As we know, notwithstanding the success of this form of currency board control in Hong Kong, the City are most skeptical of any such form of control being effective. It remains to be seen whether the note issue of ECOMs will be sufficient for control.

A ECOM Monopoly for the Community ?

If there is to be a monetary union which develops as Delors envisaged through the EMS becoming more stringent, that is to say with narrower bands and virtually no realignments, then it must be based on the dominant role of Germany (FRG and GDR). There are obvious political objections to this arrangement which Delors tried to solve by building up a central bank of Europe (a European System of Central Banks) which would control Europe's monetary policy. But the Bundesbank, along with Britain, has strongly resisted any encroachment on its powers and prerogatives. In fact the Bundesbank must be the main agent controlling Europe.

The reluctance of countries in surrendering their monetary sovereignty to another sovereign state is entirely understandable. And this must be an especial concern if that state is a Greater Germany - so much the dominant power in the Community. It is, however, a different matter if monetary sovereignty is surrendered

not to any state but to the standard of an inflation-free currency. The government of Britain, for example, would not be giving up its sovereignty to any other legislature or to any foreign central bank. It would be surrendering its power to expropriate its citizens by inflation. Monetary policy would be depoliticized. Neither domestic nor foreign politicians and functionaries would have any control over the money of Europe.

This suggests that once the ECOM has been introduced and used for some time, it might well be that an ECOM currency union could be formed for Europe. If the ECOM displaced national currencies to any considerable extent, it would be a natural development to adopt the ECOM as the currency for the Community. Indeed, just as the gold standard was widely adopted throughout the world in the 1870s, so might the ECOM, in one or other its many mutations, be embraced by countries outside Europe - even the United States and Japan. But these are, of course, pipe dreams of an inflation free world.

Pros and Cons of the ECOM

When discussing the likely consequences of an ECOM system, one must always specify, as best one can, the best feasible alternative. A point by point discussion would try any reader's patience. It might be useful instead to lay out what I believe are the major issues

and indicate my judgement about where the balance of advantage lies.

Consider first for Britain the alternative of the free float and a monetary policy that maintains a constant quantity of Mo, preferably through the operation of a monetary base control system. This, I believe, would be superior to the ECOM arrangement. The constancy of the monetary base would ensure that there was no runaway inflation or crushing deflation. True, one would not enjoy the great price stability of the ECOM, but it is often more efficient to adjust to technological progress, changes in the terms of trade (increases in the price of oil, for example) etc., by allowing exchange rates freedom to move to their market value. The central point is that if markets are not allowed to adjust exchange rates, then the burden of adjustment will fall on other markets: commodity, labor, money, bond and stock markets. A change in exchange rates is likely to be the best way of making such adjustments.

The objections to this system of monetary-base-control with floating exchange rates, compared with the ECOM, are easy to list. The change in the velocity of circulation may be different from the 3 percent upward drift that we have conveniently assumed. (Although I believe it is consistent with the history of the last two or three

decades, there is no guarantee that trends can be extrapolated). The great advantage of the ECOM system is that the velocity adjusts endogenously, whatever happens to the demand for (base) money, to keep the price level constant. There is no opportunity for making mistakes in forecasting money demand; if there are changes in technology or monetary markets that increase the demand for money, then the ECOM system will ensure a response at the fixed price level. There will be no monetary excess or starvation of the economy.

An interesting question is whether it is indeed plausible so to divorce monetary and exchange rate policy from political control. In the case of monetary base control, I very much doubt it. In practice, in order to deal with liquidity crises and dramatic changes in the public's choice of a cash-deposits ratio, we must allow some over-ride discretion on the part of the monetary authorities. This has been demonstrated in many liquidity crises throughout history, and most recently in October 1987. In the ECOM system, however, there is no need for any such over-ride. Provided there is a wide enough spread of reserve assets (and substantial quantities of reserve assets can be sold by making their price attractive), the EIB will provide ample liquidity to prevent any deflationary slump. But would not governments be tempted to "improve" on the performance of the EIB ? Since we lack any relevant experience with

such as system we do not know the answer.¹¹ If the EIB and ECOM were the result of a treaty of the EEC governments, however, it would be difficult for any particular government to play fast and loose with its constitutional provisions; but one should not be so sanguine about the institutions of the Community.

Conclusion

In reflecting on monetary constitutions I have wandered a long way from the immediate issues of exchange rates and monetary policy. Yet it is important to inject new ideas into the problems of monetary systems in Europe. I do not believe that monetary integration of Europe is desirable unless there are considerable obvious gains to be so made. The only test of desirability is that people freely choose one currency as the vehicle for their transactions and wealth holding and accounting. The fabulous success of European civilization was founded on freedom. Liberty is as important in money as in anything.

¹¹. One form of "improvement" might be to specify the currency in terms of a constant rate of inflation, say 3 percent per annum. This could be done easily in the ECOM framework, and it might be argued that, because of downward rigidities in the prices, such a constant inflation would involve less frictional costs. In my view, however, adding 3 percent to all prices and wages will not solve problems of rigidities



tw
A: WALTERS

10 DOWNING STREET

From the Principal Private Secretary

SIR ROBIN BUTLER

Sir Alan Walters's Book

Graham Mather's letter attached reports that Sir Alan Walters has accepted the latest batch of amendments set out in my letter of 21 May. I propose, therefore, to confirm that our objections to publication are now lifted.

I will keep in touch with Mr. Mather in order to get a clearer idea of the date of publication.

I am copying this minute to Sir Peter Middleton.

ANDREW TURNBULL

29 May 1990

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The Institute of Economic Affairs

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Publishing Director: Walter Allan



Andrew Turnbull Esq
No.10 Downing Street
London SW1A 2AA

25 May 1990

Rec Andrew

top

Alan Walters has passed me your letter of 21 May on residual points. He is able to accept all of the points made and we will incorporate these in the final version. His answer to your point 1 is "no".

As to publication, we are targeting July/August at the moment but no doubt we can talk further as things become clearer.

All good wishes.

Graham Mather
General Director

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PMW

file



cc: Sir Robin Butler
Sir Peter Middleton

10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

21 May 1990

Dear Alan,

I attach a list of outstanding points on the latest text, as sent to me by Graham Mather. Points 1 and 2 were sought in my letter of 30 April but have not been made; points 3,4,5, and 6 were deleted in the previous draft but the deletions have not been carried through into this one; point 7 is new but would help to lower the emotional tone.

Please could you confirm that these changes are being made. That will clear the way for publication. Could you also tell me, as requested in my last letter, when you propose to publish.

Yours sincerely
Andrew Turnbull

ANDREW TURNBULL

Professor Sir Alan Walters
Putnam, Hayes & Bartlett Ltd,
Lansdowne House,
Berkeley Square,
London, W1X 5DH.

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86

SIR ALAN WALTERS' BOOK

RESIDUAL POINTS

1. Chapter 4 page 74 Can Mr. Lawson's position as described here be documented?
2. Chapter 5 page 113 Delete "by the end of July I did".
3. Chapter 6 page 145 Penultimate line delete "by hook or by crook". Deleted in last draft.
4. page 145 Line 11 delete "It must have been.... of the world". Deleted in last draft.
5. page 146 Delete last full sentence ie "it is inconceivable that on this period". Deleted in earlier draft.
6. page 146 Delete footnote 15. Deleted in earlier draft.
7. page 146 Line 17/18 delete "before saddling up for another ride of the tiger".

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DCA.

*cc Fero
Sir P. Middleton
Prof. Griffiths*

10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

30 April 1990

Dear Alan,

Sterling and Inflation in the 1980s

In my letters of 13 and 30 March, I raised objections to the early draft of your book in relation to the personalised attacks on Mr. Lawson and the identification of the positions taken and advice given by Ministers and officials within Government. In both respects the text was not consistent with the normal conventions for Ministerial and official memoirs.

I am grateful to you for looking again at chapters 1 and 6 where most of the difficulties arose. I am content that your revised text has almost entirely eliminated the hostile personal references to Mr. Lawson. I do, however, request you to remove the reference to "Putsch" on page 60. The implication that ERM was brought up for discussion at that time in an underhand way is not justified. ✓

I note that in the original version there was a short section at the end of chapter 6 headed "Conclusion on the Lawson Years". The passage has not re-appeared in amended form in the latest draft. I assume that you do not propose to include such a passage.

There are, however, still a few points in the text where you go too far in identifying the positions taken within Government by Ministers and officials. I attach a note setting out the amendments and omissions which, on the advice of Sir Robin Butler, I am requesting you to make. This includes one or two amendments on the other chapters.

Even in this revised form, the book could set off some degree of political controversy. It would be very helpful if you could let me know in advance the date of publication so that I am in a position to brief the Prime Minister.

In addition to the points of propriety in relation to which changes have been requested, there are one or two factual points which you might find it helpful to have. These are also attached.

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- 2 -

If you will confirm that the suggested amendments are acceptable, I will confirm that objections to publication have been lifted. I hope you will find that this provides a satisfactory resolution of the problems which have arisen.

*Your sincerely
Andrew*

(ANDREW TURNBULL)

Professor Sir Alan Walters

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Passages which should be deleted from Sir Alan Walters' Book
under para 56(a) of Radcliffe Report

Chapter 6 (Revised)

Page 58, first main paragraph:

delete all after the first sentence and proceed direct to next paragraph, which maintains the sense. ✓

Page 59, first main paragraph:

third sentence to read "As Financial Secretary he was closely involved in the MTFS and Funding Policy, including the introduction of indexed gilts". ✓

delete last sentence of that paragraph and the first sentence of the following one i.e. "I believe he was a strong supporter of the whole program. On the issue of exchange rate targeting and the ERM, Mr. Lawson was firmly in the Thatcher camp". ✓

Page 60, first main paragraph:

delete third sentence, i.e. "I suspect that the change in his ideas probably took place much earlier in 1984, fairly soon after his appointment as Chancellor". ✓

Page 62, first main paragraph

the account of the conversation between Sir Alan and the Chancellor, starting after the second sentence, should be deleted under para 93(a) of Radcliffe. ✓

Page 63, first main paragraph:

delete all after first sentence, i.e. from "Many other senior members of Cabinet ... a committee of Cabinet". ✓

Page 64, last main paragraph:

delete ^{the} second sentence, i.e. "Under such circumstances the Chancellor and Governor would have been vindicated". ✓

Delete sentence beginning "In my view, Mrs. Thatcher ...". ✓

Page 67, first main paragraph

delete second sentence, i.e.
"The Governor was quite firmly
in his camp". ✓

delete footnote 70. Text to
which it was attached has been
deleted.

Page 71, at top:

delete "Mr. Lawson, it was
said, thought that his penny
numbers adjustment process
showed that he was in control ✓
and in no panic, but merely
adjusting with prudence to the
new situation".

Chapter 2 (Original)

last sentence to read "As we
shall see, this is what was
done in May of 1988". ×

Chapter 4 (Original)

Middle of third para in
section headed "Persuasion and
Sanctions", delete "by
Mr. Lawson and Mr. Brittan". p 74 ✓

Chapter 5 (Original)

delete last two sentences of
footnote 47, i.e. "By the end
of July ... I did". × 115

FACTUAL POINTS

Chapter 5: Footnote 40.

Is it really wise to put so much weight, in judging the performance of the ERM, on a study ending in 1985. Surely you need to adduce evidence for the second half of the decade as well.

Chapter 5: Footnote 50.

As drafted this sounds as if Madrid was the first occasion at which the UK agreed to join the ERM. I would redraft: "... in June 1989, the Prime Minister, in setting the conditions for when sterling could join the ERM, required that such regulations and controls should be eliminated". As drafted you imply that the Prime Minister referred by name to particular features of German capital markets. ✓

Chapter 6: Page 68, second main para.

The reduction in the top rate of tax to 40 per cent was in 1988, not 1987, i.e. it came after the election. ✓

Chapter 6: Page 69, first para.

The statement in lines 6-7, intervention was undertaken specifically to build up reserves in preparation for entry into the ERM cannot be substantiated: your guess that £10 billion of the \$22 billion increase was associated with intervention is puzzling. Where did the remaining \$12 billion come from? ✓

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~~GD~~

~~At type as amended~~

45 2/14

Ref. A090/1020

MR TURNBULL

Sir Alan Walters' Book

Sir Robin has suggested a couple of drafting amendments to the draft letter to Sir Alan Walters attached to your minute of --- 26 April; these are marked on the enclosed copy. Sir Robin will approach Mr Lawson once we have Sir Alan's acceptance of the amendments; he has commented that waiting for notice of a publication date might give only very short notice.

Sonia Phippard

MISS S C PHIPPARD

30 April 1990

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10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

26 April 1990

Sterling and Inflation in the 1980s

In my letters of 13 and 30 March, I raised objections to the early draft of your book in relation to the personalised attacks on Mr. Lawson and the identification of the positions taken and advice given by Ministers and officials within Government. In both respects the text was not consistent with the normal conventions for Ministerial and official memoirs.

I am grateful to you for looking again at chapters 1 and 6 where most of the difficulties arose. I am content that your revised text has almost entirely eliminated the hostile personal references to Mr. Lawson. I do, however, request you to remove the reference to "Putsch" on page 60. The implication that ERM was brought up for discussion at that time in an underhand way is not justified.

I note that in the original version there was a short section at the end of chapter 6 headed "Conclusion on the Lawson Years". The passage has not re-appeared in amended form in the latest draft. I assume that you do not propose to include such a passage, ~~but if you do include a concluding section, may I take it that it too would be consistent in tone with the rest of the chapter as it now is.~~

There are, however, still a few points in the text where you go too far in identifying the positions taken within Government by Ministers and officials. I attach a note setting out the amendments and omissions which, on the advice of Sir Robin Butler, I am requesting you to make. This includes one or two amendments on the other chapters.

~~If you are prepared to make these changes on top of those you have suggested yourself, it will be possible for the objections to publication to be lifted.~~

Even in this revised form, the book could set off some degree of political controversy. It would be very helpful if you could ~~give me some advance warning of publication~~ so that I am in a position to brief the Prime Minister.

In addition to the points of propriety in relation to which changes have been requested, there are one or two factual points which you might find it helpful to have. These are also attached.

If you will confirm that ~~these~~ ^{the suggested} amendments are acceptable, I will confirm that ~~objections to~~ ^{objections to} publication have been lifted.

~~I hope you will find~~ that this provides a satisfactory resolution of the problems which have arisen.

(ANDREW TURNBULL)

Professor Sir Alan Walters

Passages which should be deleted from Sir Alan Walters' Book under para 56(a) of Radcliffe Report

Chapter 6 (Revised)

Page 58, first main paragraph: delete all after the first sentence and proceed direct to next paragraph, which maintains the sense. ✓

Page 59, first main paragraph: third sentence to read "As Financial Secretary he was closely involved in the MTFB and Funding Policy, including the introduction of indexed gilts". ✓

delete last sentence of that paragraph and the first sentence of the following one i.e. "I believe he was a strong supporter of the whole program. On the issue of exchange rate targeting and the ERM, Mr. Lawson was firmly in the Thatcher camp". ✓

Page 60, first main paragraph: delete third sentence, i.e. "I suspect that the change in his ideas probably took place much earlier in 1984, fairly soon after his appointment as Chancellor". ✓

Page 62, first main paragraph the account of the conversation between Sir Alan and the Chancellor, starting after the second sentence, should be deleted under para 93(a) of Radcliffe. ✓

Page 63, first main paragraph: delete all after first sentence, i.e. from "Many other senior members of Cabinet ... a committee of Cabinet". ✓

Page 64, last main paragraph: delete ^{the} second sentence, i.e. "Under such circumstances the Chancellor and Governor would have been vindicated". ✓

Delete sentence beginning "In my view, Mrs. Thatcher ...". ✓

Page 67, first main paragraph

delete second sentence, i.e.
"The Governor was quite firmly ✓
in his camp".

delete footnote 70. Text to ✓
which it was attached has been
deleted.

Page 71, at top:

delete "Mr. Lawson, it was
said, thought that his penny
numbers adjustment process ✓
showed that he was in control
and in no panic, but merely
adjusting with prudence to the
new situation".

Chapter 2 (Original)

last sentence to read "As we
shall see, this is what was X
done in May of 1988".

Chapter 4 (Original)

Middle of third para in
section headed "Persuasion and
Sanctions", delete "by X
Mr. Lawson and Mr. Brittan".

Chapter 5 (Original)

delete last two sentences of
footnote 47, i.e. "By the end X
of July ... I did".

FACTUAL POINTS

Chapter 5: Footnote 40.

Is it really wise to put so much weight, in judging the performance of the ERM, on a study ending in 1985. Surely you need to adduce evidence for the second half of the decade as well.

Chapter 5: Footnote 52.

As drafted this sounds as if Madrid was the first occasion at which the UK agreed to join the ERM. I would redraft: "... in June 1989, the Prime Minister, in setting the conditions for when sterling could join the ERM, required that such regulations and controls should be eliminated". As drafted you imply that the Prime Minister referred by name to particular features of German capital markets.

Chapter 6: Page 68, second main para.

The reduction in the top rate of tax to 40 per cent was in 1988, not 1987, i.e. it came after the election.

Chapter 6: Page 69, first para.

The statement in lines 6-7, intervention was undertaken specifically to build up reserves in preparation for entry into the ERM cannot be substantiated: your guess that £10 billion of the \$22 billion increase was associated with intervention is puzzling. Where did the remaining \$12 billion come from?

FROM: The Rt Hon. The Lord Joseph CH PC

R3014



Prime Minister
I will arrange a meeting. I think
Alan is here sometime in May
JT 30/4.

The Rt Hon. Mrs Margaret Thatcher MP
The Prime Minister
10 Downing Street
London SW1A 2AA

27 April 1990

PRIVATE
AND PERSONAL

Dear Margaret,

I gave Alan Walters your message only yesterday -
because he was out of reach in Eastern Europe till
then. He was very glad to hear that you would like to
see him on some weekend - and will be getting in
touch with Brian Griffiths to let him know when he will
be in England.

I am copying this letter privately to Brian.

Yours as ever,

Kevin

ms

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FILE DAS

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBIN BUTLER

SIR ALAN WALTERS' BOOK

The Prime Minister has agreed that, provided Sir Alan makes the amendments we are requesting, the objections to publication of his book may be withdrawn. I attach a draft letter for your comments. I would like to associate you, as guardian of the Radcliffe Conventions, with the changes sought. You may have views on the way in which I have done this.

The Prime Minister was content with your suggestion that someone should explain to Mr Lawson the care we had taken to ensure there were no personal attacks in the book and to express the hope that he would not find it necessary to respond in a way which would reopen old wounds. The Prime Minister has accepted your offer to take on this task.

As you will see, I have asked Sir Alan to tell us when the book is likely to come out so that there will be time for the discussion with Mr Lawson.

I am copying this minute to Sir Peter Middleton.

AT

ANDREW TURNBULL
26 April 1990

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#

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FROM: SIR PETER MIDDLETON
DATE: 24 April 1990
EXT: 4360

MR A TURNBULL - No 10

SIR ALAN WALTERS' BOOK

The dangers in this book are not so much in Sir Alan Walters' views - they are well known - but in the possible reaction of Mr Lawson and the media. Mr Lawson may be invited to review the book or be provoked into some other sort of statement which would re-open old wounds. We must try to avoid anything of that sort while political problems are affecting the markets.

- file with AT.*
- X 2. So I agree with all Sir Robin Butler's points. The book is so much better than the original version that one is tempted to overlook dangers which still lurk. We cannot entirely avoid these if the book is to come out at all. But it will certainly reduce them if we obtain the exclusions he suggests. In addition, you might consider five more:

(i) Page 58

- X Delete, in addition to the first paragraph excision suggested by Sir Robin Butler, the second paragraph and the first sentence of paragraph 3.

(ii) Paragraph 59

Delete the second sentence of the first main

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paragraph. This is a bit hard on Sir G Howe. And the point could be made without picking out particular aspects of Mr Lawson's role as a junior Minister.

(iii) Paragraph 64

I should greatly like to lose the last sentence.

(iv) Paragraph 67

I hope that footnote 70 is to go along with the sentence to which it relates. Mr Lawson did not, of course, resign for this reason.

(v) Paragraph 69

I find the material in the middle of this paragraph baffling. It is not a Radcliffe point, but he might be asked to look at it.

3. I am copying this to Sir Robin Butler.

RJ Evans
Private Secretary
P E MIDDLETON pp.

1A-B

PRIME MINISTER

SIR ALAN WALTERS' BOOK

When you saw the first draft of Alan's book you were concerned that it would provoke Nigel Lawson into an angry response which would open up divisions within the Government. Sir Robin Butler and Sir Peter Middleton also advised that the draft was inconsistent with the conventions on Ministerial and official memoirs set out in the Radcliffe Report of 1976. There were two particular problems:

- (i) the highly personalised attack on Nigel Lawson
- (ii) the identification of the views Ministers and officials took in various policy discussions.

In both respects the draft contained material which, in the words of the report, "would be destructive of the confidential relationships which may subsist between Minister and Minister, Ministers and their advisers, and between other outside bodies or private persons".

At your request I wrote to Alan informing him of your wish that he should postpone publication. Flag A.

Alan replied to me asking whether, if he substantially rewrote Chapters 1 and 6, the objections to publication would be withdrawn. I replied that if the book were rewritten in a way which eliminated the theme of "The Economic Consequences of Mr. Lawson" it would, in effect, be a very different book and we would be prepared to look at it afresh.

Alan has now sent new versions of Chapters 1 and 6 - Flag B. He has almost entirely expunged the hostile personal references to Nigel Lawson. There are, however, still some points at which he has identified the positions taken within Government and where I think we should ask for changes or omissions to be made. A list

B

of these is at Flag C? No Flag C. But have looked for example at p. 58 where I think you have

If Alan is prepared to make these changes, I think you should be ready to withdraw your objections to publication. Nevertheless, the fact that the text is such an improvement on the first version should not blind us to the difficulties it could create. The main danger lies not so much in Alan's views; following his City University lecture, the book will be seen as an expansion of views that are already in the public domain. The difficulty lies in the possible reaction by Nigel Lawson. A newspaper might well be tempted to stir up trouble by asking him to review the book. We need to do everything possible to avoid such a reaction. One possibility would be to explain to Nigel Lawson the care we had taken to (eliminate) personal attacks and to express the hope that he would not find it necessary to respond in a way which would reopen old wounds. Robin Butler has offered to take this on.

- Agree to withdraw objections to publication provided the further amendments and deletions suggested are made?
- Content for Robin Butler to speak to Nigel Lawson?

AT

to ensure there were no

ANDREW TURNBULL

24 April 1990

c:\pps\walters (kk)

personal attacks

In principle I agree with this approach. The book is written in a clear & lively way. It is

understandable and

that's rare for an economist etc

Ref. A090/956

MR TURNBULL

Sir Alan Walters' Book

Thank you for your minute of 18 April attaching the revised versions of chapters 1 and 6 of Sir Alan Walters' book. I agree that these represent a great improvement. Nevertheless, there are still references to the views of others which, even though they may be public knowledge, I suggest that we should ask Sir Alan to remove, partly because they are a breach of the Radcliffe rules - even when the views are publicly known, a statement of them may provoke their owners on the grounds that it is distorted or incomplete - and partly because the remaining references can --- be removed without doing violence to the sense. I attach a list of the amendments which I suggest that you ask Sir Alan to make under this heading.

2. I agree with you that you should ask Sir Alan to confirm that he intends to omit the paragraphs which appeared at the end of the previous version of chapter 6 under the heading "Conclusion on the Lawson Years". I also suggest that you ask him to omit the word "putsch" on page 60.

3. I fear that, even after all these changes, you may be too sanguine about the political consequences of the publication. For one thing, I would not be surprised if a pirate copy of the original version of chapters 1 and 6 was leaked to the press. Second, I am afraid that even in its revised version, publication may well be regarded as provocative by Mr Lawson and stimulate a rejoinder from him. It seems to me a good idea that someone should see Mr Lawson in advance of publication and, by giving

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him an account of the extent to which Sir Alan has been restrained, seek to persuade him to restrain his own response. If it would help, I would be prepared to do so, but it may be that an approach on the political net would be more effective. You may like to take the Prime Minister's mind about this.

4. I am copying this minute to Sir Peter Middleton.

F.R.B.

ROBIN BUTLER

23 April 1990

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23
This sentence to read "Mr
'Mr Finance Secretary he is clearly involved
in the MTFB and funding
policy, including the introduction of budget
cuts"

Passages which should be deleted from Sir Alan Walters' Book under para 56(a) of Radcliffe

Page 58, first main paragraph:

delete all after the first sentence and proceed direct to next paragraph, which maintains the sense.

Page 59, first main paragraph:

delete last sentence of that paragraph and the first sentence of the following one ie:-

"I believe he was a strong supporter of the whole program. On the issue of exchange rate targeting and the ERM, Mr Lawson was firmly in the Thatcher camp".

Page 60, first main paragraph:

delete third sentence, ie "I suspect that the change in his ideas probably took place much earlier in 1984, fairly soon after his appointment as Chancellor".

Page 62, first main paragraph:

the account of the conversation between Sir Alan and the Chancellor, starting after the second sentence, should be deleted under para 93(a) of Radcliffe.

Page 63, first main paragraph:

delete all after first sentence, ie from "Many other senior members of Cabinet ... a committee of Cabinet".

Page 64, last main paragraph:

delete second sentence, ie:-
"Under such circumstances the Chancellor and Governor would have been vindicated".

Page 67, first main paragraph:

delete second sentence, ie:-
"The Governor was quite firmly in his camp".
delete footnote 70 along with text to which it was attached.
delete sentence beginning "In my view, his Thatcher..."

Page 68, second main paragraph:

this is not a matter for the Radcliffe rules but as a matter of fact there appears to be a confusion between the 1987 and 1988 budgets in the reference to marginal personal tax rates being reduced to a maximum of 40%.

Page 71, at top:

delete "Mr Lawson, it was said, thought that his penny numbers adjustment process showed that he was in control and in no panic, but merely adjusting with prudence to the new situation".

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Cite JM
c:/pps/saw

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBIN BUTLER

SIR ALAN WALTERS' BOOK

Sir Alan has now sent me revised versions of chapters 1 and 6 of his book. Whether it was our heavy handed intervention or advice from colleagues such as Walter Eltis I do not know, but he has made a genuine effort to tone down the personal attacks on Mr. Lawson. He has also gone a long way to eliminating references to the positions taken by Ministers and officials so that they are no more than could be said to be already in the public domain.

In my view the text is largely acceptable though I would query the reference to "putsch" on page 60. This implies, quite wrongly, that there was something devious about the proposal. I note also that the three paragraphs at the end of chapter 6 which appeared in the earlier version under the heading "Conclusion on the Lawson years" have not reappeared. It is not clear whether they have been dropped or are still being rewritten. I propose, however, to draw this to Sir Alan's attention.

Following his recent City University Lecture, Sir Alan's book will now, I believe, be seen largely as an expansion of views which are already on the public record. The political consequences should therefore be containable. I detected in the reaction to the lecture a sense of "yesterday's man", with the momentum towards ERM membership leaving Sir Alan on the sidelines. This was, for example, very much the flavour of the Times leader of 12 April.

I would be grateful to know whether you share this assessment and whether you have any other drafting amendments to suggest. Could any comments reach me by close of play on Monday 23 April.

I am copying this minute to Sir Peter Middleton.

ANDREW TURNBULL

18 April 1990

CONFIDENTIAL

 PUTNAM, HAYES & BARTLETT, INC.
ECONOMIC AND MANAGEMENT COUNSEL

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17 April 1990

Mr. Andrew Turnbull
Principal Private Secretary
to the Prime Minister
Office of the Prime Minister
No. 10 Downing Street
London SW1 A2AA
UNITED KINGDOM

Dear Andrew:

I enclose a new version of Chapter 1. I have purged it of material that you might find offensive and rewritten it substantially. I have also carried out similar amendments to Chapter 6. The arguments are the same, but the text is now sanitized.

I would be glad if you could give me a speedy opinion on Chapter 1. It would be useful at this stage if you could be specific with your objections.

Regards,


Alan A. Walters

Sterling and Inflation in the Eighties:

Code :F:\AAW

Date : Dec 11th 1989

Chapter 1.
Floating and Anchoring CurrenciesTwo Fixes - 1924 and 1987

In the long record of financial history, moneys have normally been either commodities, such as silver or gold, or titles to specific quantities of such metals. ~~The convertibility of sterling currency notes into gold.~~ In fact, since 1717 Britain has spent more than 200 years with a gold convertible currency. During wars and their aftermath, gold convertibility was usually suspended but was resumed again after a period of inconvertible paper currency. Under the exigencies of World War I, Britain decreed the gold-inconvertibility of the pound and allowed sterling to float. The post war inflation and rapid deflation, as well as the 1923 hyperinflation in Germany, gave graphic evidence of the fragility of irredeemable paper currencies. An anchor was required. In the mid 1920s, therefore, it seemed entirely natural to return to the standard which had served the Western countries well in the last half century - gold. After eight years of a floating exchange rate, in 1925 Churchill, then Chancellor of the Exchequer, had chosen to peg the pound at the equivalent of the pre-war parity of \$4.87 (the United States dollar was convertible into gold at \$34 per fine ounce).

In one of the great economic tracts of the 20th century - "The Economic Consequences of Mr. Churchill"(1925) - John Maynard Keynes argued that the return to the prewar gold parity for sterling would entail the most painful deflation of British prices and wages. Keynes said that at a stroke it would render uncompetitive much of industry, and particularly the great export trades such as coal. Keynes proved to be quite right. In particular the pressure to reduce wages and make coal exports profitable lead to the strikes of 1926, which embittered workers and exacerbated class conflicts for many years. True, Britain continued to grow in 1926-28, but at a low rate compared with the United States and Germany. Finally the high value of sterling exacted its toll in full measure when the world economy took a sharp downturn in 1929. The dole queues lengthened dramatically and output fell sharply. Only when Britain went off gold, in 1931, did the economy show signs of recovery. With a floating rate from 1931, Britain's recovery proceeded until overtaken by the rumblings of World War II.

The return to a golden anchor had validated all Keynes' dire predictions. He saw the advantages of an anchor, but he condemned the tight golden chain which would pull the ship underwater; he wanted enough chain to manoeuvre the ship of state. Keynes knew that World War I had seen the end of the old gold standard. Countries were no longer prepared to follow the old golden rules; allowing the money supply to

contract when they lost, and to expand when they gained, specie. Governments wanted to have their cake and eat it. More than ever before World War I they wished to tailor their domestic monetary policy to their need to create jobs, rather than allowing the gold flows to dictate monetary contraction and further recession. This fundamental dilemma was put succinctly in 1923 by Keynes in yet another great tract.¹ If there is a conflict between the policy requirements for domestic conditions and the policy needed for international obligations, then, argued Keynes, domestic objectives should take precedence. Certainly in those years between the two world wars, Keynes was proved to be right.

In the 1980s, alas we have no Keynes (but) the same dilemma persists. The menu of choice, however, had been widened. In the 1920s Churchill's choice was between floating and joining the gold standard at a truly fixed rate. It was expected that the parity would "never" be adjusted (except under the then unthinkable conditions of another World War), and the rate was to be kept within the "gold points" - about 1/2 percent. By the 1980s, however, we had experienced the "fixed but flexible" - or pseudo-fixed - system of Bretton Woods and, in the 1970s and 1980s, the European "snake" and its successor, the European Monetary System (EMS). These systems were eventually quite free from any gold anchor. They provided for much more variation about the par value (plus or minus 2.25 and even 6 percent in the case of the EMS). Furthermore, after consultation and some sort of agreement, the par or central value could be realigned. With a bureaucratic logic, these "fixed but flexible" systems were thought to capture the best of the truly fixed anchor and the best of the free flexible float. The central banks could keep their power to create money at their (or their government's) discretion to control demand, while at the same time an anchor (albeit a rather draggin anchor), not to gold but to a trusted currency such as the dollar in the 1950s and early 1960s or, ~~as far as the European Community was concerned,~~ the Deutschmark in 1970s and 1980s, would prevent inflation or deflation getting out of hand. *Because of its special status as an international gold currency, Britain stayed out of the ERM.*

During the 1980s there have been many campaigns to induce Britain to join the Exchange Rate Mechanism (ERM) of the EMS. ~~This would then provide an~~ *about* ~~dragging anchor in the form of the~~ *1380-1985* ~~Deutschmark~~. It has been widely represented as a touchstone of the degree of commitment to the European Community or to the objective of a monetary union of Europe. Much of the support for joining the EMS rests not so much on economic argument as on political conviction and concern about "missing the Eurobus", two-tier Europe, and on a forlorn Britain excluded from the great blocs of the rest of the world. *[*But as so often the case, political persuasion and debate, in its search for alliances and support, ignores critical differences in economic analysis and policy. One of the main points of this book is that in economic terms one can see much virtue in either absolutely free exchange rates and, alternatively, in a monetary union with a unified currency; yet the pseudo-fixed system of the ERM is an anathema and inherently flawed. Consequently in economic terms, it is quite sensible to have serious reservations about the ERM/EMS but to be an enthusiast for

¹ A Tract on Monetary Reform, 1923, reprinted in Keynes, Collected Writings, Vol IV, London Macmillan for the Royal Economic Society.

some particular forms of monetary union.

The unity of Europe was also a major difference compared with Churchill's interwar uncertainties. European union was far from Churchill's mind, whereas today Eurounion proceeds at a rattling pace. Europhilliacs (or Europhiles) have identified the degree of enthusiasm for ERM/ERS participation as a "touchstone" measuring the degree of commitment to a United Europe (Economist Dec 9th 89). In political terms, however, M.Delors has persuaded the media that enthusiasm for the EMS is the acid test for communautaire, and that the ERM is the only path to economic and monetary union.

In 1925, Churchill looked towards what appeared to be the only safe anchorage the world had known - gold convertibility. Keynes may well rail against gold as a "barbaric relic" but it had always been the refuge of any responsible government after periods with an inconvertible paper currency. The dollar then was "as good as gold" - with no fears about inconvertibility. And so the dollar was disciplined by the promise of the Federal Reserve Board to redeem dollars in gold.

In the 1980s, however, the gold anchor had long been cut loose by all states. Nor had any other commodities, or bundles of commodities, replaced gold. (This had occurred formally when the United States severed the gold link, but in reality convertibility had been much diminished in the years after World War II). When the British government decided to peg sterling in 1987, it was not to gold but to the Bundesbank's Deutschmark. And the Deutschmark had abolished gold convertibility almost two decades before.

The consequences of the fix of 1926 were severe. As Keynes so powerfully argued, the return to the gold standard at \$4.83 rendered British exports (particularly of coal) quite uncompetitive on world markets, so the only possible adjustment for British wages and prices to fall. And Keynes rightly predicted that the only way they could fall was by having a prolonged recession. And in 1926 Britain began the downswing into the great depression. Only in 1931 when sterling was floated free off its gold anchor and depreciated did Britain begin to emerge from the slump. The cost of Mr. Churchill was far greater than even Keynes calculated. And the divisiveness and distortions of that period remain with us, in muted form, even to this day.

In 1987 sterling was pegged at 3.00 (or strictly just below 3) Deutschmarks. True this was no official peg, but the markets were given to believe that 3.00 was the appropriate value and that the Treasury and Bank would jolly well see it stuck. Everyone believed it. Why 3.00 and not 3.30 or 2.70. It is not clear why this value was chosen as the pegging level - partly, one supposes, because it had been hovering near three at the time, or perhaps because it is nice round number. If one wished to provide a rationalization consistent with economic theory, one would have to argue that 3.00 was near and under expected differential inflation rates, was likely to remain near the "fundamental real equilibrium exchange rate" (FREER) - an elusive concept that will worry me, if not you the reader, in chapter..

The 1925 fix was much more disastrous than that of 1987. Instead of the for six years of absolute fixity to 1931, the wobbly fix of 1987 did not make it through a

second year. In 1926 Churchill fixed above the market, making sterling too dear, whereas in 1987 sterling was fixed initially below the market value making the pound too cheap. In stead of the National Strike of 1926 and the depression and deflation of the 1930s, the pegging of sterling in 1987 launched Britain into a boom and inflation. Soon the inflation and the rise in interest rates required to control the monetary growth and prevent that dreaded "free-fall" of sterling ensured that a marked slowdown, even a recession would be required in order to restore price stability.

The consequences of returning to gold in 1925 included a breakdown of the international trade and monetary systems, massive trade restrictions, ultimately exchange controls, and all the curious panoply of agricultural support, 'reconstruction' measures that are still with us in one form or another. The short fix of 1987, I believe, is likely to have no such long term consequences. It is plausible to suppose that it will be but a "blip" (but rather a large one) on the third Thatcher government's record, and that open commodity and financial markets will continue to be the proud result of the Thatcher renaissance.

Fixes, Floats and Fudges in Exchange Rates

Of course I cannot leave the matter there. Underlying much of the discussion of international monetary arrangements in the 1970s and 1980s has been the yearning for some system. The present arrangements where the major currencies, dollar, Deutschemark and yen, float more or less freely against one another, is often called pejoratively the non-system. Notwithstanding the obloquy that has been poured on this non-system, certainly since 1982 it has served the world well in. first the disinflation of the early 1980s and secondly it has provided the stable environment for the longest inflation free expansion in most Western countries. Yet there is good reason for believing that although the non-system has performed remarkably well, if there is no acknowledged anchor for currencies, there are still dangers of runaway inflation.

The underlying rationale of the EMS/ERM was that, while we could not anchor to any commodity or gold, we could anchor to the currency with the best reputation and institutions to ensure stability...the "zone of stability" which was the original aim of the founders of the EMS. There is much to be said for this basic idea, provided that the rate is absolutely fixed. But, over the life of the EMS, exchange rates have not been fixed. They have wobbled in the band and moved at realignment. If the ERM/EMS rates had been really fixed, instead of pseudo fixed, then there would be no possibility of profit from speculative capital movements, and indeed one of the main indictments of the EMS would have been null and void.

There is, however, a fundamental divide on the issue of fixed and pseudo-fixed exchange rates and monetary policy. I argue that absolutely fixed exchange rates is a good alternative to a free float. But then you must set up monetary institutions, such as a currency board, that are consistent with such fixity. There is no room for a monetary policy at all; in that sense monetary sovereignty is relinquished to Germany. This is a matter of both logic and fact, as is clear from the records of the many countries that have, over centuries, operated currency board systems. The only monetary role of a central bank is to exchange currencies at the fixed rate. I regard

the pseudo-fixed system, with its wobbling in the band and the propensity to leap to a new level on a 'realignment' session, as the worst of both worlds. Furthermore pseudo fixed exchange rates are accompanied by a pseudo monetary policy. Both are indeed half-baked.

Another disconcerting feature of the EMS/ERM arrangement is its dependence on the proper behaviour of the Bundesbank as an anchor. Historically, over more than three decades, the independent Bundesbank has behaved, if not impeccably, then certainly far better than any other central bank in defending the value of its currency. But, apart from the question whether that is good enough, legitimate doubts may be voiced about whether history is a reliable guide to future performance. Will the Bundesbank maintain its true independence and will it be able always to resist political pressures, such as those arising from the unification of the two Germanys, or those which emerge from international coordination similar to the Louvre accord?² One notes that the Federal Reserve Board, the other major independent central bank, did succumb to political pressures to inflate in the 1960s and 1970s. Inevitably the Bundesbank, just like the Fed, depends on the discretionary behaviour of people, rather than on the automatic rules of the old gold standard. C

An Inflation-free Currency for Europe

Mr. Lawson's idea that there should be competitive currencies to see which is the choice, not of the bureaucrats of Brussels, but of the private citizens of Europe is attractive. However I believe that there should be another competitor in the field - a currency which by its very constitution is neither inflationary nor deflationary. A currency which maintains its constant and true value in terms of a defined basket of goods, such as the average consumption basket of European citizens. We shall call this currency an ECOM, to indicate that it is a European commodity money. Such a currency could be written into the constitution of Europe. It requires no central bank, only a bank of issue or currency board.

If the ECOM is successful in its competition with other currencies, then it has a fair chance of being adopted as "the" currency of Europe. Indeed governments may agree to allow their currencies to be subsumed, initially by fixed exchange rates with the ECOM, and then entirely abolished in the adoption of the ECOM as the European currency. The great advantage of the ECOM is that it does not involve any surrender of sovereignty to any Central Bank of Europe, to the Bundesbank, or to Brussels bureaucrats or European politicians. A Community state will surrender its monetary sovereignty to the principle of an inflation-free currency. That may well be a surrender which might be attractive to many of the twelve.

And not only the twelve. Since the departure from the old gold standard in 1914, the whole world has experienced persistent inflation (the only exceptional period being

²The retirement of that rock of monetary integrity, Dr. Helmut Schlesinger in 1990 will provide a good test of the robustness of the institution.

the period from 1929 to 1936.). The world cannot and, indeed should not, return to the old gold standard or any version of the gold exchange and Bretton Woods systems. Gold is indeed a barbarous metal, of dubious provenance and subject to all the vagueries of technology and taste. A currency based on preserving constant the unit of account for a wide basket of commodities is much more desirable than a monetary unit linked to merely one precious metal. Nor do we need to keep stocks of commodities to operate the system. We can create paper assets which perform as surrogates for such commodities (unlike the old gold standard where stocks of gold were *de rigueur*). The attractions are clear. And if the Community were to make an obvious success of this ECOM, would not the United States, Canada, Japan etc be quick to follow? Just as the old gold standard rose around the preeminence of a liberal Britain, so might the ascent of a truly liberal Europe promote the new Thatcher standard by the end of this century.

Such reflections are, of course, far beyond the economic consequences of Mr. Lawson. But Mr. Lawson can fairly claim to have opened wide (perhaps inadvertently) the debate on the monetary constitution for a liberal Europe. I hope that this book will add at least something to ~~the~~ debate.

Chapter 2

Ideas on Money and Exchange Rates

Definitions ?

Ask the man on the Clapham omnibus, "what is money?" and he will give you an immediate answer. It is what he uses to pay his fare. It is the stuff with which one pays ones bills. The Clapham answer is a useful one for even the most highbrow economist. Money is the medium by which we make payments in discharging our obligations.

Monetary Policy and the effect on Exchange Rates

Exchange Rates

An exchange rate is the price of one money in terms of another. A pound is expressed as, say 2.5 Deutschmarks, a dollar as 0.65 of a pound. A fall in the price of a pound, to 2.0 Deutschmarks is often called a depreciation of the pound in terms of the mark, or symmetrically it is an appreciation of the mark in terms of sterling. But those terms are simply synonyms for movements in the price.³

³. I would warn the reader that exchange rates are subject to very misleading terminology in different parts of the world. If the price of a Mexican peso falls in terms of US dollars, the Mexicans would refer to this as the exchange rate of the peso "rising" not falling. The reason for such a usage is that in Latin America generally, and

part this may be due to the perverse incentives generated by the ERM. The essence of the ERM prevents automatic adjustment mechanisms in response to shocks, and induces perverse oscillations in monetary policy. Ironically the ERM mechanism works well when there are the same inflation and interest rates in all countries - but then why bother ?

Chapter 6

Chapter 6

Exchange Rate Policy and Politics
The Lawson Years

The Medium Term Financial Strategy

As the EMS started on March 13th 1979, Britain had to have an election within the next three months. The economy was in a parlous state. Neither party had any intention of joining what most thought to be an offspring of a snake. Experience since the breakdown of Bretton Woods showed that it was extraordinarily difficult to maintain nominal exchange rates at levels which differed substantially from the market. The massive outflows and inflows of money in 1975-77 had made their point.

The first Thatcher government saw its first main task as that of securing financial stability. In particular the high inflation, at an underlying 15 percent, had to be brought under control. The main instruments for bringing inflation under control were evident from the beginning; the rate of growth of the money supply, which in the first half of 1979 had been running at some 16 per cent, had to be brought down. Mr Lawson was one of the main architects of the document that set out Britain's Medium Term Financial Strategy. This envisaged a steady downward trend in the rate of monetary growth (of M3) and a decline in the fiscal deficit that was consistent with the monetary targets. If anyone suggested that Britain should tie itself through a fixed exchange rate in order to reduce inflation, I can attest that the suggestion did not get very far.

To the modern reader this may seem odd. In the many attempts that have been made to control inflation (albeit near hyperinflations) in Latin America, in Israel and now in Eastern Europe, the conventional wisdom is that the exchange rate must be controlled and usually that it should be fixed. But even in France and Italy in 1979-81 where inflation was in the teens, a fixed (or strictly pseudo fixed) exchange rate was thought to be a central plank of a disinflationary policy. It was a way of converging on the low inflation rate of Germany. Why not in Britain ? And indeed why not in the United States ?

The first answer is that while an exchange rate fix may be useful for bringing really high inflations down, it is clearly not a necessary or even useful condition for controlling inflation rates of circa 10 to 20 percent. The disinflationary policy with a flexible exchange rate will have lower costs than the policy of fixing the rate. (The evidence on the higher growth rates and lower inflation rates of the non-ERM countries reviewed in chapter 5 is relevant here.) The argument, however, may be that one needs an anchor for the currency in order to ensure that the appropriate monetary squeeze is properly applied; one can, so to speak, trust the monetary authorities to stick to an exchange rate target whereas, because of political pressure it is very difficult for them to pursue the appropriate policy of monetary restraint. That view is clearly not merely discredited but shown to be perverse by experience both in the UK and the USA. As we saw, both sterling and the dollar soared to new heights as the monetary squeeze took effect. If an exchange rate fix had been employed in the UK, then the monetary squeeze would have been quickly reversed in order to stop sterling rising above its upper bound. The fix would have had the opposite effect on monetary policy to that which was intended.⁵³ The inflations would have been refueled rather than doused.

Secondly, and this is peculiar to the UK not to the USA, Mrs Thatcher first major act in international economic policy was to abolish exchange controls in 1979. No such liberalization would have been possible if Britain had been on a fixed exchange rate regime. And since the effects of the abolition of exchange controls were unknown (and incidentally turned out to be quite different from forecasts), it would have been folly on a grand scale to give any commitment to any fixed regime. In addition, it was widely argued, Britain was a large oil producer, and one could not anticipate, nor be expected to counter, the effects of variations in the oil price on the exchange rate. For my part, I doubt whether the oil-price argument was entirely valid, or if so was at all powerful.⁵⁴ Most observers, however, believed that oil was most important, and there is no unequivocal evidence to discredit that view. So it was prudent to eschew the ERM and all its uncertainties.

⁵³. I confess to being most dubious about the advantages claimed for an exchange rate fix as a necessary element of a monetary reform program. It has failed in Argentina, Brazil and Chile in the 1980s. The seemingly effective case in Israel turns out, on examination, to be quite different from appearances. Israel fixed to the dollar in 1985, but this was just at the peak of the dollar value. From 1985 the dollar fell precipitously, and this ensured that the effective exchange rate of the shekel also fell. The nominal fix was not an effective fix. By 1989, however, the inflation rate of Israel had risen again to 20 percent. Bolivia is also a case where the exchange rate fix appeared to work well - but again it was over the same lucky time period. The essential element in both, albeit partial, successes was the reduction in the monetary growth rate.

⁵⁴. For arguments on this point see my Britain's Economic Renaissance: Margaret Thatcher's Reforms 1979-1984, Oxford University Press and American Enterprise Institute, London 1986, particularly p.142, and 160 et seq.

The Role of the Exchange Rate 1980-1982

The exact role of the exchange rate in economic policy is subject to many subtle interpretations. During this period, however, there was a general attitude, albeit with different degrees of emphasis, to the exchange rate which was broadly shared by the civil servants and ministers. First the exchange rate was not a target for policy. This applied to the whole range of instruments: interest rates, funding operations, and fiscal measures. All instruments were concentrated primarily on domestic targets and indicators. The exchange rate was left very largely to market forces. This did not mean that there was no intervention at all, or even that it was restricted merely to smoothing operations. The Bank of England did, on occasion, intervene in markets quite heavily, but virtually always sterilized through the money markets. The prime purpose was to prevent what was usually called a "free-fall" in the exchange rate having an effect on the market for gilts. But there was no target rate. Indeed from the Budget on March 11th over the next nine months (to Dec 11th) the effective exchange rate fell about 10 percent.

Although the exchange rate was not a target, it would have been foolish simply to ignore it. The exchange rate may tell us something about the severity or laxity of monetary policy. This may be a useful indicator when, as sometimes happens, the usual indicators of monetary growth are badly distorted or, for some reason, unavailable. Such conditions occurred in 1981. The deregulation of financial markets caused a great growth of M3 and other broad money aggregates - the targets of the MTF. And there was industrial action by the civil service which caused long delays in the production of the monetary statistics; but of course the exchange rate was readily available.

So the exchange rate loomed large in the discussions of policy. The decline in sterling's dollar exchange rate (about 18 percent from March 10 to Sept 29) was the primary reason for raising interest rates from 12 to 16 percent. In retrospect the squeeze was overdone. The steep decline in narrow money (both M1 and non-interest bearing M1) in the third quarter of 1981 undoubtedly caused a marked slowdown in the recovery in 1982. The exchange rate had misled us into the belief that the monetary laxity was far greater than it was in reality. As for the reasons for such a misleading indicator, it was like "rounding up the usual suspects". First the United States had embarked on a severe monetary squeeze which made the normal dollar comparison particularly wayward, secondly there were rumours about the price of oil, and lastly, as reflected in the opinion polls, the government appeared to be distinctly shaky. All had a depressing effect on the exchange rate, which had nothing to do with domestic monetary policy.

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From September 1981 through to October 1982 it appeared that the authorities were on an exchange rate target of sorts. The effective rate remained in the relatively small range 90 to 92 over this whole period (1975=100). But from the overt statistics it could have been just as readily asserted that Britain was on a Friedmanian path of stable monetary expansion. Monetary growth (Mo) remained in the 2 to 5 percent range. Indeed all the monetary aggregates were in the target range for the financial year 1982/83.

Election 1983

Not only was Britain not on an exchange rate target, I believe that everyone, except the most absurd ideologists, knew that such a target, or even the market perception of such a target, might well be disastrous in the environment of a closely fought election. The scenario was stark. The Labour party platform was clearly to resocialise Britain. Inflationary expansion was one of its main planks. Increased taxation, renationalization, and a substantial spread of controls were among the main instruments for change. And various promises had been made to reintroduce exchange controls and bring back much of the capital that had fled the country so that it could finance job creation at home.

Such a program is a warning to any asset holder to get out while the going is good. The warning is the more to be heeded, the higher the Labour party scores in the opinion polls and the more it appears that the policy is expropriatory. This is a great temptation to Labour. ~~It appears that~~ the more socialist the policy, the greater the capital flight. If the government were on an exchange rate target, it would have to raise interest rates - probably very sharply. But this would squeeze business, lower output and probably throw more on the dole. Not the sort of scenarios in which governments are reelected. The alternative of avoiding the monetary squeeze and letting the exchange rate find its own depreciated level does avoid the election-induced recession.

The government followed this strategy by letting the exchange rate fall 15 percent both in nominal and real terms from November 1982 to March 1983.⁵⁵ Interest rates rose 2 percentage points, Mo's growth rate was reduced, and this was enough to ensure the gentle but persistent disinflationary pressure. In the event, the run up to the election was smooth. Although it has been claimed ~~for example by Sir Terence~~ ~~Pratt~~ that devaluations do even more political damage than monetary squeezes, the 1983 election discredits that view.⁵⁶

It appears that a socialist opposition has an enormous advantage in inducing capital flight, interest rate increases, and wrong footing governments economic policy. But, like most things, it can be carried too far. True the more rabid the socialist program, the greater the capital flight. But, ~~of course~~, the more extensive the expropriation, the less the electoral support. If its purpose is to maximize the probability of gaining power, then the Labour party will pitch its program to balance this reduction in the vote against the gain in support derived from the perversion of the government's policy. In the events of 1983, I believe that the Labour party, largely because of internal tensions, badly miscalculated the trade-off. Their program of old fashioned unreconstructed socialism put off the voters so that the party never really looked as though it had a

⁵⁵. This fall in the nominal exchange rate was even more sharp than the fall in 1981.

⁵⁶ ~~To do Sir Terence justice, I believe that he was arguing this in the context of an avowed fixed-exchange-rate policy, and not in terms of a floating regime.~~

chance of gaining power.⁵⁷ The Tories won.

The EMS and the 1982 Decision

The EMS, and exchange rate targetting, had hardly figured in the election at all. Labour were far more vitriolic than any Tory about the iniquities of any community constraint on their sovereignty. Nevertheless in 1981 the issue of Britain's membership had been raised, largely at the behest of the existing members of the ERM. The Governor of the Bank (then Mr. Gordon Richardson) had favoured Britain joining the ERM as soon as possible. ~~There was much more skepticism lower down in the Bank's hierarchy, but since the Bank was not a collegiate institution, little dissent percolated through to ministerial discussion.~~ The Chancellor, Sir Geoffrey Howe, was favourably disposed to the idea, ~~but no one could claim that he was enthusiastic.~~ The officials in the Treasury and particularly the ~~Second Permanent Secretary~~ responsible for international finance were highly sceptical. As one would expect, the Foreign and Commonwealth officials were enthusiastic - believing that joining the ERM would help in securing advantages from the EEC on such matters as the budget, trade etc. ~~Clearly enough, Lord Carrington the foreign secretary, took a much more jaundiced view of these advantages.~~ The Prime Minister was unequivocally opposed to joining the ERM, particularly in recognising that ~~we would be the only country with really free financial markets and no overt or covert exchange controls.~~ In her view the speculative capital movements would be so destabilizing, that it would be virtually impossible to hold any rate without inducing quite perverse policies domestically.

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As was widely reported in the media, in January 1982 at No. 10, a meeting, chaired by the Prime Minister, was held of the Chancellor, ~~and the Governor with their advisers;~~ ~~later Lord Carrington joined the discussion.~~ In addition to general issues of strategy with respect to monetary policy, the meeting considered the ERM issue. After all arguments had been aired and everyone had their say, it was clear that the Prime Minister's views had won the day. There was clearly no case for joining the ERM either then or for next year. Of course this did not mean that there would never be good reason to join. Circumstances may change or the ERM may change. The issue was left open; one should join only when and if it was appropriate.

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The meeting decided that it was not an appropriate time for Britain to join the ERM

That decision was fortunate. Had Britain joined the ERM at the average mark rate of 4.331 (for first quarter of 1981), it would have required very large increases in interest rates to hold this parity. ~~Even with the 2 percent increase in interest rates that actually occurred,~~ the Deutschmark rate had slipped to 3.684 by the first quarter of 1983 - the eve of the election. But in the ERM for such a short period there would have been much reluctance to realign substantially enough to put to rest the speculative

⁵⁷ It is worth noting that the government had taken many precautions against capital flight. First there had been an extensive issue of indexed gilts which would protect the holders against a Labour (or Conservative) inflation. Secondly, the government developed "Maggie Mae's" a conventional gilt with the option of switching, after the election into an indexed instrument. In the event, the capital flight was minimal.

It says the 4% rate that a 4% increase in interest rate is equivalent to a 2% increase in the exchange rate, the required interest rate increase would have been 6 percent rather than 2 percent

See page
for some calculation of the effect on interest rates

capital raiders. In my judgement, had we have joined the ERM in early 1982, the pressures would have been ~~so great that there was a real danger of reintroducing exchange controls.~~ *insupportable*

The New Chancellor

Mr. Lawson must be considered among the best prepared chancellors of the century. He had been financial secretary in 1979-82 and secretary of state for energy in 1982-3. In the treasury he had been instrumental in pressing through the MTF, the indexed gilts, and the funding policy. I believe he was a strong supporter of the whole program. ~~In my first brush with him at the time of the 1981 budget, he ask me whether it was true that I had suggested an even tighter budget than the one actually adopted. I said yes - but marginally so. His reaction was a "phew!", but in approbation rather than reproach.~~⁵⁸

On the issue of exchange rate targetting and the ERM, Mr. Lawson was firmly in the Thatcher camp. The basic policy was to continue with Sir Geoffrey Howe's gentle but persistent downward pressure on the monetary instruments to bring inflation down. The exchange rate was one of the factors to be taken into account in judging the tightness of monetary policy. But there was no targetting of the exchange rate and no shadowing of the EMS. Both these trends can be easily seen in charts... and ... (Pepper's charts III and V. Note that chart III will have a notional trend value added continuing the trend fall over 1983-1986 to 1989 where it will approximately intersect at a growth rate of zero). The growth of Mo was on a gently declining trend from the middle of 1983, when it was about 7 percent per annum, to the last quarter of 1986, when it was about 3 per cent. If this downward trend had been continued then the growth of the monetary base would, by the end of 1988, have been approximately zero.

In my view the policy over the period 1983-1986 was about as close as one could get to ideal. The underlying inflation rate fell, with a bump or "blip" in 1985, from about five percent to some 3 percent in 1986. Had the policy been continued, so that zero Mo growth rate was achieved by the end of 1988 and thereafter the monetary base had remained unchanged, it is likely that the inflation rate would also have been approximately zero. Mr. Lawson had on various occasions said that the ultimate aim was to eliminate inflation completely and over the years ensure a stable price level. Here he was within two years of achieving that once elusive goal.⁵⁹

⁵⁸. I believe I first met Mr. Lawson shortly after my attack on Heath's policies in 1972. Then I had always thought he was a kindred spirit. After the fall of the Heath government, Mr. Lawson was an important discussant in developing a new economic policy.

⁵⁹. In a memorandum dated Dec 6th 1985 I said "If monetary growth (Mo) is held at its present level (i.e. virtually zero) for a period of two or three years, then it is likely that inflation will fall to about zero before the end of the 1980s and perhaps even by 1988.. At last we shall have price stability". I had left my government employment in 1984, but, as an interested citizen, I still offered my views.

The Curious Case of Hong Kong 1983

The remarkable story of how this opportunity was not merely missed but actually thrown away can only be related from my partial point of view. The conversion of Mr. Lawson to an enthusiast for Britain's entry into the ERM took place between February and November 1985. I suspect that the change in his ideas probably took place much earlier in 1984, fairly soon after his appointment as Chancellor. It may well be that the experience of fixing the Hong Kong dollar in October 1983 had a influence on his views.

Until the breakdown of Bretton Woods, Hong Kong had been on a currency board with a fixed sterling exchange rates. The sterling parity was maintained by the Hong Kong Currency Board always being ready to exchange Hong Kong dollar notes against sterling notes at a fixed exchange rate. During the next decade, the Hong Kong dollar could be characterised as floating amid the jetsam of the 1970s. But there was no discipline of monetary control to replace the currency board. The escalation of the US dollar, the recession, inflation, justifiable doubts about government monetary policy and the political uncertainties generated by the end of the lease (1997) caused a number of runs out of the Hong Kong dollar. These finally culminated in a massive flight in September 1983. The Thatcher government reacted with exemplary speed and decisiveness. The Currency Board was reinstated. The Hong Kong dollar was fixed at a parity of 7.8 Hong Kong dollars for a US dollar. Immediately the run ceased and capital flooded back into Hong Kong. The policy was a great success. (See appendix... for a more extensive discussion).

It was clearly best to engineer a rapid return of a currency board system. Although there were many questions about the adequacy of Hong Kong's reserves, whether it should be fixed to the dollar or the SDR (I do not think that sterling was a serious possibility), and exactly how the Currency Board would operate, the need for a speedy decision was clear. The policy was duly agreed. Mr Lawson did wonder, and with good cause, why I, an avowed British floater, could be so enthusiastic in proposing a fix for Hong Kong. I explained my penchant for clarity in policy and the perils of pseudo systems. I doubt whether my explanation had any effect whatsoever, but I suspect the subsequent euphoric experience of Hong Kong did dispose Mr. Lawson, and perhaps many others, to be more favourably inclined towards a pseudo-fix for sterling.

X Preparing a Putsch for ERM 1985

The year 1985 began with the Chancellor saying that in monetary policy most attention should be paid to the exchange rate. However, in February he was still opposed to Britain then joining the ERM; but by September the campaign to join was in full swing. Corresponding to the elevation of the exchange rate into proposed ERM entry, was the downgrading of monetary indicators. Sterling M3 had been downgraded somewhat in 1981 with some attention being given to the exchange rate. In 1982 narrow money in the form of M1 had entered the target list, and the exchange rate gained even more prominence. After M0 replaced M1 in 1984, the exchange rate was accorded primacy among monetary indicators.

This became quite clear in early 1985. Base rates were increased from 9.5 percent in December 1984 to 14 percent in February. The reasons could not be seen in any sustained acceleration of Mo. True there was a spike in December, but this was soon corrected by a trough in January.

(INSERT here Pepper's Chart IV) ←

Nor could one point to any clear explosive behaviour in sterling M3, PSL2 or any of the broad aggregates.⁶⁰ On the other hand, the dramatic fall in the dollar exchange rate to near to one-for-one in February (a near 20 percent fall over the year), and the reduction of 15 percent in the effective rate were powerful reasons for the Chancellor imposing his monetary squeeze.⁶¹ Yet there was no question, at that time, of joining the ERM. Exchange rates were too turbulent and monetary conditions appeared to need tightening (at least according to the exchange rate interpretation).

But there is no doubt that joining the ERM at a propitious time had become a central plank of the Chancellor's policy. This became clear ~~to me after a visit to London~~ in early June 1985. Several city commentators had been arguing that "monetarism was dead".⁶² Were there parallels between 1972-4 and 1985-? Retail price inflation had reached 7 percent in May and June 1985 compared with 5.1 percent in mid 1984. The growth rate of M3 had begun to accelerate. In their attempts to contain the growth rate of M3, the authorities had accumulated a massive "bill mountain", which many thought, erroneously, represented a great monetary laxity. In

⁶⁰. The annual rate of growth of sterling M3 had increased from 8.2 percent in September 1984 to 10.0 percent in February 1985. By the end of the year, however, the growth rate was near 14 percent. The Chancellor was, in my view rightly, convinced that sterling M3 was a misleading indicator of monetary stringency. One should not ignore it, but in view of the rapid changes in credit markets, it was very difficult to interpret.

⁶¹ Note that the reduction in the exchange rate of the Deutschmark was only from 3.889 to 3.608 - about 8 percent - during the year ending February 1985. By July 1985 the mark was at 4.014.

⁶². For example, Phillips & Drew, "The Death of Monetarism", Market Review May 1985, and de Zoete & Bevan, Weekly Economic Survey, Issue 85/19, May 16th 1985. Of course the "death" of monetarism had been pronounced many times. In my recollection the earliest declaration was by John Kenneth Galbraith in 1980. The City commentators, however, presented a serious argument to support their case. The most sophisticated analysis of the situation was given by Gordon Pepper in Greenwell's Monetary Bulletin, No. 172, May 1985. He argued that the growth of M3 was primarily due to the increase in the real interest rates, and was not a harbinger of inflation. But he did strongly, and in my view rightly, condemn the inefficiency of the demand-side control of monetary aggregates.

my view the fact that the monetary base had been well contained (see the Pepper chart IV), was good evidence that there was no inflationary Armageddon coming in 1986-87. The absence of any take-off of inflation in asset prices, particularly land and houses, was additional evidence to support the argument that monetary policy had not been loose. In the presence of both Mo and asset prices, the situation in 1985 was quite unlike that in 1982. ~~From my meetings with the Chancellor, I believe there was substantial agreement between us on these issues, and that the Prime Minister was assured that the economy was on the right track.~~

But whether and when to join the ERM was another matter on which there was no agreement. I had made my views clear in the manuscript of my Britain's Economic Renaissance, a copy of which had been mulled over in the treasury and Number 10. I do not know whether the Chancellor read my manuscript - perhaps not, because he asked me to his study in Number 11 to talk about my views on the EMS. I explained as best I could what my objections were. My notes after the meeting indicate that the Chancellor did not attempt to discredit my arguments about capital movements, exchange controls, and perverse incentives; what he was concerned to stress was the discipline on any government (the possibility of a Labour government in 1987-8 was not all that remote at that time), and the wage demands by powerful unions. I conceded that such a discipline argument had some plausibility, but I did not see that membership of the ERM had in fact given rise to any more stiffening of government sinews, compared with countries outside the ERM. The abiding impression, however, was the complete conviction that Britain should join the ERM as soon as possible. ~~I interpreted his motives for initiating the discussion, and I now think perhaps wrongly, as an attempt to enlist my support in persuading the Prime Minister to embrace the ERM.~~

The October-November Attempt to Enter the ERM

During the next few months, the Treasury and the Bank prepared ~~their case~~ ^{the arguments for and against} for entry into the ERM. By November the inflation rate had subsided to 5.5 per cent and was expected (and did) fall to about 2.5 per cent by June 1985. One of the conditions for ease of entry had been satisfied. The mark-sterling exchange rate had been fairly stable over 1984. 1985, however, was a year of great instability. The rate of 3.5 in February was clearly reckoned ^{Deutsche} as too low and a threat to antiinflationary policy. By July 1985 it had exceeded 4 and this was thought to be too high and put too much pressure on industry. In early November the rate had slipped to half way between these two values, at 3.75; ~~this~~ ^{it} was thought about right.

~~The case for entry was put in speeches by the Chancellor and the Governor, with substantial support from Sir Geoffrey Howe.~~ It was argued that joining the ERM (and I believe everyone had in mind a narrow band of plus or minus 2.25 percent) would reinforce the counter inflationary strategy. It would be not only an anchor but an observable and credible anchor. Businessmen would know that they could not look to a slide in the exchange rate to bail them out of their own mismanagement. This, of course, was a repeat of the 1972-3 trap. But in addition there was the waywardness

of the monetary targets, particularly sterling M3.⁶³ (In fact the misleading nature of M3 had been argued by me from the end of 1980 and thereafter) It was said that it was very difficult to present monetary policy in a credible form. An exchange rate target would solve all such psychological and presentational difficulties. Thus solved, there would be such an effusion of confidence in the conduct of the authorities that the uncertainty premium which was attached to interest rates would fall.⁶⁴ Much weight was placed on the additional stability in the (Deutschemark) exchange rate through expectations generated by the ERM, and there would be less room for speculation.

I have reviewed the case against entry, and with varying degrees of emphasis, I imagine that this was put by the Prime Minister. Many other senior members of cabinet undoubtedly supported the Prime Minister's view that the time was not ripe. Nicholas Ridley and Norman Tebbit, for example, have been highly skeptical of the virtues of entry. But some, such as Michael Heseltine and Peter Walker, were undoubtedly sympathetic to the Chancellor's proposal. Although so far as I am aware there was no full scale debate at a committee of cabinet.

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What if Britain had entered the ERM in 1985 ?

It is at least interesting, if not particularly informative, to reflect on what would have happened if Mrs Thatcher had been taken over by the Chancellor's case and Britain had entered the ERM in early or mid November. The parity or central rate at which one enters a fixed exchange rate system is always a critical decision - as Churchill found in 1925, the Chileans discovered in 1979, and Hong Kong observed in 1983. We can get some idea of what would have happened if Britain had entered the ERM at 3.75 by observing what actually happened to the mark-sterling rate from November 1985. By the end of December the rate had sagged to 3.53, by mid 1986 to 3.00, and by the end of 1986 it was hovering around 2.80. In 13 months sterling had fallen about 27 percent.

In order to give some idea of the effect of the ERM on Britain's policy I shall assume that there was no realignment in the first year or so of entry. The 2.75 rate is held. The question is then, how far would interest rates have to rise in order to hold the central rate at that level? Some estimates can be made by applying the so-called "4 to 1" rule, namely that a 4 percent depreciation in the exchange rate is is

⁶³. In his Mansion House speech in October 1985, the Chancellor had announced that the sterling M3 target had been suspended, and that "The inflation rate is judge and jury"

⁶⁴. For a number of repetitions of these arguments. See Samuel Brittan's articles which began with his conversion in The Financial Times, November 14th 1985 with "Now, alas, it is time to join the EMS" (he meant the ERM).

counterbalanced by a 1 percent increase in base rate.⁶⁵ This would imply that, holding the ERM central value at 3.75 would have required increases of (27/4) 6.75 percentage points in interest rates over and above the 10 to 12.5 percent that were in effect throughout. This would have meant interest rates of some 17 to 20 percent.

Many EMS protagonists would claim that this estimate does not take account of the beneficial effects on expectations, including the greater certainty and credibility of being in the ERM.⁶⁶ It seems dangerous to rely so much on a subject we know so little about, namely expectations. But, in any case, exchange rate pressure which induced such high interest rates would clearly generate expectations of realignment or perhaps even withdrawal, or, worse still, of incipient exchange controls.

In retrospect the widely reported intransigence of the Prime Minister to entering the ERM was a godsend. If we had entered, then raising interest rates to new highs in late 1985 and throughout 1986 would have jeopardized, even ruined, the conservatives in the elections of 1987. After such a very tight monetary squeeze through 1986, there would have been a recession - and most likely a deep one - in 1987-88. This would have been exacerbated by the ~~closing of the gap between the parties and the effect on~~ capital flight and interest rates discussed above. No doubt that, in the event, the government would have taken some evasive action, such as realignment, as the dire consequences of the decision to join the ERM became apparent. But, willy nilly, any such actions would be acknowledgment of ~~an~~ error of policy, and hardly a basis for asking for another term in government.

It is easy to conclude that Mrs Thatcher was lucky in just happening to be right. The market exchange rate might have remained more or less constant and so there would have been no trouble in maintaining the ERM central rate up to the election. Under such happy circumstances the Chancellor and Governor would have been vindicated. Before mellowing with such comforting thoughts, one should review the history of exchange rates since 1972 (as in the Pepper chart V). There are few periods where one could describe the exchange rate as being stable without a pronounced drift. (We must acknowledge, however, that 1984 was relatively stable with a small drift from near 4.0 to 3.5 - a near 10 percent devaluation). Alternatively the underlying market exchange rate might just have gone the other way and massively appreciated. ~~But, as we shall see, in 1987-88, this is exactly what did happen and with the shadowing of the Deutschmark, this delivered a~~ substantial inflation in 1989. In my view, Mrs Thatcher understood the basic problems with the ERM and was unwilling to put the

⁶⁵ See Charles Goodhardt, "British Monetary Policy" (check title), Economic Journal 1989. The rule refers not to the Deutschmark but to the effective exchange rate index. The fall in the effective exchange rate over this period was of the order of 20 percent. But the defence of the central parity in the ERM is effectively with respect to the mark, so in these very rough calculations I have assumed the same rule applies to the mark-sterling rate as to the effective rate.

⁶⁶ This is a moot point since the "4 to 1" calculation was over the period of which included the period of shadowing the Deutschmark.

British economy, not to mention the election, through such a risky wringer.

The "End of Monetarism" 1986

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Without/restrictions imposed by the ERM, 1986 was a good year. Growth was about 3.5 percent and inflation was way down, partly because of the collapse of the oil price and partly because of the reductions in mortgage interest rates. (It is odd that few commentators observed the collapse of the Deutschmark exchange rate and the fall, rather than the rise, of inflation.) But even as early as 1986 the writing was, albeit faintly, on the wall.

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At various stages since 1983 the Chancellor had announced that the ultimate objective was stability of the price level - that is to say zero inflation. Indeed the joining of the ERM policy was thought to be consistent with this aim, since the objective of the Bundesbank was a stable price level. A stable price level required a reduction in the rate of growth of Mo from its ambient 3 to 5 percent in 1985 to zero. This monetary growth path consistent with the objective of zero inflation by 1990 is shown in (chart V of Pepper); by 1988 the quantity of Mo is stable, and its growth rate zero. From 1983 to mid 1986 the trend rate of growth of Mo is gently declining, and had it continued to decline at that rate, the goal of zero inflation would have been reached in 1990. The actual record, however, shows a marked increase of some 2 percentage points above the trend line in the last half of 1986.

was

At least as far as Mo is concerned, this marked a turning point in the policy of persistent pursuit of lower inflation which had been manifest since the 1983 election. It was not a dramatic reversal. The change was initially small, almost imperceptible. Yet, as can be seen in (Pepper chart III), the divergence between my target path of zero inflation by 1990 and the actual growth rate of Mo grew inexorably throughout 1987 and 1988. Finally in September 1988, the growth rate of Mo was over 8 percent and the difference from my preferred path was as much as 7 percentage points. If ever one is to date the "end of monetarism" in the Lawson record, then I think that the middle of 1986 has a good claim. Of course it may be argued that this was nothing more than the usual pre-election expansion to give the voters an aura of prosperity in which, it is hoped, they will reelect the incumbents. But it was more than that. The boost persisted for three years, long after the election.

expansion

possible

There are many explanations of this change in policy. The temperament of Mr. Lawson was different from his predecessor. Lawson was said to "...have the temperament of a financial operator, even a gambler..."⁶⁷ The temptation to indulge in "wizard wheezes", to "have a go" and to deliver spectacular growth may well have

⁶⁷ See Peter Riddell, The Thatcher Decade, Blackwell, Oxford 1989, p. 20. In the television interview with Brian Waldron on "Weekend World" in November 1989, Mr Waldron referred to Lawson as a gambler. It was widely reported that Mr. Lawson was not a rich man; apparently he inherited a substantial sum but lost it in investments in the early 1970s.

First there were growing doubts about the reliability of the monetary aggregates as harbingers of inflation

The Chancellor

~~overcome his initial prolixity. He had come a long way from the Mais lecture of June 1984 when he said: "It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macro-economic policy". There was also the fact that, although treasury officials had demonstrated that Mo was an efficient guide for monetary policy, various commentators, such as the ubiquitous Mr. Brittan, had repeated that the City could not conceivably regard such small change as an appropriate target. If the City could ignore Mo, why not the Chancellor? Similarly he could brush off much of the criticism of the burgeoning broader aggregates and particularly sterling M3. In a financial system that was changing its very structure so dramatically, M3 was a dog that had barked too often to be taken seriously. But I suspect that the most seductive influence was the general attitude among the G5 finance ministers that exchange rates were too important to be left to the whims of markets. All right-thinking finance ministers agreed on the need to topple the dollar in 1985 - hence the Plaza agreement. (Note that this was before the fiasco of the Louvre in 1987). Among the G5, Mr. Lawson was clearly the most clever and most experienced. It must have been quite heady stuff to redraw the financial map of the world. To deliver what all people who really matter knew what was right. Power is the goal of all politicians. Here it was - but in half rather than full measure.~~

Samuel

explain way

The Untarnished Attraction of the EMS ^{targeting on a grand scale with the domestic problem of the UK,}

It must have appeared the logical next step to take Britain into the ERM and, most important, to play a full role as the second most important financial power in Europe, first in influencing policy of the Bundesbank and secondly as the honest broker between Germany and France in developing an ~~an~~ integrated financial system for Europe. Indeed it would be entirely logical to see Mr. Lawson as clearly the best candidate for the role of monetary czar, or president of the central bank, of Europe in say 2000. Thus may private ambition and intellectual persuasion happily mesh.⁶⁸

All these considerations might explain the persistence of the drive, by hook or by crook, to get Britain into the ERM. And there is also the obvious personal reason. With the conviction that he was right, it was galling to have the Prime Minister exercise her prerogative in 1985. And it was tempting for him to show how right he was after

Secondly, ^{that} there was the argument that, if the exchange rates were pegged, ultimately Britain would have approximately the same inflation rate in traded goods as Germany.

⁶⁸ This depends on Mr. Lawson having come to terms with the fact that he is unlikely to be leader of the conservative party. I am sure he has sufficient self-knowledge to have arrived at that conclusion long ago. A "financial leader", who insists on anonymity, told me that, because of his arrogance, Mr. Lawson could not conceivably be appointed to, for example, the job of Managing Director of the International Monetary Fund, let alone Governor of the Central Bank of Europe. Although Mr. Lawson is somewhat assertive, I should have thought that his considerable ability would have been the most decisive factor, and thus I still conjecture that his prospects are quite rosy.

~~all.⁶⁹ I believe these factors largely explain the decision to "shadow" the mark from early 1987 onwards. The idea was to demonstrate his wisdom and to show that the Prime Minister's fears were quite groundless.~~

In this endeavour, Mr. Lawson had powerful allies, ~~outside the cabinet.~~ The Governor was quite firmly in his camp. ~~One detected, however, much less enthusiasm among the Bank staff and among junior ministers and officials in the treasury - perhaps because they had been through similar hoops before. But their loyalty was unquestioned.~~⁷⁰ The City was said to be enthusiastic for a fixed mark parity and entry into the ERM. The CBI had stated ~~clearly~~ its full and complete support for entry. This ~~at least~~ offset the much more skeptical view coming from the management of industry - the Institute of Directors. And above all, as a highly successful reforming Chancellor, Mr. Lawson had fullsome support on the conservative benches in the House of Commons. ~~From all this he could well conclude that he had a mandate from front~~
~~all quarters except Number 10.~~

In view of the behaviour of the sterling-mark exchange rate in 1985-86, and the obvious difficulties Britain would have encountered had she joined at the November rate of 3.75, one would have thought that this would have given the Chancellor pause before saddling up for another ride on the tiger. Clearly it did not. Nor can I find any satisfactory explanation for ~~his~~ ignoring the lessons of 1985-86. ~~It is inconceivable that the treasury official did not carry out "what if..." exercises on this period.~~⁷¹ I suppose he may have surveyed the evidence and drawn quite different conclusions from those which I adduced above. For example accepting the facts as I outlined, he may have believed that ~~the magic ingredient of~~ expectations and confidence would ~~clearly bail sterling out of any difficulties, as had apparently happened in Italy,~~ notwithstanding Britain's open financial markets. More likely he ignored the ~~reasoned~~

⁶⁹. It has been suggested that there was also a 'macho' element in Mr. Lawson's behaviour, namely that he was furious because a 'mere woman' was thwarting his policy and ambition. I am very doubtful if such a macho factor played any role at all. I suspect he would have been just as annoyed if the Prime Minister had been a male.

⁷⁰. It is noteworthy that, while the resignation of Peter Thorneycroft from the the Macmillan government was accompanied by the resignation of his junior ministers, Enoch Powell and Nigel Birch, there was no hint of any of Mr. Lawson's junior ministers accompanying him to the back benches.

⁷¹. It has been reported (Keegan) that senior officials in the treasury were entirely surprised by the Chancellor's announcement at the IMF in January (?) 1987 that exchange rates were the main guide for monetary (interest rate) policy. The decision to shadow had not been a considered in depth or detail by officials. It was represented as the consequence of a number of discussion between Mr. Lawson and Sir Terence Burns, with offstage assistance from that most distinguished financial journalist, Mr. Samuel Brittan. This report is consistent with the picture of Mr. Lawson as a gambler who likes to keep his cards close to his chest.

economic arguments on the grounds, alas not unjustified, that the economists had usually been useless on predicting exchange rate movements. ~~Like many a gambler,~~ he felt more at home with his hunches.

may have

Shadowing the Mark

And his hunches, tactically, were good. When sterling began shadowing the mark in early 1987, the Deutschemark rate had fallen below 2.8, even though base rates were relatively high at 11 percent. Sterling had then hit its nadir. At this value the mood of the market was that sterling had reached its bottom. A policy to maintain the rate around 3.0 was both attractive and easy. Indeed it was combined with a fall in base rates from 11 at the turn of the year to 9 per cent for the election in May. Sterling soon appreciated in February to 2.9 and thereafter it rarely deviated more than 1.5 per cent (0.05 Deutschemark) from 3.0.

1987
L

1987

The economic ambience of this policy seemed like a new golden age. ~~One can easily forgive the Chancellor any hubris.~~ Growth proceeded at between 4 and 6 percent, according to the measure used. Investment boomed with a 7 percent growth. Inflation remained low, a little over 4 percent, but the tax-price index was only about 2.5 per cent. A great tax reform was introduced in the March budget. Marginal personal tax rates were reduced to a maximum of 40 percent, and many loopholes and anomalies were swept away. Yet, such was the ebullience of the economy that revenue increased dramatically and the deficit in the public sector turned into a surplus. Debt retirement began. Interest rates fell. The election was won.

1987

The pre-tax real rate of return on assets in the corporate sector had been rising since 1981 (when it was 2 percent) and finally by the end of 1987 it had reached 12 percent. It was expected to rise even further, and so it did - to over 13 percent in 1989. Such high rates of return had not been seen since 1964. More important they clearly exceeded the rates of return in other OECD countries.⁷² Much of this improvement was due to supply side changes, which were expected to continue.⁷³ This meant that there was a great attraction for investors, both domestic and foreign, to invest in Britain, either through foreign direct investment or through portfolios. The demand for sterling was boosted by this investment effect. There was perhaps an even larger demand created by the interest differential between the United Kingdom and overseas. United States treasury bills in January 1987 were yielding only 5.85 percent compared with about 11 percent on sterling bills. The risks of a three month devaluation of sterling were clearly low, so sterling attracted many buyers.

⁷² See "Company Profitability and Finance" in Bank of England Quarterly Bulletin, Vol 29, no.1, August 1989, page 377.

⁷³ These have been analysed in detail by Patrick Minford in von Fuerstenberg (ed) (CHECK ref)

The increase in the demand for sterling buoyed up the exchange rate at 3.00; there was initially no difficulty in holding it there. The authorities ~~did~~ intervened largely to prevent the rate rising above the 3.0 limit. This took the form of selling sterling and buying convertible currencies. Intervention statistics remain a secret. It is interesting to note however that the convertible currency reserves increased over 1987 from \$13.78 billion to \$35.73. Much of the increase was due to a deliberate policy by the Chancellor to prepare for defence of a fixed exchange rate whether in or out of the ERM. I would guess that some \$10 billion of the increase was associated with the intervention.⁷⁴ The intervention was formally sterilized in the sense that it was not allowed to have any persistent direct impact on the money market rates of interest. Bills were sold to take sterling off the market. Thus the bill mountain, such a source of concern in 1985, ~~did~~ melted away.

Many studies have shown that sterilized intervention has little lasting effects on exchange rates. Since most of it was sterilized in 1987, the persistent pressure for an appreciation of sterling continued. The only way to prevent it was a reduction in interest rates relative to those in other OECD countries. ~~This was the Lawson's policy.~~ First however there was a ~~little~~ diversion due to the Louvre agreement. In May the United States authorities were driven to raise interest rates sharply to stop the decline of the dollar (again after a failure of massive internationally coordinated sterilized intervention to do the trick). US rates continued to rise throughout the year until the stock market crash of October 19th. In July British interest rates were increased by one percent, but thereafter they did not follow the dollar up further. And following the October crash, base rates resumed their downward path to 8.5 at the end of the year, ~~and 7.5 percent by May 1988.~~

It is ironic that during 1987 the attempt to put a floor under the dollar and the attempt to put a cap on sterling both failed. ~~Yet~~ Both were fought with the biggest intervention funds ever deployed. Both substantially sterilized their intervention, and discovered it was ineffective. Both were driven back to monetary policy, to higher interest rates in the United States and ~~low~~ ones in Britain. ~~!~~

The massive interventions in Britain came to an end in the first months of 1988. It was rumoured that more than \$2bn was spent on intervention in one day. Intervention was scaled back to the normal smoothing operations. There was a well publicized disagreement between the Chancellor and the Prime Minister. Just before the March budget, the Prime Minister made it clear that you "cannot buck the market". ~~The fact that it was manifestly true, did nothing to abate, indeed probably exacerbated the fury of the Chancellor.~~ In any case the 3 Deutschemark fix was finished on March 4th. By the end of March the mark rate was at 3.125.

Lawson's Crowning Error and The October Excuse

⁷⁴ Gordon Pepper shows that the net effect on M4 of foreign exchange reserves in 1979 was 7.2 billion sterling. He concludes, however, that although the authorities failed to "sterilize" (in the sense of having no direct effects on M4) all the intervention in 1987, they did manage to catch up in the first quarter of 1988.

* More important internationally was the reduction in US and ~~interest~~ rates to 2.5 percent in order to prop up the dollar. This resulted in a massive real estate and stock market inflation in 1989-90.

(expansionary policy)

But this did not mark the end of the ~~policy~~. In what can only be seen as a vain attempt to put a somewhat higher cap on the exchange rate, interest rates were reduced again ~~and again~~ to their low of 7.5 percent in May. The only conceivable rationalization for such ~~policy~~ was that the exchange rate appreciation, both overt and incipient, showed that monetary policy was still "too tight". Yet every other indicator suggested that monetary policy was too loose rather than too tight. The labour market was showing distinct signs of strain and unemployment was falling by about 50,000 a month. The prices of assets - and particularly real estate - were rising strongly. The current balance of payments had turned markedly into the red, and there was a clear import boom. Investment boomed ahead at record rates.

The monetary indicators were all pointing to an inflationary surge. The Mo figures suggested that there would be a two percent increase in underlying inflation coming in 1988-89, and the broader money aggregates were suggesting even more alarming forecasts of price inflation. Only the exchange rate could be adduced as evidence that monetary policy was "too tight". (still)

What possible excuses could there be for ignoring this weight of evidence? One such excuse, according to the Economist, Mr. Brittan and other supporters of the Lawson line, is that a monetary expansion was the appropriate response to the October 19th 1987 crash. This would then avoid the mistakes made following the crash of 1929 and 1931. But the appropriate response to a crash is not inflationary excess.⁷⁵ The problem in October might well have been a run on the banking system or some other form of liquidity run. This calls for the Central Bank to stand ready to discount paper to stem the run, not to flood the market with money. In the event, the Federal Reserve Board of the United States handled the October crash in an exemplary manner, ~~which should have been a model for the United Kingdom.~~ In the Economic Report of the President, February 1988, (page 39), it was shown that, in spite of October's troubles, the Fed actually tightened monetary policy in 1987 - because it feared that the expansionary policies of 1986 would promote inflation. This is exactly what was needed in the United Kingdom.⁷⁶ ~~There was nothing that prevented such a prudent policy being pursued - except Mr Lawson's fatal obsession with the exchange rate.~~
The Governor, in his Durham speech, observed that there had been errors of policy. ~~I think the Governor was wrong~~

From June 1988 monetary policy was successively tightened by raising interest rates frequently but by only half a percentage point. This was new. Normally in a squeeze the interest rate is put up substantially - usually by 2 percentage points. Then the market is much less certain about the next move of interest rates, whereas using the

⁷⁵ Nor is it to hold fixed the exchange rate. As is well known, Britain entered the recession by Churchill's fix in 1925, and it began to emerge from the slump after floating the exchange rate in 1931. The United States hung on to its fixed exchange rate (with respect to gold) for two more bitter years until 1933; then having floated the dollar, the United States started its recovery. In 1987-8 the fixing of the mark-sterling rate at too low a level led to inflation.

⁷⁶ Most of the other major OECD countries appear to have acted with a prudence similar to that of the United States. Britain was the odd man out.

policy

not only to observe expansion

1988

innovation of Mr. Lawson, the market was ^{practically} certain of the direction of the next interest rate movement. Mr. Lawson, it was said, thought that his penny-numbers adjustment process ~~was much better because it~~ showed that he was in control and in no panic, but merely adjusting with prudence to the new situation. By August base rates were up to 12 percent.

The question remained, however: was ~~Mr. Lawson~~ still operating with an exchange rate band as the target? Albeit the band had moved to 3.1 to 3.3 or so, but the rate was kept in that band until ~~a month or so before he left office in October 1989.~~ ^{Sept} ~~We do not know what would have happened if there had been no resignation.~~ But the evidence of incipient inflation became more evident with every passing day. House prices boomed, labour shortages were spreading, unemployment was falling as fast as ever, and all the signs of overheating were there to see. The need for a substantial increase in interest rates, whatever the exchange rate consequences, was manifest. ^{for all} Fortunately the exchange rate pressure was downwards and so provided a convenient argument for increasing interest rates in one percent steps from 12 percent in October 1988 to 15 percent one year later; thus, at last, there was the coincidence of the exchange rate giving an appropriate direction to monetary policy.⁷⁸ The market was quite convinced that it was virtually only concern about the Deutschmark and German interest rates that was driving interest rate policy in the UK. Indeed the Chancellor and the Governor had given the market good reason for believing that exchange rates were the main determinant of interest rates.⁷⁹ And once the belief is ingrained in market lore, it is very costly to try and change ~~that belief.~~ ^{d.}

Britain was on the back of the tiger, ~~of its fix.~~ ^g As the exchange rates fell, or threatened to fall, in the autumn of 1989, so the interest rate was driven up by market expectations. The authorities had the choice of validating expectations or changing them. However desirable it might be to avoid riding the tiger, the alternative was to fall into its jaws. The government would certainly be chewed up if they had announced a substantial change in their macroeconomic targets. Even though 15 percent interest

⁷⁷. Additional evidence on this point is derived from the ruminations of Mr. Samuel Brittan. In the Financial Times.... (date etc to be checked), he opined that the main mistake made by Mr. Lawson was to fix at 3.0 instead of 3.3. The reader may himself conjecture the economic costs of a belief in Brittan.

⁷⁸. There is still room for debate about whether the monetary squeeze from 1988 onwards was too tight or still too loose. There was no doubt at all that interest rates of at least 12 percent were needed in order to get the growth of the monetary base under some sort of control.

⁷⁹ In his speech at the Party Conference in October, only days after the increase of base rates from 14 to 15 percent, the Chancellor made it clear that the Conservative Party would not be "the party of devaluation".

needed
and
came

rates may seem like riding the tiger into a recession, the alternative was even worse.⁸⁰

(TO BE COMPLETED)

The Foreign Exchange Reserves

(THIS MAY NOT BE SUITABLE AT THIS JUNCTURE - POSSIBLY NOTE OR APPENDIX?)

So far we have ignored the consequences, particularly the costs, of fixing the exchange rate on the foreign exchange reserves. One of the little known consequences of the first Thatcher government's financial program was the privatization of a substantial fraction of the official foreign exchange reserves. In 1979-1980 the authorities held more than \$18 billion in convertible currencies.⁸¹ By 1984 this had been run down to about \$7.5 billion. This reduction was possible because the authorities did not need any substantial reserves if sterling were floating. If it were a free or pure float, then, apart from the needs for normal operations, there is no need for any official reserves. But Britain was on a dirty float and the Bank always liked to smooth the path of sterling, so some balances were needed for these operations. We can conjecture that if Britain joined the ERM, then considerably more reserves would be required. One notes that France and Italy maintained reserves of 18. and 23 percent of their exports in 1984, whereas Britain's reserves were only 6.5 percent. It is reasonable to suppose that, were Britain to join the ERM, reserves of about three to four times the \$7.5 billion, that is \$22.5 to \$30 billion (for 1984 export volumes and in 1984 prices) would be required. Bringing them up to 1989 values, one would get a required reserves of \$30 to \$40 billion. (Just to confirm this figure, the official reserves in 1988 rose to \$40 billion at the end of July and to over \$42 billion by the end of the year). The ERM, therefore, would require us to have additional reserves of some \$20 to \$30 billion - let us assume hereafter that the extra reserves amount to \$25 billion.⁸²

What are the costs of keeping these reserves? The real rate of return on the reserves is roughly the real short term interest rates in the money markets of New York and, to a lesser extent, Frankfurt and Tokyo; a figure of around 2 percent seems appropriate as the average value of the return to be expected. If these funds had not

⁸⁰ Reports appeared in the media that I was opposed to the increase in interest rates to 15 percent in October 1989. Other reports said I supported the increase. My position was that we were in no position to change the market expectations, and that moving up to 15 percent was the least bad alternative.

⁸¹ See Bank of England Quarterly Bulletin, table 17.1. Note that I am including only convertible currencies and excluding gold, and the IMF reserve and special drawing rights.

⁸² In 1984 I ignored the \$2.5 billion floating rate note issue which the treasury issued for the specific purpose of increasing the reserves. Obviously this issue had potential ERM entry in mind.

been required for padding the reserves, they would have been employed by the private sector, as in 1980-1984, as capital assets. We know that the average real rate of return on capital employed in private industrial and commercial companies in the UK in 1988 was about 12 percent.⁸³ If these were the rates of return of alternative investments forgone, then the costs of the reserves were about 10 percent of the \$25 billion, or \$2.5 billion a year. Of course the alternatives forgone may be overseas investment, either in portfolio form or in the acquisition of real assets or direct capital formation. We do not know the full rate of return on these investments, mainly because of the lack of information on capital gains.⁸⁴ But from the information available, it appears that over the Thatcher years the rate of return has been very very high at some 15 to 20 percent, and substantially larger than that on domestic investment. Thus the cost of the reserves for the ERM is between \$2.5 and \$5 billion (or 1.5 and 3.0 billion stg)

Thus, in maintaining these additional reserves, the ERM will cost us some half to one percent of GNP each year. Whether this is considered large or small depends on the alternatives. One possible alternative is to go the whole hog and switch to a Deutschemark currency or to a currency board system. (This is the logical consequence of Delors stage 2.) Instead of pound notes, Deutschemark notes would circulate and we would be on a full Deutschemark standard. The Bundesbank would hold reserves; we would simply hold some of their currency. At present currency and coin in the UK amount to about 17 billion stg, or some \$26 billion. This capital value of the seignorage is about the same as the additional reserves for joining the ERM. If a currency board substitutes sterling currency at a fixed rate for Deutschemark notes, then the \$26 million equivalent can be at least partly invested in short term mark financial assets. So the cost of the ERM is about the same as the cost of a full currency board system.

⁸³. Bank of England Quarterly Bulletin, Vol 29 No 3, August 1989, p.377. A more conservative calculation may take the point that a 12 percent rate of return cannot be sustained and that a 10 percent, or even an 8 percent, rate would be more appropriate in the long run.

⁸⁴ See "External Balance Sheet of the United Kingdom", in Bank of England Quarterly Bulletin, vol 28 no 4, p 520-527. The net asset position grew from 12.1 stg at the end of 1979 to 113.2 and 89.5 billion stg at the end of 1986 and 1987 respectively. Such assets are obviously in part acquired by the cumulation of current balance surpluses, but this can only account for some 17 billion stg in the published statistics. (The reader may well believe that the current account balance is much underestimated in the official statistics. But even if we double it to 34 billion stg, it still cannot account for the bulk of the additional net foreign assets.) The balance is largely accounted for by the yield, and in particular the capital gain including currency revaluation, on such foreign assets. On certain assets the Bank has calculated the full rate of return on assets (not net assets) - see chart 6 p.525. This suggests that the full rate of return has been about 20 percent over the period end 1979 to end 1986. This appears to be the nominal rate of return, so the real rate of return would be somewhat below this, but almost certainly in excess of 15 percent.

LONDONER'S DIARY

Walters book shakes Whitehall

WHEN MRS T's former economics advisor Sir Alan Walters arrives in London tomorrow to give a lecture at the City University on "Constitutions for Monetary Systems", he will have time to complete another task whose implications are likely to be far more wide-reaching. For I understand he plans to drop off at his publishers the completed manuscript of his running battle with former Chancellor Nigel Lawson.

sultant, will be subject to the same Official Secrets Act restrictions as full-time civil servants.

"We won't be liaising with the Cabinet Office over the publication of this book; I have a horror of bureaucratic entanglements," the IEA's Graham Mather, who is overseeing publication, tells me adamantly.

But the Cabinet Office has a different view. "Sir Alan will certainly have to submit the book to us, and we may have to consult the Treasury and Number Ten about what chapters, if any, would have to be rewritten."



Lawson and Walters: at odds

Provisionally entitled *The Economic Consequences of Mr Lawson*, the book will be published jointly by Collins and the Institute of Economic Affairs. I understand the prospect of imminent publication is driving the Treasury into paroxysms of dismay and already sections of the text have been seen in senior political circles.

"They are having kittens about it. They think it implies that Mrs Thatcher gratefully made use of Walters's interventions against Lawson, but didn't stand by him when Lawson blamed Walters for his resignation. They are terrified that it will provoke Lawson into making disloyal anti-Thatcher statements," a Whitehall insider tells me.

But there is a catch. Successful publication hinges on whether or not Sir Alan, as a former part-time con-

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NOTE FOR THE RECORD

cc Press Office

MR. LAWSON'S BOOK

A report appeared in the Daily Express of 5 April that Mr. Lawson's book would not ^{only} give a blow by blow account of how the community charge came to be decided and how the former Chancellor opposed it, but also that the book would appear before the next election rather than after as we had previously supposed.

I spoke to David Willetts who was at one time thinking of helping Mr. Lawson with the book. He told me that he could not spare enough time and Mr. Lawson has therefore taken on Dominic Hobson; that the contract with the publishers called for the manuscript to be delivered to them by December 1991; but that he still thought that intention was for publication to be after the election if it had not taken place by then.

AT

ANDREW TURNBULL

6 April 1990

c:\pps\note

PRIVATE AND CONFIDENTIAL



10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

30 March 1990

Thank you for your letter of 20 March. I do not accept that my letter to you of 13 March was hostile. It was blunt, but its purpose was to make clear to you how strongly people here would feel if you were to publish something along the lines of the original draft. It would have served neither of us to have pulled punches at this stage only to let misunderstandings develop later.

You say you are at a loss to understand why it was necessary to invoke the conventions of the Radcliffe Report on Ministerial Memoirs - a copy of which is enclosed. The answer is that they exist and apply to this book, and it is my duty to draw them to your attention. They were drawn up following the Crossman diaries case. As you will see from paragraph 75, they are not backed by Statute (except, of course, if breaches of the Official Secrets Act were to be involved) but all former Ministers and officials are expected to observe them. This is the basis on which former Ministers and officials are asked to submit their memoirs before publishing them, as you did in 1984 with your earlier book.

From the first paragraph of your letter I see that others have counselled you to recast this book. If you were now to produce a calm and dispassionate examination of the case for free or fixed exchange rates, it would be a completely different book. Of course, we should be ready to look again at such a book, although the fact that it may then satisfy the rules does not mean that it will avoid risk of embarrassment for the Prime Minister.

ANDREW TURNBULL

Professor Sir Alan Walters.

PRIVATE AND CONFIDENTIAL

FILE LB

C: Walters

cc FEBS
Sir P Middleton

HM Treasury

~~CONFIDENTIAL AND PERSONAL~~



Parliament Street
London SW1P 3AG
Telephone 01 270

4360

Sir Peter Middleton GCB
Permanent Secretary

A Turnbull Esq
10 Downing Street
LONDON
SW1

30 March 1990

Dear Andrew,

SIR ALAN WALTERS' BOOK

Thank you for copying to me your minute of 27 March. *with AT?*

I am content with the reply, subject to the points which Sir Robin Butler has made. I greatly prefer his version of the second paragraph.

I also rather wonder whether the start of the final paragraph might read:

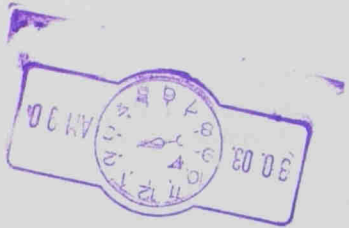
A "From the first paragraph of your letter I see that others have counselled you to recast this book. If you ^{now} produce a calm and dispassionate examination of the case for free or fixed exchange rates, the book will be completely different..."

But I should be happy with it the way it was if you prefer.

P E MIDDLETON

Copy to: Sir Robin Butler

CONFIDENTIAL AND PERSONAL



MINISTERIAL MEMOIR
Policy
pt 2

FILE KK



10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

30 March 1990

I would be grateful if you could pass the enclosed letter and document to Sir Alan Walters. If his office is phoned (202-2236665) I am sure someone from there would be happy to collect it.

(ANDREW TURNBULL)

E. A. Oakden, Esq.

Ref. A090/799

MR TURNBULL

Sir Alan Walters' Book

Thank you for your minute of 27 March. I agree with what you say in it.

2. On the draft reply to Sir Alan Walters, I have a few drafting amendments to suggest to the second paragraph, which are incorporated in the following redraft:-

✓ "You say you are at a loss to understand why it was necessary to invoke the conventions of the Radcliffe Report on Ministerial Memoirs - a copy of which is enclosed. The answer is that they exist and apply to this book, and it is my duty to draw them to your attention. ~~I am surprised that you do not already know of them.~~ They were drawn up following the Crossman diaries case. As you will see from paragraph 75, they are not backed by Statute (except, of course, if breaches of the Official Secrets Act were to be involved) but all former Ministers and officials are expected to observe them. This is the basis on which former Ministers and officials are asked to submit their memoirs before publishing them, ^{as you did in 1984.}"

3. The last sentence of your draft may give Alan Walters too strong an impression that a revised book on the lines he describes would not be open to objections. I suggest that you

revise the last sentence as follows:-

+ B "Of course, we ^{should} ~~shall~~ be ready to look again at such a book, although the fact that it may then satisfy the rules does not mean that it will avoid risk of embarrassment for the Prime Minister."

4. I am copying this minute to Sir Peter Middleton.

H.R.B.

ROBIN BUTLER

28 March 1990

FILE JD



c: Walters

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

SIR ROBIN BUTLER

I have received the attached letter from Sir Alan Walters which follows a telephone conversation I had with him. I made no apologies for the forthright tone of my letter (I would not accept that it was hostile). I told him there was no point in pulling punches at this stage only to find ourselves at cross purposes later on. My purpose was to make it quite unambiguous that a book with a title proposed, and developing the theme of Chapters 1 and 6, was strongly opposed by the Prime Minister.

2. It is clear that others, for example, Mather and Eltis, have also told Sir Alan to cut out the personal stuff. If he is prepared radically to recast the book, and in particular the offending chapters, then I think we should be ready to look at it afresh.

3. What may emerge is a book which is critical of the conduct of monetary policy, and in particular the flirtation with the ERM, but which expresses that criticism in terms of the Government rather than attempting to pin the blame on Mr. Lawson personally. Such a book may well satisfy the Radcliffe conventions, though it may still be unwelcome to the Prime Minister. We will then need to take her mind on whether she wants to seek postponement, but that would be an appeal more on political grounds than on the grounds of propriety.

4. I attach a draft reply on which I would welcome comments.

5. A copy of this minute and enclosures goes to Sir Peter Middleton.

AT

27 March 1990.

PERSONAL AND CONFIDENTIAL

DRAFT LETTER TO SIR ALAN WALTERS FROM ANDREW TURNBULL

Thank you for your letter of 20 March. I do not accept that my letter to you of 13 March was hostile. It was blunt, but its purpose was to make clear to you how strongly people here would feel if you were to publish something along the lines of the original draft. It would have served neither of us to have pulled punches at this stage only to let misunderstandings develop later.

You say you are at a loss to understand why it was necessary to involve the convention of the Radcliffe Report on Ministerial Memoirs - a copy of which is enclosed. The answer is simple - that they exist and it is my duty to draw them to your attention. It is not for me to decide where they should and should not be invoked. As you will see, however, from paragraph 75, there are no legal sanctions underpinning these conventions.

I see that it is not just me who has counselled you to recast the book to cut out what you yourself identify as "personal animus" and "political poison". If you are going to recast the book radically to examine "calmly and dispassionately" the case for freedom or fixity of the exchange rate, then you will be producing a quite different sort of book. In these circumstances we are, of course, ready to look at the matter afresh.

jd c:draft

2820 P St NW
Washington
DC 20007
USA

R2713

March 20th 1990

Andrew Turnbull,
10 Dowing St.,
London SW1A 2AA

Dear Andrew,

I was surprised at the hostile tone of your letter of March 13th. As I have repeatedly said, I would not do anything that could in any way harm the Prime Minister. This was the context in which I sent you what I emphasised was literally a first draft. I was reluctant because there was so much that was wrong with it. You were very anxious, however, to see this first draft, in spite of the fact that I told you that much had to be changed - especially the perhaps understandable but clearly unacceptable personal references to Mr. Lawson. I proposed to Graham Mather that we trust the advice of his panel of readers (Walter Eltis in particular) to instruct me on how to eliminate the personal animus, which, I believe, subtracts from ~~the~~ any value the book may have in setting out and settling the issues.

I am at a loss to understand your invocation of the Radcliffe Report on Ministerial Memoirs. It is the first I have heard of such a Report, and I would be glad if you would send me a copy of the complete Report. (From what I read however of Dick Crossman and Barbara Castle, they cared not a fig for the Radcliffe "Convention" of the third category in para 49). If you intend to pursue this line of restraint (and for the life of me I cannot see why it is necessary), then I need to be clear on the nature of the law or the contractual obligation that I would have supposedly violated. Then I think it is a matter for lawyers to so decide. I do hope, however, that we can drop it.

You must know that there are many other accounts being written about the Lawson affair, some of them quite scandalous, others more restrained. I certainly do not want to add to any such tittle-tattle. My objective was to air the issues. not pillory the personalities. In spite of your blanket rejection of chapters 1 and 6 and your refusal to consider that any changes would make them less damaging to the Prime Minister, I think that it is worthwhile trying to purge these chapters of their political poison so that the case for freedom or real fixity in Britain during the late 1980s can be examined calmly and dispassionately. Not only Britain but much of the world has much to learn from these years.

Finally, as a practical matter, I probably do not need to warn you that there is the possibility of unauthorized publication. I do not have the security system or the legal resources that I enjoyed in Downing Street to prevent leaks or to prosecute leakers. Although I am sure that Graham Mather has sent the copies to trusted readers, there is, as you well know in the Treasury, always the possibility of disclosure and pirate publication. I am particularly worried about the possibility of a leak of the Prime Minister's reported vehement opposition to my first draft - this would prove devastatingly news worthy and alas damaging. Thus I am showing this letter to no-one - not even my wife !

Your sincerely
Alan Walker

ANDREW

Liz
~~File~~
Fax to Washington
Send to Anne Clack
with instructions to
fax to Washington. She
can then make it to him
when she speaks to him on the
phone.

Sir Alan is returning to the States on
16 March.

Ann gave me his Washington fax. no.
(0101 222 296 3858) and also a fax. in
Budapest at the guest house of the Hungarian
Government (no. 0101 36 1 1128617) but she is
not sure how secure this would be.

LIZ

13 March 1990

Anne Clack's fax:

01.629.9994

(Letter sent by registered
mail)

10 DOWNING STREET
LONDON SW1A 2AA

TO ANNE CLACK

FROM ANDREW
TURNBULL

DATE

13.3.90

NO OF PAGES TO FOLLOW 5

Anne

Please fax to Washington
and mention the letter to
Alan when you next speak
to him on the phone.

PRIVATE AND CONFIDENTIAL

ECU



file
C/PPS/Walters

10 DOWNING STREET
LONDON SW1A 2AA

bc FERIS
Sir P. Riddleton

From the Principal Private Secretary

13 March 1990

STERLING AND INFLATION IN THE 1980s

When we spoke on the 'phone, I raised a number of objections to your publishing a book in the form proposed. You asked me to set these out for you in writing.

First, publication of an attack of this sort on the last Chancellor of the Exchequer written by you as an internal adviser in the centre of Government economic policy making, known to have the confidence of the Prime Minister, would be entirely contrary to the conventions on memoirs by former public servants. I attach a copy of relevant paragraphs of the Radcliffe Report on Ministerial Memoirs. (I can provide a copy of the complete report if you wish.) The fact that for much of the period about which you write you were outside the Government would not mitigate this.

Your book would be bound to call forth a hostile response from Mr. Lawson. Apart from his statement to the House and one television interview, Mr. Lawson has made no public comment either on his stewardship as Chancellor or on the circumstances leading to his resignation. He is writing a book but intends to publish it after the election. The effect of your highly personal attack on him would be to goad him into a counter attack on you as an adviser. This would attract a lot of sympathy and would be very damaging not only to the Government but also to the future confidence between Ministers and advisers, and to economic policy making in Government. In short, it could only lead to a situation which, as Radcliffe expressed it, was "destructive of the confidential relationship which may subsist between Minister and Minister, Ministers and their advisers, and between either outside bodies or private persons".

The Prime Minister also would be put in an impossible position. She would be asked if she had seen the book in draft; and would have to reply that she had. She would then be accused of condoning a stinging attack on a former colleague. Her only way out of this would be to let it be known that she had objected to the publication of the book in its present form and had requested you not to proceed with it.

I do not believe that these objections can be dealt with by drafting changes to "tone down" the references to Mr. Lawson.

PRIVATE AND CONFIDENTIAL

The whole theme of the book, as summarised in the opening chapter, is that Mr. Lawson was personally responsible for a major mishandling of economic policy and you invite the reader to draw a comparison, in an eye catching way, with what many saw as one of the most serious errors of economic policy this country has known. While it may be a convenient shorthand to identify Mr. Lawson personally with recent policy, you ignore the fact that you cannot attack him without at the same time attacking the Prime Minister since she, as a colleague in the Cabinet, is bound to share responsibility collectively for the conduct of policy.

I have to ask you, therefore, to postpone publication for a considerable period and radically to recast chapters 1 and 6. I want you to know that I have shown this letter to the Prime Minister and that she has specifically authorised me to write to you in these terms. You should be in no doubt therefore that the request to postpone publication represents her views.

I have also discussed the draft of the book with the Secretary to the Cabinet and this letter reflects his advice.

(ANDREW TURNBULL)

Professor Sir Alan Walters

so as to give time for clearance on reserved subjects, discussion of objections, mediation and, where appropriate, advice. This amount of consultation is the necessary condition of the liberty that he is given.

45. Within the limits of the general conception that the author is free to use his Ministerial experience for the purpose of giving an account of his own work and not for the purpose of discussing or criticising the policies and opinions of other Ministers who have been his colleagues, we identify certain separate categories of subject that call for restriction. We will mention and discuss them in what follows.

46. First, the author must not reveal anything that contravenes the requirements of national security operative at the time of his proposed publication. We do not anticipate serious debate about this. Secrecy on such matters is regularly accepted in other countries, and we have not observed any disposition to question its propriety in controversy in this country. National security is a vague enough idea in the conditions of the modern world and its subjects range much further afield than the simpler categories of earlier days, such as the plans of fortresses or the designs of warships or aeroplanes. Nevertheless experience has shown that, when it comes to a practical issue turning on a particular set of facts, it is not usually difficult to agree whether they fall within or without the security net.

47. Ministers are likely to come into possession of secret information of this sort during their period of office. The significance of such information is often shortlived: but not necessarily so. That is a point upon which the ex-Minister, just because he is retired, is not competent to rely upon his individual judgment. He must, we think, be content to await clearance from the Government of the day on any disputed security issue. How this is to be done and what possible right of challenge he may invoke we will deal with when we come to the title of "Enforcement" in Part III: but as to his general obligation to subordinate his judgment to that of those carrying the immediate responsibility we feel no doubt.

48. The second category is that described by Sir Edward Bridges as disclosures which would be injurious to this country's relations with other nations. They seem to us very much on a parallel with those offending national security and they raise the same sort of considerations. This country does not exist in a world in which we can escape the necessity of maintaining friendly and often confidential relations with other countries, upon which the negotiation and maintenance of international treaties and treaties of trade and commerce depend; and an ex-Minister cannot claim to be free to use at his own discretion any of the information potentially affecting such matters that has come to him by virtue of his office. He must clear what he wants to say with those in authority under the Government of the day. We do not in the least wish that the edge of what he wants to say should be blunted by the imposition of the small courtesies of diplomatic life. He should be given as much liberty of disclosure and of robust expression as the true interests of his country do not manifestly forbid; but in the end it comes down to the fact that he does not and cannot hold the keys to the despatch boxes of the day nor can he be fully admitted to knowledge of their contents and of their current significance. We think that here again it is his duty to defer.

49. The third category of restriction has as its text the phrase "information the publication of which would be destructive of the confidential relationships . . . which may subsist between Minister and Minister, Ministers and their advisers, and between either and outside bodies or private persons". The idea is very comprehensive, it involves the exercise of a much more subjective type of assessment than that required for the two preceding categories, and its application to any given set of circumstances calls for what is essentially editorial judgment. For this reason alone it does not break down easily into any set of more precise rules. It is a general principle and everything depends on its interpretation.

50. These considerations, which distinguish it from the previous more objective categories that we have discussed, may well justify a distinction also in the arrangements for its enforcement, which we shall come to in Part III: but we are convinced that they do not invalidate the importance of asserting the general principle. We asked ourselves very seriously the question whether, with all the pressure of the day in favour of openness of government and public participation in the formation of public policies, the principle itself which enjoins confidentiality in all that goes to the internal formulation of Government policy ought to be regarded as an outmoded and undesirable restriction. We always came round to the same answer. It is necessary and it ought to be observed.

51. The argument in its favour is quite simple and does not gain by elaboration. We have indicated it before. Those who are to act together in pursuance of a policy agreed in common do require and expect the observance of confidence as to what they say to each other; and unless they can be assured of the maintenance of that confidence they will not speak easily or frankly among themselves. Opinions, perhaps unpopular, perhaps embarrassing, will be muted or suppressed if they are known to be liable to future disclosure at the whim of some retired colleague. Business which should be discussed by the whole body will tend to be settled by two or three in a corner. Given our system of Cabinet and Parliamentary government, the interests of the State will suffer if policy cannot be formed on a basis of mutual confidence. We realise, of course, that this depends on a very sweeping generalisation about the likely conduct and responses of a succession of very diverse public figures. We do not suppose that they will all react in the same way. But the history of the development of the tradition of confidentiality as well as the experience of the present leads us to accept the generalisation as a working principle.

52. The proceedings of the Cabinet are the classic model for analysing the need and purpose of confidentiality. Cabinet Committees, however, are no less at the centre of the process of government and they attract the same principle. So too, we think, do all the interdepartmental exchanges that one Minister finds himself engaged in when discussing Government business with one or more of his colleagues. They should all be governed by the same general rule.

53. So much for Minister and Minister. But the relation between a Minister and his advisers in the Civil or other Services is just as clearly one of inherent confidence. Indeed the case of the departmental adviser is stronger than any other since it is his professional duty to tender his advice

when so required, and in our view it is critically important that he should be free to do so in the assurance that the confidence that he has given will be respected. He should be entitled to think that his advice will be confined to the departmental purpose that called it forth and will not be treated as available for general publication and comment by the Minister to whom it was offered. We accept the validity of the description of an adviser's task which Lord Bridges offered to the House of Lords after his retirement:

"He has to analyse the position and set out all the courses, and not cover up any uncomfortable facts. That is a job which has to be done fearlessly and frankly, and if it is going to be done as it ought to be done, the people concerned must have confidence that their advice will not be disclosed prematurely. That, of course, is the basis of the whole confidential relationship between civil servants and Ministers, and likewise between Ministers and the Cabinet."⁽¹⁸⁾

54. We have no doubt that the emphasis in that general statement lies in the word "prematurely". The adviser needs no assurance of permanent protection for the confidentiality of his work and the public would be the loser if such secrecy were to be enforced. But he is a professional man whose whole career is *prima facie* committed to working in the public service, and the period over which it is fair to give special attention to his claims cannot be less than that of the remainder of his Service life. In service he cannot fight the memoir writer on equal terms. The discipline of the Service itself ties his hands, and it is desirable that it should. Controversy would be disastrous to the ethos of a Service that prides itself on impartial loyalty to its political masters: but the obligation must be understood as reciprocal, and one of its essential terms is that the Minister must observe a scrupulous reticence with regard to the attitudes and personalities of those who have served him in office. When we come to Part IV, we shall say something on the related topic of publication by former members of the public services.

55. The only other aspect of the obligations of Service loyalty that we need mention is one which has recently been brought into prominence by the Crossman case. A Minister in office has to come into contact with the problems of personnel management in the Department for which he is temporarily responsible. He receives recommendations, assessments and criticisms of the senior officials in his Department and elsewhere and it is as much his duty to attend to them for the purpose of appointments and promotions as it is of others to tender him their candid opinions about them. It seems to us wholly repugnant that he should at a later date regard himself as free to record this material and discuss it in the course of a public account of his Ministerial experience. We regard it as belonging to the essential intimacies of personnel management, in government no less than elsewhere.

56. We are able to extract from the considerations as to confidentiality that we have now laid out three working rules as to the reticence due from an ex-Minister. We will phrase them as follows:

- (a) In dealing with the experience that he has acquired by virtue of his official position, he should not reveal the opinions or attitudes of

colleagues as to the Government business with which they have been concerned. That belongs to their stewardship, not to his. He may, on the other hand, describe and account for his own.

- (b) He should not reveal the advice given to him by individuals whose duty it has been to tender him their advice or opinions in confidence. If he wishes to mention the burden or weight of such advice, it must be done without attributing individual attitudes to identifiable persons. Again, he will need to exercise a continuing discretion in any references that he makes to communications received by him in confidence from outside members of the public.
- (c) He should not make public assessments or criticisms, favourable or unfavourable, of those who have served under him or those whose competence or suitability for particular posts he has had to measure as part of his official duties.

57. These obligations of reticence are not owed merely or even primarily to the individuals whose opinions, advice or qualifications are involved. They are public duties. They cannot therefore be released by the consent of such persons. The rules themselves and the general principle of which they are only the exponent are far-reaching and their application to the needs of particular sets of circumstances will often prove to be matter of debate and will call for sympathetic adjustment. How best to approach the question of securing their observance is something which belongs to Part III.

⁽¹⁸⁾ 282 H.L. Deb. 5s., 1666, 11 May 1967.

PUBLICATIONS BY FORMER MEMBERS OF THE
PUBLIC SERVICES

88. Having completed our consideration of the arrangements which should govern the publication by former Ministers of memoirs and other works relating to their experience as Ministers, we are now required by our terms of reference "to examine the implications of these arrangements for the rules governing the publication of similar works by former members of the public services".

89. We have already quoted in paragraph 14 the statement made by Mr. Morrison in 1946. This covered the obligations not merely of ex-Ministers but of all those who had held office under the Crown, "including former members of the Foreign, Colonial and Home Civil Services and the Fighting Services". They were to apply to the head of their former Department or to the Board of Admiralty, Army Council, or Air Council as the case might be. Their obligation was "to consult . . . in regard to the publication of any unpublished information which they have obtained by virtue of their official position and to obtain formal permission in any doubtful case".

90. This obligation is currently reflected in the detailed provisions governing the respective conditions of service in the Services concerned.

91. In Part II, we have identified three categories that call for restriction on the publication of memoirs by ex-Ministers: disclosures which would contravene the requirements of national security; those which would be injurious to this country's relations with other nations; and those which would be destructive of the confidential relationships on which our system of government is based.

92. It is clear to us that, in relation to possible disclosures of the first two kinds, a former public servant should be under just the same obligation as a former Minister to submit his manuscript to scrutiny by those carrying the immediate responsibility in the relevant fields and to defer to their judgment.

93. As regards disclosures destructive of Confidential Relationships, the obligations of former Crown servants other than Ministers arise in two ways:

- (a) They are privy to many of the confidences exchanged between Ministers which we have discussed in earlier Parts of our Report, and it is an essential part of our system of government that Ministers should feel uninhibited about admitting their officials to these confidences and talking freely with them. It follows in our view that a former member of the public services should be subject to the same obligations as a former Minister to protect confidences of this kind.
- (b) In their capacities as advisers to Ministers of successive administrations, members of the public services are required not to disclose to Ministers the views expressed by their predecessors of a different political persuasion nor the advice on which those predecessors took

memorialist should refrain from disclosing official advice for a period of 15 years or for the remainder of the Service life of the adviser, whichever be the longer. We are in no doubt that a former member of the public services should be under the same obligation.

We thus conclude that, in this matter of Confidential Relationships, the principles which we have enunciated concerning publications by ex-Ministers, the obligations which we have suggested should rest upon them, and the periods for which those obligations should be maintained, should all be reflected also in the rules governing the publication of memoirs and other works relating to their official experience by former members of the public services.

94. We have not considered what steps may be necessary to give effect to the conclusions in our two preceding paragraphs, nor whether they have implications for the process of submitting applications to Heads of Departments which was laid down in Mr. Morrison's statement. These we regard as matters for the Departments concerned.

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17 April 1990

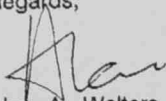
Mr. Andrew Turnbull
Principal Private Secretary
to the Prime Minister
Office of the Prime Minister
No. 10 Downing Street
London SW1 A2AA
UNITED KINGDOM

Dear Andrew:

I enclose a new version of Chapter 1. I have purged it of material that you might find offensive and rewritten it substantially. I have also carried out similar amendments to Chapter 6. The arguments are the same, but the text is now sanitized.

I would be glad if you could give me a speedy opinion on Chapter 1. It would be useful at this stage if you could be specific with your objections.

Regards,


Alan A. Walters

Sterling and Inflation in the Eighties:

Code : F:\AAW

Date : Dec 11th 1989

Chapter 1.
Floating and Anchoring CurrenciesTwo Fixes - 1924 and 1987

In the long record of financial history, moneys have normally been either commodities, such as silver or gold, or titles to specific quantities of such metals. ~~The convertibility of sterling currency notes into gold.~~ In fact, since 1717 Britain has spent more than 200 years with a gold convertible currency. During wars and their aftermath, gold convertibility was usually suspended but was resumed again after a period of inconvertible paper currency. Under the exigencies of World War I, Britain decreed the gold-inconvertibility of the pound and allowed sterling to float. The post war inflation and rapid deflation, as well as the 1923 hyperinflation in Germany, gave graphic evidence of the fragility of irredeemable paper currencies. An anchor was required. In the mid 1920s, therefore, it seemed entirely natural to return to the standard which had served the Western countries well in the last half century - gold. After eight years of a floating exchange rate, in 1925 Churchill, then Chancellor of the Exchequer, had chosen to peg the pound at the equivalent of the pre-war parity of \$4.87 (the United States dollar was convertible into gold at \$34 per fine ounce).

In one of the great economic tracts of the 20th century - "The Economic Consequences of Mr. Churchill"(1925) - John Maynard Keynes argued that the return to the prewar gold parity for sterling would entail the most painful deflation of British prices and wages. Keynes said that at a stroke it would render uncompetitive much of industry, and particularly the great export trades such as coal. Keynes proved to be quite right. In particular the pressure to reduce wages and make coal exports profitable lead to the strikes of 1926, which embittered workers and exacerbated class conflicts for many years. True, Britain continued to grow in 1926-28, but at a low rate compared with the United States and Germany. Finally the high value of sterling exacted its toll in full measure when the world economy took a sharp downturn in 1929. The dole queues lengthened dramatically and output fell sharply. Only when Britain went off gold, in 1931, did the economy show signs of recovery. With a floating rate from 1931, Britain's recovery proceeded until overtaken by the rumblings of World War II.

The return to a golden anchor had validated all Keynes' dire predictions. He saw the advantages of an anchor, but he condemned the tight golden chain which would pull the ship underwater; he wanted enough chain to manouvre the ship of state. Keynes knew that World War I had seen the end of the old gold standard. Countries were no longer prepared to follow the old golden rules; allowing the money supply to

contract when they lost, and to expand when they gained, specie. Governments wanted to have their cake and eat it. More than ever before World War I they wished to tailor their domestic monetary policy to their need to create jobs, rather than allowing the gold flows to dictate monetary contraction and further recession. This fundamental dilemma was put succinctly in 1923 by Keynes in yet another great tract.¹ If there is a conflict between the policy requirements for domestic conditions and the policy needed for international obligations, then, argued Keynes, domestic objectives should take precedence. Certainly in those years between the two world wars, Keynes was proved to be right.

In the 1980s, alas we have no Keynes (but) the same dilemma persists. The menu of choice, however, had been widened. In the 1920s Churchill's choice was between floating and joining the gold standard at a truly fixed rate. It was expected that the parity would "never" be adjusted (except under the then unthinkable conditions of another World War), and the rate was to be kept within the "gold points" - about 1/2 percent. By the 1980s, however, we had experienced the "fixed but flexible" - or pseudo-fixed - system of Bretton Woods and, in the 1970s and 1980s, the European "snake" and its successor, the European Monetary System (EMS). These systems were eventually quite free from any gold anchor. They provided for much more variation about the par value (plus or minus 2.25 and even 6 percent in the case of the EMS). Furthermore, after consultation and some sort of agreement, the par or central value could be realigned. With a bureaucratic logic, these "fixed but flexible" systems were thought to capture the best of the truly fixed anchor and the best of the free flexible float. The central banks could keep their power to create money at their (or their government's) discretion to control demand, while at the same time an anchor (albeit a rather draggin anchor), not to gold but to a trusted currency such as the dollar in the 1950s and early 1960s or, ~~as far as the European Community was concerned,~~ the Deutschmark in 1970s and 1980s, would prevent inflation or deflation getting out of hand. *Because of its special status as an international and oil currency, Britain drifted out of the ERM.*

During the 1980s there have been many campaigns to induce Britain to join the Exchange Rate Mechanism (ERM) of the EMS. ~~This would then provide an albeit dragging anchor in the form of the Deutschmark.~~ It has been widely represented as a touchstone of the degree of commitment to the European Community or to the objective of a monetary union of Europe. Much of the support for joining the EMS rests not so much on economic argument as on political conviction and concern about "missing the Eurobus", two-tier Europe, and on a forlorn Britain excluded from the great blocs of the rest of the world. *130 Oct 85* But as so often the case, political persuasion and debate, in its search for alliances and support, ignores critical differences in economic analysis and policy. One of the main points of this book is that in economic terms one can see much virtue in either absolutely free exchange rates and, alternatively, in a monetary union with a unified currency; yet the pseudo-fixed system of the ERM is an anathema and inherently flawed. Consequently in economic terms, it is quite sensible to have serious reservations about the ERM/EMS but to be an enthusiast for

¹ A Tract on Monetary Reform, 1923, reprinted in Keynes, Collected Writings, Vol IV, London Macmillan for the Royal Economic Society.

some particular forms of monetary union.

The unity of Europe was also a major difference compared with Churchill's interwar uncertainties. European union was far from Churchill's mind, whereas today Eurounion proceeds at a rattling pace. Europhilliacs (or Europhiles) have identified the degree of enthusiasm for ERM/ERS participation as a "touchstone" measuring the degree of commitment to a United Europe (Economist Dec 9th 89). In political terms, however, M. Delors has persuaded the media that enthusiasm for the EMS is the acid test for communautaire, and that the ERM is the only path to economic and monetary union.

In 1925, Churchill looked towards what appeared to be the only safe anchorage the world had known - gold convertibility. Keynes may well rail against gold as a "barbaric relic" but it had always been the refuge of any responsible government after periods with an inconvertible paper currency. The dollar then was "as good as gold" - with no fears about inconvertibility. And so the dollar was disciplined by the promise of the Federal Reserve Board to redeem dollars in gold.

In the 1980s, however, the gold anchor had long been cut loose by all states. Nor had any other commodities, or bundles of commodities, replaced gold. (This had occurred formally when the United States severed the gold link, but in reality convertibility had been much diminished in the years after World War II). When the British government decided to peg sterling in 1987, it was not to gold but to the Bundesbank's Deutschemark. And the Deutschemark had abolished gold convertibility almost two decades before.

The consequences of the fix of 1926 were severe. As Keynes so powerfully argued, the return to the gold standard at \$4.83 rendered British exports (particularly of coal) quite uncompetitive on world markets, so the only possible adjustment for British wages and prices to fall. And Keynes rightly predicted that the only way they could fall was by having a prolonged recession. And in 1926 Britain began the downswing into the great depression. Only in 1931 when sterling was floated free off its gold anchor and depreciated did Britain begin to emerge from the slump. The cost of Mr. Churchill was far greater than even Keynes calculated. And the divisiveness and distortions of that period remain with us, in muted form, even to this day.

In 1987 sterling was pegged at 3.00 (or strictly just below 3) Deutschemarks. True this was no official peg, but the markets were given to believe that 3.00 was the appropriate value and that the Treasury and Bank would jolly well see it stuck. Everyone believed it. Why 3.00 and not 3.30 or 2.70. It is not clear why this value was chosen as the pegging level - partly, one supposes, because it had been hovering near three at the time, or perhaps because it is nice round number. If one wished to provide a rationalization consistent with economic theory, one would have to argue that 3.00 was near and under expected differential inflation rates, was likely to remain near the "fundamental real equilibrium exchange rate" (FREER) - an elusive concept that will worry me, if not you the reader, in chapter..

The 1925 fix was much more disastrous than that of 1987. Instead of the for six years of absolute fixity to 1931, the wobbly fix of 1987 did not make it through a

second year. In 1926 Churchill fixed above the market, making sterling too dear, whereas in 1987 sterling was fixed initially below the market value making the pound too cheap. In stead of the National Strike of 1926 and the depression and deflation of the 1930s, the pegging of sterling in 1987 launched Britain into a boom and inflation. Soon the inflation and the rise in interest rates required to control the monetary growth and prevent that dreaded "free-fall" of sterling ensured that a marked slowdown, even a recession would required in order to restore price stability.

The consequences of returning to gold in 1925 included a breakdown of the international trade and monetary systems, massive trade restrictions, ultimately exchange controls, and all the curious panoply of agricultural support, 'reconstruction' measures that are still with us in one form or another. The short fix of 1987, I believe, is likely to have no such long term consequences. It is plausible to suppose that it will be but a "blip" (but rather a large one) on the third Thatcher government's record, and that open commodity and financial markets will continue to be the proud result of the Thatcher renaissance.

Fixes, Floats and Fudges in Exchange Rates

Of course I cannot leave the matter there. Underlying much of the discussion of international monetary arrangements in the 1970s and 1980s has been the yearning for some system. The present arrangements where the major currencies, dollar, Deutschemark and yen, float more or less freely against one another, is often called pejoratively the non-system. Notwithstanding the obloquy that has been poured on this non-system, certainly since 1982 it has served the world well in. first the disinflation of the early 1980s and secondly it has provided the stable environment for the longest inflation free expansion in most Western countries. Yet there is good reason for believing that although the non-system has performed remarkably well, if there is no acknowledged anchor for currencies, there are still dangers of runaway inflation.

The underlying rationale of the EMS/ERM was that, while we could not anchor to any commodity or gold, we could anchor to the currency with the best reputation and institutions to ensure stability...the "zone of stability" which was the original aim of the founders of the EMS. There is much to be said for this basic idea, provided that the rate is absolutely fixed. But, over the life of the EMS, exchange rates have not been fixed. They have wobbled in the band and moved at realignment. If the ERM/EMS rates had been really fixed, instead of pseudo fixed, then there would be no possibility of profit from speculative capital movements, and indeed one of the main indictments of the EMS would have been null and void.

There is, however, a fundamental divide on the issue of fixed and pseudo-fixed exchange rates and monetary policy. I argue that absolutely fixed exchange rates is a good alternative to a free float. But then you must set up monetary institutions, such as a currency board, that are consistent with such fixity. There is no room for a monetary policy at all; in that sense monetary sovereignty is relinquished to Germany. This is a matter of both logic and fact, as is clear from the records of the many countries that have, over centuries, operated currency board systems. The only monetary role of a central bank is to exchange currencies at the fixed rate. I regard

the pseudo-fixed system, with its wobbling in the band and the propensity to leap to a new level on a 'realignment' session, as the worst of both worlds. Furthermore pseudo fixed exchange rates are accompanied by a pseudo monetary policy. Both are indeed half-baked.

Another disconcerting feature of the EMS/ERM arrangement is its dependence on the proper behaviour of the Bundesbank as an anchor. Historically, over more than three decades, the independent Bundesbank has behaved, if not impeccably, then certainly far better than any other central bank in defending the value of its currency. But, apart from the question whether that is good enough, legitimate doubts may be voiced about whether history is a reliable guide to future performance. Will the Bundesbank maintain its true independence and will it be able always to resist political pressures, such as those arising from the unification of the two Germanys, or those which emerge from international coordination similar to the Louvre accord?² One notes that the Federal Reserve Board, the other major independent central bank, did succumb to political pressures to inflate in the 1960s and 1970s. Inevitably the Bundesbank, just like the Fed, depends on the discretionary behaviour of people, rather than on the automatic rules of the old gold standard. C

An Inflation-free Currency for Europe

Mr. Lawson's idea that there should be competitive currencies to see which is the choice, not of the bureaucrats of Brussels, but of the private citizens of Europe is attractive. However I believe that there should be another competitor in the field - a currency which by its very constitution is neither inflationary nor deflationary. A currency which maintains its constant and true value in terms of a defined basket of goods, such as the average consumption basket of European citizens. We shall call this currency an ECOM, to indicate that it is a European commodity money. Such a currency could be written into the constitution of Europe. It requires no central bank, only a bank of issue or currency board.

If the ECOM is successful in its competition with other currencies, then it has a fair chance of being adopted as "the" currency of Europe. Indeed governments may agree to allow their currencies to be subsumed, initially by fixed exchange rates with the ECOM, and then entirely abolished in the adoption of the ECOM as the European currency. The great advantage of the ECOM is that it does not involve any surrender of sovereignty to any Central Bank of Europe, to the Bundesbank, or to Brussels bureaucrats or European politicians. A Community state will surrender its monetary sovereignty to the principle of an inflation-free currency. That may well be a surrender which might be attractive to many of the twelve.

And not only the twelve. Since the departure from the old gold standard in 1914, the whole world has experienced persistent inflation (the only exceptional period being

²The retirement of that rock of monetary integrity, Dr. Helmut Schlesinger in 1990 will provide a good test of the robustness of the institution.

the period from 1929 to 1936.). The world cannot and, indeed should not, return to the old gold standard or any version of the gold exchange and Bretton Woods systems. Gold is indeed a barbarous metal, of dubious provenance and subject to all the vagueries of technology and taste. A currency based on preserving constant the unit of account for a wide basket of commodities is much more desirable than a monetary unit linked to merely one precious metal. Nor do we need to keep stocks of commodities to operate the system. We can create paper assets which perform as surrogates for such commodities (unlike the old gold standard where stocks of gold were de rigueur). The attractions are clear. And if the Community were to make an obvious success of this ECOM, would not the United States, Canada, Japan etc be quick to follow? Just as the old gold standard rose around the preeminence of a liberal Britain, so might the ascent of a truly liberal Europe promote the new Thatcher standard by the end of this century.

Such reflections are, of course, far beyond the economic consequences of Mr. Lawson. But Mr. Lawson can fairly claim to have opened wide (perhaps inadvertently) the debate on the monetary constitution for a liberal Europe. I hope that this book will add at least something to the debate.

Chapter 2

Ideas on Money and Exchange Rates

Definitions ?

Ask the man on the Clapham omnibus, "what is money?" and he will give you an immediate answer. It is what he uses to pay his fare. It is the stuff with which one pays ones bills. The Clapham answer is a useful one for even the most highbrow economist. Money is the medium by which we make payments in discharging our obligations.

Monetary Policy and the effect on Exchange Rates

Exchange Rates

An exchange rate is the price of one money in terms of another. A pound is expressed as, say 2.5 Deutschemarks, a dollar as 0.65 of a pound. A fall in the price of a pound, to 2.0 Deutschemarks is often called a depreciation of the pound in terms of the mark, or symmetrically it is an appreciation of the mark in terms of sterling. But those terms are simply synonyms for movements in the price.³

³. I would warn the reader that exchange rates are subject to very misleading terminology in different parts of the world. If the price of a Mexican peso falls in terms of US dollars, the Mexicans would refer to this as the exchange rate of the peso "rising" not falling. The reason for such a usage is that in Latin America generally, and

part this may be due to the perverse incentives generated by the ERM. The essence of the ERM prevents automatic adjustment mechanisms in response to shocks, and induces perverse oscillations in monetary policy. Ironically the ERM mechanism works well when there are the same inflation and interest rates in all countries - but then why bother ?

Chapter 6

Chapter 6

Exchange Rate Policy and Politics
The Lawson Years

The Medium Term Financial Strategy

As the EMS started on March 13th 1979, Britain had to have an election within the next three months. The economy was in a parlous state. Neither party had any intention of joining what most thought to be an offspring of a snake. Experience since the breakdown of Bretton Woods showed that it was extraordinarily difficult to maintain nominal exchange rates at levels which differed substantially from the market. The massive outflows and inflows of money in 1975-77 had made their point.

The first Thatcher government saw its first main task as that of securing financial stability. In particular the high inflation, at an underlying 15 percent, had to be brought under control. The main instruments for bringing inflation under control were evident from the beginning; the rate of growth of the money supply, which in the first half of 1979 had been running at some 16 per cent, had to be brought down. Mr Lawson was one of the main architects of the document that set out Britain's Medium Term Financial Strategy. This envisaged a steady downward trend in the rate of monetary growth (of M3) and a decline in the fiscal deficit that was consistent with the monetary targets. If anyone suggested that Britain should tie itself through a fixed exchange rate in order to reduce inflation, I can attest that the suggestion did not get very far.

To the modern reader this may seem odd. In the many attempts that have been made to control inflation (albeit near hyperinflations) in Latin America, in Israel and now in Eastern Europe, the conventional wisdom is that the exchange rate must be controlled and usually that it should be fixed. But even in France and Italy in 1979-81 where inflation was in the teens, a fixed (or strictly pseudo fixed) exchange rate was thought to be a central plank of a disinflationary policy. It was a way of converging on the low inflation rate of Germany. Why not in Britain ? And indeed why not in the United States ?

The first answer is that while an exchange rate fix may be useful for bringing really high inflations down, it is clearly not a necessary or even useful condition for controlling inflation rates of circa 10 to 20 percent. The disinflationary policy with a flexible exchange rate will have lower costs than the policy of fixing the rate. (The evidence on the higher growth rates and lower inflation rates of the non-ERM countries reviewed in chapter 5 is relevant here.) The argument, however, may be that one needs an anchor for the currency in order to ensure that the appropriate monetary squeeze is properly applied; one can, so to speak, trust the monetary authorities to stick to an exchange rate target whereas, because of political pressure it is very difficult for them to pursue the appropriate policy of monetary restraint. That view is clearly not merely discredited but shown to be perverse by experience both in the UK and the USA. As we saw, both sterling and the dollar soared to new heights as the monetary squeeze took effect. If an exchange rate fix had been employed in the UK, then the monetary squeeze would have been quickly reversed in order to stop sterling rising above its upper bound. The fix would have had the opposite effect on monetary policy to that which was intended.⁵³ The inflations would have been refueled rather than doused.

Secondly, and this is peculiar to the UK not to the USA, Mrs Thatcher first major act in international economic policy was to abolish exchange controls in 1979. No such liberalization would have been possible if Britain had been on a fixed exchange rate regime. And since the effects of the abolition of exchange controls were unknown (and incidentally turned out to be quite different from forecasts), it would have been folly on a grand scale to give any commitment to any fixed regime. In addition, it was widely argued, Britain was a large oil producer, and one could not anticipate, nor be expected to counter, the effects of variations in the oil price on the exchange rate. For my part, I doubt whether the oil-price argument was entirely valid, or if so was at all powerful.⁵⁴ Most observers, however, believed that oil was most important, and there is no unequivocal evidence to discredit that view. So it was prudent to eschew the ERM and all its uncertainties.

⁵³ I confess to being most dubious about the advantages claimed for an exchange rate fix as a necessary element of a monetary reform program. It has failed in Argentina, Brazil and Chile in the 1980s. The seemingly effective case in Israel turns out, on examination, to be quite different from appearances. Israel fixed to the dollar in 1985, but this was just at the peak of the dollar value. From 1985 the dollar fell precipitously, and this ensured that the effective exchange rate of the shekel also fell. The nominal fix was not an effective fix. By 1989, however, the inflation rate of Israel had risen again to 20 percent. Bolivia is also a case where the exchange rate fix appeared to work well - but again it was over the same lucky time period. The essential element in both, albeit partial, successes was the reduction in the monetary growth rate.

⁵⁴ For arguments on this point see my Britain's Economic Renaissance: Margaret Thatcher's Reforms 1979-1984, Oxford University Press and American Enterprise Institute, London 1986, particularly p.142, and 160 et seq.

The Role of the Exchange Rate 1980-1982

The exact role of the exchange rate in economic policy is subject to many subtle interpretations. During this period, however, there was a general attitude, albeit with different degrees of emphasis, to the exchange rate which was broadly shared by the civil servants and ministers. First the exchange rate was not a target for policy. This applied to the whole range of instruments: interest rates, funding operations, and fiscal measures. All instruments were concentrated primarily on domestic targets and indicators. The exchange rate was left very largely to market forces. This did not mean that there was no intervention at all, or even that it was restricted merely to smoothing operations. The Bank of England did, on occasion, intervene in markets quite heavily, but virtually always sterilized through the money markets. The prime purpose was to prevent what was usually called a "free-fall" in the exchange rate having an effect on the market for gilts. But there was no target rate. Indeed from the Budget on March 11th over the next nine months (to Dec 11th) the effective exchange rate fell about 10 percent.

Although the exchange rate was not a target, it would have been foolish simply to ignore it. The exchange rate may tell us something about the severity or laxity of monetary policy. This may be a useful indicator when, as sometimes happens, the usual indicators of monetary growth are badly distorted or, for some reason, unavailable. Such conditions occurred in 1981. The deregulation of financial markets caused a great growth of M3 and other broad money aggregates - the targets of the MTF. And there was industrial action by the civil service which caused long delays in the production of the monetary statistics; but of course the exchange rate was readily available.

So the exchange rate loomed large in the discussions of policy. The decline in sterling's dollar exchange rate (about 18 percent from March 10 to Sept 29) was the primary reason for raising interest rates from 12 to 16 percent. In retrospect the squeeze was overdone. The steep decline in narrow money (both M1 and non-interest bearing M1) in the third quarter of 1981 undoubtedly caused a marked slowdown in the recovery in 1982. The exchange rate had misled us into the belief that the monetary laxity was far greater than it was in reality. As for the reasons for such a misleading indicator, it was like "rounding up the usual suspects". First the United States had embarked on a severe monetary squeeze which made the normal dollar comparison particularly wayward, secondly there were rumours about the price of oil, and lastly, as reflected in the opinion polls, the government appeared to be distinctly shaky. All had a depressing effect on the exchange rate, which had nothing to do with domestic monetary policy.

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From September 1981 through to October 1982 it appeared that the authorities were on an exchange rate target of sorts. The effective rate remained in the relatively small range 90 to 92 over this whole period (1975=100). But from the overt statistics it could have been just as readily asserted that Britain was on a Friedmanian path of stable monetary expansion. Monetary growth (Mo) remained in the 2 to 5 percent range. Indeed all the monetary aggregates were in the target range for the financial year 1982/83.

Election 1983

Not only was Britain not on an exchange rate target, I believe that everyone, except the most absurd ideologists, knew that such a target, or even the market perception of such a target, might well be disastrous in the environment of a closely fought election. The scenario was stark. The Labour party platform was clearly to resocialise Britain. Inflationary expansion was one of its main planks. Increased taxation, renationalization, and a substantial spread of controls were among the main instruments for change. And various promises had been made to reintroduce exchange controls and bring back much of the capital that had fled the country so that it could finance job creation at home.

Such a program is a warning to any asset holder to get out while the going is good. The warning is the more to be heeded, the higher the Labour party scores in the opinion polls and the more it appears that the policy is expropriatory. This is a great temptation to Labour. ~~It appears that~~ The more socialist the policy, the greater the capital flight. If the government were on an exchange rate target, it would have to raise interest rates - probably very sharply. But this would squeeze business, lower output and probably throw more on the dole. Not the sort of scenarios in which governments are reelected. The alternative of avoiding the monetary squeeze and letting the exchange rate find its own depreciated level does avoid the election-induced recession.

The government followed this strategy by letting the exchange rate fall 15 percent both in nominal and real terms from November 1982 to March 1983.⁵⁵ Interest rates rose 2 percentage points, Mo's growth rate was reduced, and this was enough to ensure the gentle but persistent disinflationary pressure. In the event, the run up to the election was smooth. Although it has been claimed ~~As an example by Sir Terence Punt~~ that devaluations do even more political damage than monetary squeezes, the 1983 election discredits that view.⁵⁶

It appears that a socialist opposition has an enormous advantage in inducing capital flight, interest rate increases, and wrong footing governments economic policy. But, like most things, it can be carried too far. True the more rabid the socialist program, the greater the capital flight. But, ~~of course~~, the more extensive the expropriation, the less the electoral support. If its purpose is to maximize the probability of gaining power, then the Labour party will pitch its program to balance this reduction in the vote against the gain in support derived from the perversion of the government's policy. In the events of 1983, I believe that the Labour party, largely because of internal tensions, badly miscalculated the trade-off. Their program of old fashioned unreconstructed socialism put off the voters so that the party never really looked as though it had a

⁵⁵ This fall in the nominal exchange rate was even more sharp than the fall in 1981.

⁵⁶ ~~To do Sir Terence justice, I believe that he was arguing this in the context of an avowed fixed-exchange-rate policy, and not in terms of a floating regime.~~

chance of gaining power.⁵⁷ The Tories won.

The EMS and the 1982 Decision

The EMS, and exchange rate targetting, had hardly figured in the election at all. Labour were far more vitriolic than any Tory about the iniquities of any community constraint on their sovereignty. Nevertheless in 1981 the issue of Britain's membership had been raised, largely at the behest of the existing members of the ERM. The Governor of the Bank (then Mr. Gordon Richardson) had favoured Britain joining the ERM as soon as possible. ~~There was much more skepticism lower down in the Bank's hierarchy, but since the Bank was not a collegiate institution, little dissent percolated through to ministerial discussion.~~ The Chancellor, Sir Geoffrey Howe, was favourably disposed to the idea, ~~but no one could claim that he was enthusiastic.~~ The officials in the Treasury and particularly the Second Permanent Secretary responsible for international finance were highly skeptical. As one would expect, the Foreign and Commonwealth officials were enthusiastic - believing that joining the ERM would help in securing advantages from the EEC on such matters as the budget, trade etc. ~~Oddly enough, Lord Carrington the foreign secretary, took a much more jaundiced view of these advantages.~~ The Prime Minister was unequivocally opposed to joining the ERM, particularly in recognizing that we would be the only country with really free financial markets and no overt or covert exchange controls. ~~In her view~~ The speculative capital movements would be so destabilizing, that it would be virtually impossible to hold any rate without inducing quite perverse policies domestically.

later Lord L

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As was widely reported in the media, in January 1982 at No. 10, a meeting, chaired by the Prime Minister, was held of the Chancellor, and the Governor with their advisers; ~~later Lord Carrington joined the discussion.~~ In addition to general issues of strategy with respect to monetary policy, the meeting considered the ERM issue. After all arguments had been aired and everyone had their say, it was clear that the Prime Minister's views had won the day. There was clearly no case for joining the ERM either then or for next year. Of course this did not mean that there would never be good reason to join. Circumstances may change or the ERM may change. ~~The issue was left open, one should join only when and if it was appropriate.~~

the Foreign Secretary L

The meeting decided that it was not an appropriate time for Britain to join the ERM

That decision was fortunate. Had Britain joined the ERM at the average mark rate of 4.331 (for first quarter of 1981), it would have required very large increases in interest rates to hold this parity. ~~Even with the 2 percent increase in interest rates that actually occurred, the Deutschmark rate had slipped to 3.684 by the first quarter of 1983 - the eve of the election.~~ But in the ERM for such a short period there would have been much reluctance to realign substantially enough to put to rest the speculative

⁵⁷. It is worth noting that the government had taken many precautions against capital flight. First there had been an extensive issue of indexed gilts which would protect the holders against a Labour (or Conservative) inflation. Secondly, the government developed "Maggie Mae's" a conventional gilt with the option of switching, after the election into an indexed instrument. In the event, the capital flight was minimal.

Using the 4.331 rate that a 4% increase in interest rates is equivalent to a 2% increase in the exchange rate, the required interest rate increase would have been 6 percent rather than 2 percent

See page
for some calculation of the effect on interest rates

capital raiders. In my judgement, had we have joined the ERM in early 1982, the pressures would have been ~~so great that there was a real danger of reintroducing exchange controls.~~ *insupportable*

The New Chancellor

Mr. Lawson must be considered among the best prepared chancellors of the century. He had been financial secretary in 1979-82 and secretary of state for energy in 1982-3. In the treasury he had been instrumental in pressing through the MTFSS, the indexed gilts, and the funding policy. I believe he was a strong supporter of the whole program. ~~In my first brush with him at the time of the 1981 budget, he ask me whether it was true that I had suggested an even tighter budget than the one actually adopted. I said yes - but marginally so. His reaction was a "phew!", but in approbation rather than reproach.~~⁵⁸

On the issue of exchange rate targetting and the ERM, Mr. Lawson was firmly in the Thatcher camp. The basic policy was to continue with Sir Geoffrey Howe's gentle but persistent downward pressure on the monetary instruments to bring inflation down. The exchange rate was one of the factors to be taken into account in judging the tightness of monetary policy. But there was no targetting of the exchange rate and no shadowing of the EMS. Both these trends can be easily seen in charts... and ... (Pepper's charts III and V Note that chart III will have a notional trend value added continuing the trend fall over 1983-1986 to 1989 where it will approximately intersect at a growth rate of zero). The growth of Mo was on a gently declining trend from the middle of 1983, when it was about 7 percent per annum, to the last quarter of 1986, when it was about 3 per cent. If this downward trend had been continued then the growth of the monetary base would, by the end of 1988, have been approximately zero.

In my view the policy over the period 1983-1986 was about as close as one could get to ideal. The underlying inflation rate fell, with a bump or "blip" in 1985, from about five percent to some 3 percent in 1986. Had the policy been continued, so that zero Mo growth rate was achieved by the end of 1988 and thereafter the monetary base had remained unchanged, it is likely that the inflation rate would also have been approximately zero. Mr. Lawson had on various occasions said that the ultimate aim was to eliminate inflation completely and over the years ensure a stable price level. Here he was within two years of achieving that once elusive goal.⁵⁹

⁵⁸. I believe I first met Mr. Lawson shortly after my attack on Heath's policies in 1972. Then I had always thought he was a kindred spirit. After the fall of the Heath government, Mr. Lawson was an important discussant in developing a new economic policy.

⁵⁹. In a memorandum dated Dec 6th 1985 I said "If monetary growth (Mo) is held at its present level (i.e. virtually zero) for a period of two or three years, then it is likely that inflation will fall to about zero before the end of the 1980s and perhaps even by 1988.. At last we shall have price stability". I had left my government employment in 1984, but, as an interested citizen, I still offered my views.

The Curious Case of Hong Kong 1983

The remarkable story of how this opportunity was not merely missed but actually thrown away can only be related from my partial point of view. The conversion of Mr. Lawson to an enthusiast for Britain's entry into the ERM took place between February and November 1985. I suspect that the change in his ideas probably took place much earlier in 1984, fairly soon after his appointment as Chancellor. It may well be that the experience of fixing the Hong Kong dollar in October 1983 had a influence on his views. ?

Until the breakdown of Bretton Woods, Hong Kong had been on a currency board with a fixed sterling exchange rates. The sterling parity was maintained by the Hong Kong Currency Board always being ready to exchange Hong Kong dollar notes against sterling notes at a fixed exchange rate. During the next decade, the Hong Kong dollar could be characterised as floating amid the jetsam of the 1970s. But there was no discipline of monetary control to replace the currency board. The escalation of the US dollar, the recession, inflation, justifiable doubts about government monetary policy and the political uncertainties generated by the end of the lease (1997) caused a number of runs out of the Hong Kong dollar. These finally culminated in a massive flight in September 1983. The Thatcher government reacted with exemplary speed and decisiveness. The Currency Board was reinstated. The Hong Kong dollar was fixed at a parity of 7.8 Hong Kong dollars for a US dollar. Immediately the run ceased and capital flooded back into Hong Kong. The policy was a great success. (See appendix for a more extensive discussion).

It was clearly best to engineer a rapid return of a currency board system. Although there were many questions about the adequacy of Hong Kong's reserves, whether it should be fixed to the dollar or the SDR (I do not think that sterling was a serious possibility), and exactly how the Currency Board would operate, the need for a speedy decision was clear. The policy was duly agreed. Mr Lawson did wonder, and with good cause, why I, an avowed British floater, could be so enthusiastic in proposing a fix for Hong Kong. I explained my penchant for clarity in policy and the perils of pseudo systems. I doubt whether my explanation had any effect whatsoever, but I suspect the subsequent euphoric experience of Hong Kong did dispose Mr. Lawson, and perhaps many others, to be more favourably inclined towards a pseudo-fix for sterling.

X Preparing a Putsch for ERM 1985

The year 1985 began with the Chancellor saying that in monetary policy most attention should be paid to the exchange rate. However, in February he was still opposed to Britain then joining the ERM; but by September the campaign to join was in full swing. Corresponding to the elevation of the exchange rate into proposed ERM entry, was the downgrading of monetary indicators. Sterling M3 had been downgraded somewhat in 1981 with some attention being given to the exchange rate. In 1982 narrow money in the form of M1 had entered the target list, and the exchange rate gained even more prominence. After M0 replaced M1 in 1984, the exchange rate was accorded primacy among monetary indicators.

This became quite clear in early 1985. Base rates were increased from 9.5 percent in December 1984 to 14 percent in February. The reasons could not be seen in any sustained acceleration of Mo. True there was a spike in December, but this was soon corrected by a trough in January.

(INSERT here Pepper's Chart IV) ←

Nor could one point to any clear explosive behaviour in sterling M3, PSL2 or any of the broad aggregates.⁶⁰ On the other hand, the dramatic fall in the dollar exchange rate to near to one-for-one in February (a near 20 percent fall over the year), and the reduction of 15 percent in the effective rate were powerful reasons for the Chancellor imposing his monetary squeeze.⁶¹ Yet there was no question, at that time, of joining the ERM. Exchange rates were too turbulent and monetary conditions appeared to need tightening (at least according to the exchange rate interpretation).

But there is no doubt that joining the ERM at a propitious time had become a central plank of the Chancellor's policy. This became clear ~~to me after a visit to London~~ in early June 1985. Several city commentators had been arguing that "monetarism was dead".⁶² Were there parallels between 1972-4 and 1985-? Retail price inflation had reached 7 percent in May and June 1985 compared with 5.1 percent in mid 1984. The growth rate of M3 had begun to accelerate. In their attempts to contain the growth rate of M3, the authorities had accumulated a massive "bill mountain", which many thought, erroneously, represented a great monetary laxity. In

⁶⁰ The annual rate of growth of sterling M3 had increased from 8.2 percent in September 1984 to 10.0 percent in February 1985. By the end of the year, however, the growth rate was near 14 percent. The Chancellor was, in my view rightly, convinced that sterling M3 was a misleading indicator of monetary stringency. One should not ignore it, but in view of the rapid changes in credit markets, it was very difficult to interpret.

⁶¹ Note that the reduction in the exchange rate of the Deutschmark was only from 3.889 to 3.608 - about 8 percent - during the year ending February 1985. By July 1985 the mark was at 4.014.

⁶² For example, Phillips & Drew, "The Death of Monetarism", Market Review May 1985, and de Zoete & Bevan, Weekly Economic Survey, Issue 85/19, May 16th 1985. Of course the "death" of monetarism had been pronounced many times. In my recollection the earliest declaration was by John Kenneth Galbraith in 1980. The City commentators, however, presented various arguments to support their case. The most sophisticated analysis of the situation was given by Gordon Pepper in Greenwell's Monetary Bulletin, No. 172, May 1985. He argued that the growth of M3 was primarily due to the increase in the real interest rates, and was not a harbinger of inflation. But he did strongly, and in my view rightly, condemn the inefficiency of the demand-side control of monetary aggregates.

my view the fact that the monetary base had been well contained (see the Pepper chart IV), was good evidence that there was no inflationary Armageddon coming in 1986-87. The absence of any take-off of inflation in asset prices, particularly land and houses, was additional evidence to support the argument that monetary policy had not been loose. In the presence of both Mo and asset prices, the situation in 1985 was quite unlike that in 1971. ~~From my meetings with the Chancellor, I believe there was substantial agreement between us on these issues, and that the Prime Minister was assured that the economy was on the right track.~~

But whether and when to join the ERM was another matter on which there was no agreement. I had made my views clear in the manuscript of my Britain's Economic Renaissance, a copy of which had been mulled over in the treasury and Number 10. I do not know whether the Chancellor read my manuscript - perhaps not, because he asked me to his study in Number 11 to talk about my views on the EMS. I explained as best I could what my objections were. My notes after the meeting indicate that the Chancellor did not attempt to discredit my arguments about capital movements, exchange controls, and perverse effects; what he was concerned to stress was the discipline on any government (the possibility of a Labour government in 1987-8 was not all that remote at that time), and wage demands by powerful unions. I conceded that such a discipline argument had some plausibility, but I did not see that membership of the ERM had in fact given rise to any more stiffening of government sinews, compared with countries outside the ERM. The abiding impression, however, was the complete conviction that Britain should join the ERM as soon as possible. I interpreted his motives for initiating the discussion, and I now think perhaps wrongly, as an attempt to enlist my support in persuading the Prime Minister to embrace the ERM.

The October-November Attempt to Enter the ERM

During the next few months, the Treasury and the Bank prepared their case for entry into the ERM. By November the inflation rate had subsided to 5.5 per cent and was expected (and did) fall to about 2.5 per cent by June 1986. One of the conditions for ease of entry had been satisfied. The mark-sterling exchange rate had been fairly stable over 1984. 1985, however, was a year of great instability. The rate of 3.5 in February was clearly reckoned as too low and a threat to antiinflationary policy. By July 1985 it had exceeded 4 and this was thought to be too high and put too much pressure on industry. In early November the rate had slipped to half way between these two values, at 3.75; ~~this was thought about right.~~

~~The case for entry was put in speeches by the Chancellor and the Governor, with substantial support from Sir Geoffrey Howe. It was argued that joining the ERM (and I believe everyone had in mind the narrow band of plus or minus 2.25 percent) would reinforce the counter inflationary strategy. It would be not only an anchor but an observable and credible anchor. Businessmen would know that they could not look to a slide in the exchange rate to bail them out of their own mismanagement. This, of course, was a repeat of the 1971 episode. But in addition there was the waywardness~~

ATH
BAT

The arguments for and against

Deutsche

of the monetary targets, particularly sterling M3.⁶³ (In fact the misleading nature of M3 had been argued by me from the end of 1980 and thereafter) It was said that it was very difficult to present monetary policy in a credible form. An exchange rate target would solve all such psychological and presentational difficulties. Thus solved, there would be such an effusion of confidence in the conduct of the authorities that the uncertainty premium which was added to interest rates would fall.⁶⁴ Much weight was placed on the additional stability in the (Deutschemark) exchange rate through expectations generated by the ERM, and there would be less room for speculation.

I have reviewed the case against entry, and with varying degrees of emphasis, I imagine that this was put by the Prime Minister. Many other senior members of cabinet undoubtedly supported the Prime Minister's view that the time was not ripe. Nicholas Ridley and Norman Tebbit, for example, have been highly skeptical of the virtues of entry. But some, such as Michael Heseltine and Peter Walker, were undoubtedly sympathetic to the Chancellor's proposal. Although so far as I am aware there was no full scale debate at a committee of cabinet.

taken into account in the discussion

behaved
Joining

What if Britain had entered the ERM in 1985 ?

It is at least interesting, if not particularly informative, to reflect on what would have happened if Mrs Thatcher had been in over by the Chancellor's case and Britain had entered the ERM in early or mid November. The parity or central rate at which one enters a fixed exchange rate system is always a critical decision - as Churchill found in 1925, the Chileans discovered in 1979, and Hong Kong observed in 1983. We can get some idea of what would have happened if Britain had entered the ERM at 3.75 by observing what actually happened to the mark-sterling rate from November 1985. By the end of December the rate had sagged to 3.53, by mid 1986 to 3.00, and by the end of 1986 it was hovering around 2.80. In 13 months sterling had fallen about 27 percent.

In order to give some idea of the effect of the ERM on Britain's policy I shall assume that there was no realignment in the first year or so of entry. The 2.75 rate is held. The question is then, how far would interest rates have to rise in order to hold the central rate at that level? Some estimates can be made by applying the so-called "4 to 1" rule, namely that a 4 percent depreciation in the exchange rate is

⁶³ In his Mansion House speech in October 1985, the Chancellor had announced that the sterling M3 target had been suspended, and that "The inflation rate is judge and jury"

⁶⁴ For a number of repetitions of these arguments see Samuel Brittan's articles which began with his conversion in the Financial Times, November 14th 1985 with "Now, alas, it is time to join the EMS" (he meant the ERM).

counterbalanced by a 1 percent increase in base rate.⁶⁵ This would imply that, holding the ERM central value at 3.75 would have required increases of (27/4) 6.75 percentage points in interest rates over and above the 10 to 12.5 percent that were in effect throughout. This would have meant interest rates of some 17 to 20 percent.

Many EMS protagonists would claim that this estimate does not take account of the beneficial effects on expectations, including the greater certainty and credibility of being in the ERM.⁶⁶ It seems dangerous to rely so much on a subject we know so little about, namely expectations. But, in any case, exchange rate pressure which induced such high interest rates would clearly generate expectations of realignment or perhaps even withdrawal, or, worse still, of incipient exchange controls.

The calculation

In retrospect the widely reported intransigence of the Prime Minister to entering the ERM was a godsend. If we had entered, then raising interest rates to new highs in late 1985 and throughout 1986 would have jeopardized, even ruined, the conservatives in the elections of 1987. After such a very tight monetary squeeze through 1986, there would have been a recession - and most likely a deep one - in 1987-88. This would have been exacerbated by the ~~closing of the gap between the parties and the effect on~~ capital flight and interest rates discussed above. No doubt that, in the event, the government would have taken some evasive action, such as realignment, as the dire consequences of the decision to join the ERM became apparent. But, willy nilly, any such actions would be acknowledgment of ~~an~~ error of policy, and hardly a basis for asking for another term in government.

The result was

It is easy to conclude that Mrs Thatcher was lucky in just happening to be right. The market exchange rate might have remained more or less constant and so there would have been no trouble in maintaining the ERM central rate up to the election. Under such happy circumstances the Chancellor and Governor would have been vindicated. Before mellowing with such comforting thoughts, one should review the history of exchange rates since 1972 (as in the Pepper chart V). There are few periods where one could describe the exchange rate as being stable without a pronounced drift. (We must acknowledge, however, that 1984 was relatively stable with a small drift from near 4.0 to 3.5 - a near 10 percent devaluation). Alternatively the underlying market exchange rate might just have gone the other way and massively appreciated. ~~But, as~~ we shall see, in 1987-88, this is exactly what did happen ~~and~~ with the shadowing of the Deutschmark, ~~this delivered~~ a substantial inflation in 1989. In my view, Mrs Thatcher understood the basic problems with the ERM and was unwilling to put the

⁶⁵ See Charles Goodhardt, "British Monetary Policy" (check title), Economic Journal 1989. The rule refers not to the Deutschmark but to the effective exchange rate index. The fall in the effective exchange rate over this period was of the order of 20 percent. But the defence of the central parity in the ERM is effectively with respect to the mark, so in these very rough calculations I have assumed the same rule applies to the mark-sterling rate as to the effective rate.

⁶⁶ This is a moot point since the "4 to 1" calculation was over the period of which included the period of shadowing the Deutschmark.

British economy, not to mention the election, through such a risky wringer.

The "End of Monetarism" 1986

the
Without/restrictions imposed by the ERM, 1986 was a good year. Growth was about 3.5 percent and inflation was way down, partly because of the collapse of the oil price and partly because of the reductions in mortgage interest rates. (It is odd that few commentators observed the collapse of the Deutschemark exchange rate and the fall, rather than the rise, of inflation.) But even as early as 1986 the writing was, albeit faintly, on the wall.

*Coincidence
of the
L*

At various stages since 1983 the Chancellor had announced that the ultimate objective was stability of the price level - that is to say zero inflation. Indeed the joining the ERM policy was thought to be consistent with this aim, since the objective of the Bundesbank was a stable price level. A stable price level required a reduction in the rate of growth of Mo from its ambient 3 to 5 percent in 1985 to zero. This monetary growth path consistent with the objective of zero inflation by 1990 is shown in (chart V of Pepper); by 1988 the quantity of Mo is stable, and its growth rate zero. From 1983 to mid 1986 the trend rate of growth of Mo ~~is~~ gently declining, and had it continued to decline at that rate, the goal of zero inflation would have been reached in 1990. The actual record, however, shows a marked increase of some 2 percentage points above the trend line in the last half of 1986.

was

At least as far as Mo is concerned, this marked a turning point in the policy of persistent pursuit of lower inflation which had been manifest since the 1983 election. It was not a dramatic reversal. The change was initially small, almost imperceptible. Yet, as can be seen in (Pepper chart III), the divergence between my target path of zero inflation by 1990 and the actual growth rate of Mo ~~grew~~ inexorably throughout 1987 and 1988. Finally in September 1988, the growth rate of Mo was over 8 percent and the difference from my preferred path was as much as 7 percentage points. If ever one is to date the "end of monetarism" ~~in the Lawson record~~, then I think that the middle of 1986 has a good claim. Of course it may be argued that this was nothing more than the usual pre-election expansion to give the voters an aura of prosperity in which, it is hoped, they will reelect the incumbents. But it was more than that. The boost persisted for three years, long after the election.

expanded

possible
There are many explanations of this change in policy. The temperament of Mr. Lawson was different from his predecessor. Lawson was said to "have the temperament of a financial operator, even a gambler..."⁶⁷ The temptation to indulge in "wizard wheezes", to "have a go" and to deliver spectacular growth may well have

⁶⁷ See Peter Riddell, The Thatcher Decade, Blackwell, Oxford 1989, p. 20. In the television interview with Brian Waldron on "Weekend World" in November 1989, Mr Waldron referred to Lawson as a gambler. It was widely reported that Mr Lawson was not a rich man; apparently he inherited a substantial sum but lost it in investments in the early 1970s.

First there were growing doubts about the reliability of the monetary aggregates as harbingers of inflation

66

~~The Chancellor~~

~~overcame his initial reluctance. He had come a long way from the Mais lecture of June 1984 when he said: "It is the conquest of inflation, and not the pursuit of growth and employment which is or should be the objective of macro-economic policy". There was also the fact that, although treasury officials had demonstrated that Mo was an efficient guide for monetary policy, various commentators, such as the ubiquitous Mr. Brittan, had repeated that the City could not conceivably regard such small change as an appropriate target. If the City could ignore Mo, why not the Chancellor? Similarly he could brush off much of the criticism of the burgeoning broader aggregates and particularly sterling M3. In a financial system that was changing its very structure so dramatically, M3 was a dog that had barked too often to be taken seriously. But I suspect that the most seductive influence was the general attitude among the G5 finance ministers that exchange rates were too important to be left to the whims of markets. All right-thinking finance ministers agreed on the need to topple the dollar in 1985 - hence the Plaza agreement. (Note that this was before the fiasco of the Louvre in 1987). Among the G5, Mr. Lawson was clearly the most clever and most experienced. It must have been quite heady stuff to redraw the financial map of the world. To deliver what all people who really matter knew what was right. Power is the goal of all politicians. Here it was - but in half rather than full measure.~~

Samuel

explain away

The Untarnished Attraction of the EMS

targeting on a grand scale with the domestic problem of the UK,

It must have appeared the logical next step to take Britain into the ERM and, most important, to play a full role as the second most important financial power in Europe, first in influencing policy of the Bundesbank and secondly as the honest broker between Germany and France in developing an integrated financial system for Europe. Indeed it would be entirely logical to see Mr. Lawson as clearly the best candidate for the role of monetary czar, or president of the central bank, of Europe in say 2000. Thus may private ambition and intellectual persuasion happily mesh.⁶⁸

All these considerations might explain the persistence of the drive, by hook or by crook, to get Britain into the ERM. And there is also the obvious personal reason. With the conviction that he was right, it was galling to have the Prime Minister exercise her prerogative in 1985. And it was tempting for him to show how right he was after

Secondly, ^{that} there was the argument that, if the exchange rate were pegged, ultimately Britain would have a disproportionately high inflation rate in traded goods to Germany.

⁶⁸ This depends on Mr. Lawson having come to terms with the fact that he is unlikely to be leader of the conservative party. I am sure he has sufficient self-knowledge to have arrived at that conclusion long ago. A "financial leader", who insists on anonymity, told me that, because of his arrogance, Mr. Lawson could not conceivably be appointed to, for example, the job of Managing Director of the International Monetary Fund, let alone Governor of the Central Bank of Europe. Although Mr. Lawson is somewhat assertive, I should have thought that his considerable ability would have been the most decisive factor, and thus I still conjecture that his prospects are quite rosy.

all.⁶⁹ I believe these factors largely explain the decision to "shadow" the mark from early 1987 onwards. The idea was to demonstrate his wisdom and to show that the Prime Minister's fears were quite groundless.

In this endeavour, Mr. Lawson had powerful allies, ~~outside the cabinet~~. The Governor was quite firmly in his camp. ~~One detected, however, much less enthusiasm among the Bank staff and among junior ministers and officials in the treasury - perhaps because they had been through similar hoops before. But their loyalty was unquestioned.~~⁷⁰ The City was said to be enthusiastic for a fixed mark parity and entry into the ERM. The CBI had stated ~~clearly~~ its full and complete support for entry. This ~~at least~~ offset the much more skeptical view coming from the management of industry - the Institute of Directors. And above all, as a highly successful reforming Chancellor, Mr. Lawson had fullsome support on the conservative benches in the House of Commons. ~~From all this he could well conclude that he had a mandate from from all quarters except Number 10.~~ STET

In view of the behaviour of the sterling-mark exchange rate in 1985-86, and the obvious difficulties Britain would have encountered had she joined at the November rate of 3.75, one would have thought that this would have given the Chancellor pause before saddling up for another ride on the tiger. Clearly it did not. Nor can I find any satisfactory explanation for ~~his~~ ignoring the lessons of 1985-86. ~~It is inconceivable that the treasury official did not carry out "what if..." exercises on this period.~~⁷¹ I suppose he may have surveyed the evidence and drawn quite different conclusions from those which I adduced above. For example accepting the facts as I outlined, he may have believed that ~~the magic ingredient of~~ expectations and confidence would clearly bail sterling out of any difficulties, ~~as had apparently happened in Italy, notwithstanding Britain's open financial markets.~~ More likely he ignored the ~~reasoned~~

⁶⁹ It has been suggested that there was also a 'macho' element in Mr. Lawson's behaviour, namely that he was furious because a 'mere woman' was thwarting his policy and ambition. I am very doubtful if such a macho factor played any role at all. I suspect he would have been just as annoyed if the Prime Minister had been a male.

⁷⁰ It is noteworthy that, while the resignation of Peter Thorneycroft from the the Macmillan government was accompanied by the resignation of his junior ministers, Enoch Powell and Nigel Birch, there was no hint of any of Mr. Lawson's junior ministers accompanying him to the back benches.

⁷¹ It has been reported (Keegan) that senior officials in the treasury were entirely surprised by the Chancellor's announcement at the IMF in January (?) 1987 that exchange rates were the main guide for monetary (interest rate) policy. The decision to shadow had not been a considered in depth or detail by officials. It was represented as the consequence of a number of discussion between Mr. Lawson and Sir Terence Burns, with offstage assistance from that most distinguished financial journalist, Mr. Samuel Brittan. This report is consistent with the picture of Mr. Lawson as a gambler who likes to keep his cards close to his chest.

economic arguments on the grounds, alas not unjustified, that the economists had usually been useless on predicting exchange rate movements. ~~Like many a gambler,~~ he felt more at home with his hunches.

may have

Shadowing the Mark

And his hunches, tactically, were good. When sterling began shadowing the mark in early 1987, the Deutschemark rate had fallen below 2.8, even though base rates were relatively high at 11 percent. Sterling had then hit its nadir. At this value the mood of the market was that sterling had reached its bottom. A policy to maintain the rate around 3.0 was both attractive and easy. Indeed it was combined with a fall in base rates from 11 at the turn of the year to 9 per cent for the election in May. Sterling soon appreciated in February to 2.9 and thereafter it rarely deviated more than 1.5 per cent (0.05 Deutschemark) from 3.0.

1987

1987

The economic ambience of this policy seemed like a new golden age. ~~One can easily forgive the Chancellor any hubris.~~ Growth proceeded at between 4 and 6 percent, according to the measure used. Investment boomed with a 7 percent growth. Inflation remained low, a little over 4 percent, but the tax-price index was only about 2.5 per cent. A great tax reform was introduced in the March budget. Marginal personal tax rates were reduced to a maximum of 40 percent, and many loopholes and anomalies were swept away. Yet, such was the ebullience of the economy that revenue increased dramatically and the deficit in the public sector turned into a surplus. Debt retirement began. Interest rates fell. The election was won.

1987

The pre-tax real rate of return on assets in the corporate sector had been rising since 1981 (when it was 2 percent) and finally by the end of 1987 it had reached 12 percent. It was expected to rise even further, and so it did - to over 13 percent in 1989. Such high rates of return had not been seen since 1964. More important they clearly exceeded the rates of return in other OECD countries.⁷² Much of this improvement was due to supply side changes, which were expected to continue.⁷³ This meant that there was a great attraction for investors, both domestic and foreign, to invest in Britain, either through foreign direct investment or through portfolios. The demand for sterling was boosted by this investment effect. There was perhaps an even larger demand created by the interest differential between the United Kingdom and overseas. United States treasury bills in January 1987 were yielding only 5.85 percent compared with about 11 percent on sterling bills. The risks of a three month devaluation of sterling were clearly low, so sterling attracted many buyers.

⁷² See "Company Profitability and Finance" in Bank of England Quarterly Bulletin, Vol 29, no.1, August 1989, page 377.

⁷³ These have been analysed in detail by Patrick Minford in von Fuerstenberg (ed) (CHECK ref)

The increase in the demand for sterling buoyed up the exchange rate at 3.00; there was initially no difficulty in holding it there. The authorities ~~did~~ intervened largely to prevent the rate rising above the 3.0 limit. This took the form of selling sterling and buying convertible currencies. Intervention statistics remain a secret. It is interesting to note however that the convertible currency reserves increased over 1987 from \$13.78 billion to \$35.73. Much of the increase was due to a deliberate policy by the Chancellor to prepare for defence of a fixed exchange rate whether in or out of the ERM. I would guess that some \$10 billion of the increase was associated with the intervention.⁷⁴ The intervention was formally sterilized in the sense that it was not allowed to have any persistent direct impact on the money market rates of interest. Bills were sold to take sterling off the market. Thus the bill mountain, such a source of concern in 1985, ~~did~~ melted away.

Many studies have shown that sterilized intervention has little lasting effects on exchange rates. Since most of it was sterilized in 1987, the persistent pressure for an appreciation of sterling continued. The only way to prevent it was a reduction in interest rates relative to those in other OECD countries. ~~This was the Lawson's policy~~ *Feb 1987* First however there was a ~~small~~ diversion due to the Louvre agreement. In May the United States authorities were driven to raise interest rates sharply to stop the decline of the dollar (again after a failure of massive internationally coordinated sterilized intervention to do the trick). US rates continued to rise throughout the year until the stock market crash of October 19th. In July British interest rates were increased by one percent, but thereafter they did not follow the dollar up further. And following the October crash, base rates resumed their downward path to 8.5 at the end of ~~the year~~ *1987* and 7.5 percent by May 1988.

Respect It is ironic that during 1987 the attempt to put a floor under the dollar and the attempt to put a cap on sterling both failed. ~~Yet~~ Both were fought with the biggest intervention funds ever deployed. Both substantially sterilized their intervention, and discovered it was ineffective. Both were driven back to monetary policy, to higher interest rates in the United States and ~~low~~ ones in Britain. *74*

74 The massive interventions in Britain came to an end in the first months of 1988. It was rumoured that more than \$2bn was spent on intervention in one day. Intervention was scaled back to the normal smoothing operations. There was a well publicized disagreement between the Chancellor and the Prime Minister. Just before the March budget, the Prime Minister made it clear that you "cannot buck the market". ~~The fact that~~ ~~it~~ was manifestly true, ~~did nothing to abate,~~ indeed probably exacerbated the ~~fall~~ of the Chancellor. In any case the 3 Deutschemark fix was finished on March 4th. By the end of March the mark rate was at 3.125.

Lawson's Crowning Error and The October Excuse

⁷⁴ Gordon Pepper shows that the net effect on M4 of foreign exchange reserves in 1979 was 7.2 billion sterling. He concludes, however, that although the authorities failed to "sterilize" (in the sense of having no direct effects on M4) all the intervention in 1987, they did manage to catch up in the first quarter of 1988.

** More important internationally was the reduction in US interest rates to 2.5 percent in order to prop up the dollar. This resulted in a massive real estate and stock market inflation in 1989-90.*

(expansionary policy)

But this did not mark the end of the ~~policy~~. In ~~what can only be seen as a vain~~ attempt to put a somewhat higher cap on the exchange rate, interest rates were reduced again ~~and again~~ to their low of 7.5 percent in May. The only ~~conceivable~~ *1988* rationalization for such ~~policy~~ was that the exchange rate appreciation, both overt and incipient, showed that monetary policy was still "too tight". Yet every other indicator suggested that monetary policy was too loose rather than too tight. The labour market was showing distinct signs of strain and unemployment was falling by about 50,000 a month. The prices of assets - and particularly real estate - were rising strongly. The current balance of payments had turned markedly into the red, and there was a clear import boom. Investment boomed ahead at record rates.

The monetary indicators were all pointing to an inflationary surge. The Mo figures suggested that there would be a two percent increase in underlying inflation coming in 1988-89, and the broader money aggregates were suggesting even more alarming forecasts of price inflation. *Only the exchange rate could be adduced as evidence that monetary policy was "too tight". (shll)*

and many other observers expansion

What possible excuses could there be for ignoring this weight of evidence? One such excuse, according to the Economist, ~~Mr. Britton and other supporters of the Lawson line~~, is that a monetary expansion was the appropriate response to the October 19th 1987 crash. This would then avoid the mistakes made following the crash of 1929 and 1931. But the appropriate response to a crash is not inflationary ~~excess~~.⁷⁵ The problem in October might well have been a run on the banking system or some other form of liquidity run. This calls for the Central Bank to stand ready to discount paper to stem the run, not to flood the market with money. In the event, the Federal Reserve Board of the United States handled the October crash in an exemplary manner, ~~which should have been a model for the United Kingdom~~. In the Economic Report of the President, February 1988, (page 39), it was shown that, in spite of October's troubles, the Fed actually tightened monetary policy in 1987 - because it feared that the expansionary policies of 1986 would promote inflation. This is exactly what was needed in the United Kingdom.⁷⁶ ~~There was nothing that prevented such a prudent policy being pursued - except Mr Lawson's fatal obsession with the exchange rate.~~

The Governor, in his Durham speech, observed that there had been errors of policy. I think the Governor was wrong

The Monetary Squeeze from June 1988 on

From June 1988 monetary policy was successively tightened by raising interest rates frequently but by only half a percentage point. This was new. Normally in a squeeze the interest rate is put up substantially - usually by 2 percentage points. Then the market is much less certain about the next move of interest rates, whereas using the

⁷⁵ Nor is it to hold fixed the exchange rate. As is well known, Britain entered the recession by Churchill's fix in 1925, and it began to emerge from the slump after floating the exchange rate in 1931. The United States hung on to its fixed exchange rate (with respect to gold) for two more bitter years until 1933; then having floated the dollar, the United States started its recovery. In 1987-8 the fixing of the mark-sterling rate at too low a level led to inflation.

⁷⁶ Most of the other major OECD countries appear to have acted with a prudence similar to that of the United States. Britain was the odd man out.

practically
 innovation of Mr. Lawson, the market was certain of the direction of the next interest rate movement. Mr. Lawson, it was said, thought that his penny-numbers adjustment process ~~was much better because it~~ showed that he was in control and in no panic, but merely adjusting with prudence to the new situation. By August base rates were up to 12 percent.

The question remained, however; was ~~Mr. Lawson~~ still operating with an exchange rate band as the target? Albeit the band had moved to 3.1 to 3.3 or so, but the rate was kept in that band until ~~a month or so before he left office in October 1989.~~ *Sept*
~~We do not know what would have happened if there had been no resignation.~~ But the evidence of incipient inflation became more evident with every passing day. House prices boomed, labour shortages were spreading, unemployment was falling as fast as ever, and all the signs of overheating were there to see. The need for a substantial increase in interest rates, whatever the exchange rate consequences, was manifest. *for all*
 Fortunately the exchange rate pressure ~~was~~ downwards and so provided a convenient argument for increasing interest rates in one percent steps from 12 percent in October 1988 to 15 percent one year later; thus, at last, there was the coincidence of the exchange rate giving an appropriate direction to monetary policy.⁷⁸ The market was quite convinced that it was virtually only concern about the Deutschemark and German interest rates that was driving interest rate policy in the UK. Indeed the Chancellor and the Governor had given the market good reason for believing that exchange rates were the main determinant of interest rates.⁷⁹ And once the belief is ingrained in market lore, it is very costly to try and change ~~that belief.~~

Britain was on the back of the tiger, ~~of the fix.~~ *g* As the exchange rates fell, or threatened to fall, in the autumn of 1989, so the interest rate was driven up by market expectations. The authorities had the choice of validating expectations or changing them. However desirable it might be to avoid riding the tiger, the alternative was to fall into its jaws. The government would certainly be chewed up if they had announced a substantial change in their macroeconomic targets. Even though 15 percent interest

⁷⁷. Additional evidence on this point is derived from the ruminations of Mr. Samuel Brittan. In the Financial Times.....(date etc to be checked), he opined that the main mistake made by Mr. Lawson was to fix at 3.0 instead of 3.3. The reader may himself conjecture the economic costs of a belief in Brittan.

⁷⁸. There is still room for debate about whether the monetary squeeze from 1988 onwards was too tight or still too loose. There was no doubt at all that interest rates of at least 12 percent were needed in order to get the growth of the monetary base under some sort of control.

⁷⁹ In his speech at the Party Conference in October, only days after the increase of base rates from 14 to 15 percent, the Chancellor made it clear that the Conservative Party would not be "the party of devaluation".

Reversed and became

rates may seem like riding the tiger into a recession, the alternative was even worse.⁸⁰

(TO BE COMPLETED)

The Foreign Exchange Reserves

(THIS MAY NOT BE SUITABLE AT THIS JUNCTURE - POSSIBLY NOTE OR APPENDIX?)

So far we have ignored the consequences, particularly the costs, of fixing the exchange rate on the foreign exchange reserves. One of the little known consequences of the first Thatcher government's financial program was the privatization of a substantial fraction of the official foreign exchange reserves. In 1979-1980 the authorities held more than \$18 billion in convertible currencies.⁸¹ By 1984 this had been run down to about \$7.5 billion. This reduction was possible because the authorities did not need any substantial reserves if sterling were floating. If it were a free or pure float, then, apart from the needs for normal operations, there is no need for any official reserves. But Britain was on a dirty float and the Bank always liked to smooth the path of sterling, so some balances were needed for these operations. We can conjecture that if Britain joined the ERM, then considerably more reserves would be required. One notes that France and Italy maintained reserves of 18. and 23 percent of their exports in 1984, whereas Britain's reserves were only 6.5 percent. It is reasonable to suppose that, were Britain to join the ERM, reserves of about three to four times the \$7.5 billion, that is \$22.5 to \$30 billion (for 1984 export volumes and in 1984 prices) would be required. Bringing them up to 1989 values, one would get a required reserves of \$30 to \$40 billion. (Just to confirm this figure, the official reserves in 1988 rose to \$40 billion at the end of July and to over \$42 billion by the end of the year). The ERM, therefore, would require us to have additional reserves of some \$20 to \$30 billion - let us assume hereafter that the extra reserves amount to \$25 billion.⁸²

What are the costs of keeping these reserves? The real rate of return on the reserves is roughly the real short term interest rates in the money markets of New York and, to a lesser extent, Frankfurt and Tokyo; a figure of around 2 percent seems appropriate as the average value of the return to be expected. If these funds had not

⁸⁰ Reports appeared in the media that I was opposed to the increase in interest rates to 15 percent in October 1989. Other reports said I supported the increase. My position was that we were in no position to change the market expectations, and that moving up to 15 percent was the least bad alternative.

⁸¹ See Bank of England Quarterly Bulletin, table 17.1. Note that I am including only convertible currencies and excluding gold, and the IMF reserve and special drawing rights.

⁸² In 1984 I ignored the \$2.5 billion floating rate note issue which the treasury issued for the specific purpose of increasing the reserves. Obviously this issue had potential ERM entry in mind.

been required for padding the reserves, they would have been employed by the private sector, as in 1980-1984, as capital assets. We know that the average real rate of return on capital employed in private industrial and commercial companies in the UK in 1988 was about 12 percent.⁸³ If these were the rates of return of alternative investments forgone, then the costs of the reserves were about 10 percent of the \$25 billion, or \$2.5 billion a year. Of course the alternatives forgone may be overseas investment, either in portfolio form or in the acquisition of real assets or direct capital formation. We do not know the full rate of return on these investments, mainly because of the lack of information on capital gains.⁸⁴ But from the information available, it appears that over the Thatcher years the rate of return has been very very high at some 15 to 20 percent, and substantially larger than that on domestic investment. Thus the cost of the reserves for the ERM is between \$2.5 and \$5 billion (or 1.5 and 3.0 billion stg)

Thus, in maintaining these additional reserves, the ERM will cost us some half to one percent of GNP each year. Whether this is considered large or small depends on the alternatives. One possible alternative is to go the whole hog and switch to a Deutschmark currency or to a currency board system. (This is the logical consequence of Delors stage 2.) Instead of pound notes, Deutschmark notes would circulate and we would be on a full Deutschmark standard. The Bundesbank would hold reserves; we would simply hold some of their currency. At present currency and coin in the UK amount to about 17 billion stg, or some \$26 billion. This capital value of the seignorage is about the same as the additional reserves for joining the ERM. If a currency board substitutes sterling currency at a fixed rate for Deutschmark notes, then the \$26 million equivalent can be at least partly invested in short term mark financial assets. So the cost of the ERM is about the same as the cost of a full currency board system.

⁸³ Bank of England Quarterly Bulletin, Vol 29 No 3, August 1989, p.377. A more conservative calculation may take the point that a 12 percent rate of return cannot be sustained and that a 10 percent, or even an 8 percent, rate would be more appropriate in the long run.

⁸⁴ See "External Balance Sheet of the United Kingdom", in Bank of England Quarterly Bulletin, vol 28 no 4, p 520-527. The net asset position grew from 12.1 stg at the end of 1979 to 113.2 and 89.5 billion stg at the end of 1986 and 1987 respectively. Such assets are obviously in part acquired by the cumulation of current balance surpluses, but this can only account for some 17 billion stg in the published statistics. (The reader may well believe that the current account balance is much underestimated in the official statistics. But even if we double it to 34 billion stg, it still cannot account for the bulk of the additional net foreign assets.) The balance is largely accounted for by the yield, and in particular the capital gain including currency revaluation, on such foreign assets. On certain assets the Bank has calculated the full rate of return on assets (not net assets) - see chart 6 p.525. This suggests that the full rate of return has been about 20 percent over the period end 1979 to end 1986. This appears to be the nominal rate of return, so the real rate of return would be somewhat below this, but almost certainly in excess of 15 percent.

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②
PRIME MINISTER

SIR ALAN WALTERS' BOOK

Alan has sent me a manuscript of the book he is proposing to publish this Spring. It is to be published by Collins, in association with the Institute of Economic Affairs. The provisional title is "Sterling and Inflation in the 1980s" with the subtitle "The Economic Consequences of Mr. Lawson". The book has two objectives, first a technical discussion of different exchange rate and monetary policy regimes. This is covered in Chapters 2, 3, 4, 5 and 8; and secondly, an account of UK policy in the 1980s - Chapters 1 and 6 - with the emphasis on the role of Nigel Lawson.

As one would expect the first theme develops arguments for operating an independent monetary policy with freely fluctuating exchange rates and limited intervention, as against fixed or quasi fixed exchange rate regimes whether informal, as with the Plaza and Louvre accords, or formal, as with Bretton Woods or the ERM. Chapter 8 develops the arguments for a European commodity currency. His views in this area are well-known and will come as no surprise.

The second theme is potentially explosive, and it is written as a polemical attack on Nigel Lawson. The subtitle is a reference to Keynes famous pamphlet "The Economic Consequences of Mr. Churchill". Alan argues that both Churchill and Lawson caused great damage by adhering to a fixed exchange rate, the former producing recession, the latter inflation. The argument about "Mr. Lawson's folly" is developed more fully in Chapter 6.

In commenting on the book, we have a double locus. First under his contract and under the general understandings about the publication of memoirs by ex Ministers and public servants (the Radcliffe conventions), Alan is required to submit his manuscript to ensure that it does not reveal any confidential information obtained in the course of his work, or break any

CONFIDENTIAL

confidences. There are a few passages of this kind, for example where he identifies the position taken by Ministers and officials in the 1982 and 1985 discussions on EMS. But even if these are dealt with there could still be trouble.

No. 10's other role is to advise on whether material in the book is likely to cause embarrassment to the Government or more specifically to you. In this our role is purely advisory; we have no basis for insisting on changes. I have to say that, as written, the book will cause you problems. Chapters 1 and 6 are peppered with references to "Lawson's folly", "Lawson the gambler", "arrogant Lawson", and Lawson, pursuing "private ambitions". The conclusion is that "clearly he must be accorded the main blame for the inflation of 1989-1991".

All this is very close to what you think and would love to be able to say, but you need to consider whether it would be helpful to have it said so bluntly. Nigel Lawson does not intend to publish his book until after the election, but it is certain that, faced with an attack of this kind, he would quickly come roaring back, for example, in The Times. He would get a lot of support from back benchers plus coded support from some members of the Cabinet. The argument about ERM, which has been dormant, will flare up again, quite unnecessarily as the point at which the judgement has to be taken on whether the Madrid conditions have been satisfied is still some way off.

Reports about the book have appeared in the press, no doubt stimulated by the publishers who want to hype up sales - see attached. The Chief Whip and Sir Robin Butler have both expressed concern to me about it.

There are problems for you too:

- i) although Alan identifies Nigel Lawson personally with the conduct of economic policy Nigel Lawson was, all through that time, acting in the name of the Government collectively. Although privately you recognise that you should have pulled him back earlier, the fact remains that economic policy is a collective responsibility. You will be

CONFIDENTIAL

- 3 -

asked if the policy was such a mess, whether you should not take some of the blame. The book will divert attention from how to get things right back to how the current difficulties arose. It will highlight old quarrels such as "you cannot buck the market".

- ii) the logic of Alan's case is that sterling should never join the ERM. The long-standing Government position is that it should, but only when certain conditions are satisfied. You will be asked whether you accept Alan's arguments, or are sticking with the Madrid position.

I suggest that you read Chapters 1 and 6. You will need to consider whether we want to ask Alan to postpone the book, tone it down, or both.

You may like to discuss.

AT

ANDREW TURNBULL

8 MARCH 1990

a:\pps\walters.mrm

CONFIDENTIAL

go up in smoke

THESE are hard times for R J R Nabisco, the food-and-tobacco conglomerate which was consumed a year ago by the buyout artistes Kohlberg Kravis Roberts.

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Alan Walters: memories of Sir Winston Churchill

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De
Sam

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBIN BUTLER

SIR ALAN WALTERS' BOOK

Sir Alan has now sent me a copy of the current manuscript of his book. I will now be looking at it to see whether there are any deletions or changes which we should seek, either on the grounds that there is confidential material obtained during his employment which he is bound, under his contract, not to reveal, or as part of the more general understandings about memoirs of former public servants.

I would be grateful for any observations you wish to make.

I am copying this minute to Sir Peter Middleton.

AT

ANDREW TURNBULL
3 March 1990

CA

Manous file



Government Chief Whip
12 Downing Street, London SW1A 2AA

From the Private Secretary

CONFIDENTIAL

1 March 1990

Dear Andrew,

SIR ALAN WALTER'S BOOK

The Chief Whip has asked me to thank you for your letter of 28 February. He would be most grateful if you would keep him advised.

I am copying this letter to Sir Robin Butler and Sir Peter Middleton.

yours sincerely
Murdo Maclean

(Murdo Maclean)

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

CONFIDENTIAL

Ref. A090/576

MR TURNBULL

c Sir Peter Middleton
Mr Maclean

Sir Alan Walters' Book

I have seen a copy of your letter of 28 February to Murdo Maclean. In addition to the restraint imposed on Sir Alan Walters by his contract, he is also bound by the [Radcliffe Conventions on Memoirs]. This will not cover most of the period to which his book relates, ie from 1983 to his return in 1988. But these two restraints should bite on the circumstances leading up to his and Mr Lawson's resignations, which will of course be the most attractive material for the publishers. *attached*

2. So I think that it is worth looking closely at the manuscript. I agree that a political appeal is likely to be the only effective way of stopping the damaging public wrangle between Sir Alan and Mr Lawson, but even if that appeal is successful in causing Sir Alan to delay publication I should not be surprised to find a leaked copy of the manuscript emerging in the press.

R.R.B.

ROBIN BUTLER

1 March 1990

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10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

28 February 1990

Dee Murdo.

SIR ALAN WALTERS' BOOK

The Chief Whip asked me to investigate the background to the report in the Independent on Sunday about Sir Alan Walters' forthcoming book. I tracked him down in London in transit from a meeting in Vienna. I have recorded our conversation in the attached note.

As you will see, there appears to be quite a lot of substance in the press report. Even if Sir Alan wants the book to veer towards a serious treatment of the issues, all the pressure from the publishers, and I suspect it is the IEA as co-publisher that lies behind the press report, will be the other way.

No.10 has a locus in being able to object to inclusion in the book of any material which we can argue he obtained in the course of his work as the Prime Minister's adviser. I suspect, however, that this will not give rise to major requests for deletions. If we are to have an effect on the slant of the book, it will have to be more of a political appeal, convincing him that such a personal attack on Mr. Lawson would be unhelpful to the Prime Minister's position.

I will advise further when I have obtained the manuscript.

I am copying this letter and enclosure to Sir Robin Butler and Sir Peter Middleton.

*Yours sincerely
Andrew Turnbull*

(ANDREW TURNBULL)

Murdo Maclean, Esq.,
Chief Whip's Office.

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*file slw
a:1ppst/mackean*

MEM

CONFIDENTIAL

NOTE FOR THE RECORD

SIR ALAN WALTERS' BOOK

The Chief Whip asked me to investigate the piece which appeared in the business section of the Independent on Sunday about Sir Alan Walters' forthcoming book. The Chief Whip was concerned about the political consequences should a book with this title and slant appear this spring. Although Mr. Lawson is not intending to publish his book until after the election, it would be inevitable that he would want to respond to something which was so directly an attack on him.

I spoke to Sir Alan on the phone this morning and asked him:

- whether he had delivered a manuscript to the publishers
- whether it would have the title suggested
- whether it would take the line suggested.

Sir Alan said he had given a manuscript to the IEA who are the co-publishers, and they had shown it to Collins. It was a very unpolished draft and the purpose at this stage was to establish with the two publishers whether it was along the lines they wanted. He said the provisional title was "Sterling and Inflation in the 1980s" with the sub-title "The Economic Consequences of Mr. Lawson". On content he said it was in effect two books: a tract on the theory of exchange rates, and a description of how the theory had been applied in Britain during the 1980s. There was a chapter called the Lawson years which would start with the MTFs and go through to his resignation.

I said that No.10 had two interests in the manuscript:

- we had a formal position in relation to his contract. Not only was he subject to the Official Secrets Act but his contract said it was incumbent upon him to regard all information communicated to him in the course of his work as a consultant as being entrusted to him in confidence and that he was required to keep all such information confidential during the period of

CONFIDENTIAL

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- 2 -

agreement and thereafter;

- we also had a more political interest in advising what we thought the impact would be on the Prime Minister's position.

Initially he was reluctant to send the current draft to me on the grounds that it was still rather rough. But I told him I would prefer to see something early and rough rather than later and polished. He agreed to contact the IEA to get them to send a copy.

AS

(ANDREW TURNBULL)

28 February 1990

a:\pps\Walters (srw)

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go up in smoke

THESE are hard times for RJR Nabisco, the food-and-tobacco conglomerate which was consumed a year ago by the buyout artistes Kohlberg Kravis Roberts.

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Ref. AO89/1619

MR TURNBULL

Discuss with PM 22/6
(1) She wants reference to
word deleted
(2) Also reference to "movement"
forward.
P.R.B. to relay to Mrs Currie

Mrs Currie's book

RT
22/6

I mentioned to the Prime Minister that I had vetted Mrs Currie's book, which subject to a few points presented no problems.

2. Her publisher then asked her for a chapter entitled "A Day in the Life" with something about the Prime Minister in it.

3. Mrs Currie has included two anecdotes about the Prime Minister, which I attach. I have asked her to make the amendments shown and not to quote the Prime Minister directly in the first story, on what was a private occasion. With these amendments, I think that the anecdotes are in accordance with the conventions. But I suggested to Mrs Currie that I should nevertheless ask the Prime Minister whether she was content to have the two stories included. Mrs Currie readily agreed.

4. I should therefore be grateful if the Prime Minister could glance at the pages attached and let me know whether she would be content for Mrs Currie to include them in her book.

F.R.B.

ROBIN BUTLER

21 June 1989

and chips in the cafeteria, the civil servants to sandwiches back at the department and hurried conferences over the minister's wobble this morning which the opposition are sure to jump on later, and the ministers occasionally find themselves ^{included in lunches} ~~summoned for lunch~~ at Number 10. In my time as a minister I lunched there on several occasions, and attended dinners which are rather grander. ✓ ~~But lunch is fun, as the practice is to invite about ten junior ministers from different departments, together with one or two senior figures and the chief whip.~~ ^{On such} The food is simple and nice (chicken, or salmon, often) and the meal over relatively quickly as everyone has business awaiting. ^{On such relatively informal occasions,} the conversation is matter, friendlier and livelier than on more formal occasions. I often wondered what the public might make of the hoots of laughter floating out of the Downing Street windows as the ^{commanding officers} junior officers break bread with their ^{General,} being perhaps slightly less in awe of her, but with more knowledge and admiration than many others - and more affection.

She doesn't leave anyone out of the talk and it is well to go armed with a topic you wish to air. On one occasion I teamed up with Colin Moynihan, the sports minister, to tell the Prime Minister about his thinking on the use of drugs in sport (see p.xx). More often than not I would be caught unawares by the sudden emergence of a health topic, since colleagues knew I would be there, minus advisers of course, and I had to think fast how to win the argument without

hurting anyone's feelings, how to make a useful point, and how to please our hostess all at the same time. It was hardest when the questions came from her. On one occasion the topic was the allocation of NHS resources around the country. The system since Barbara Castle's day had been known as RAWP, the "Resource Allocation Working Party". There had been devised a fiendishly complicated formula based on population, particularly the numbers of very old and very young, with mortality statistics as a measure of deprivation. Health regions worked towards targets which meant, roughly, equality of access to hospitals. This had meant for some time in the 1980's relatively low growth in the South and London, and a huge increase in activity in the Midlands and North. Now they were all close to target. Should we carry on?

Over the coffee and petit fours the Prime Minister turned to me with a challenge; ^{asking me to explain} "Explain to me, Edwina," she had said, ~~as she had said,~~ "how the reallocation of NHS resources to the north of England ^{might be defended to her} ~~might be defended to her~~ constituents in Finchley? ~~How am I to sell~~ this RAWP formula to them?"

She has a powerful blue-eyed look that has turned strong men to stone; you put down your cup, push away your plate, you start thinking fast. This lady prefers it straight. She was still looking at me, and so was the whole table.

"Well, Prime Minister," I replied, "At least it means that my

constituents in Derby are not competing with yours, filling up the same beds at the Royal Free Hospital in Hampstead. They don't have to come down to London. We have our own smart new hospital units in Derby now. [Thanks to you.] That's how."

I find this odd.
Is the point of the story about the new Derby hospital in contrast to the PM or thanks to RAMP?

AT

You know you have scored when she nods, satisfied, and turns away to make someone else tremble. Just as she did, however, she gave me a sharp look. ^{She reminded Lisa protest that I had been} ~~"You've been telling us all that~~ ^{was} ~~is~~ ^{it's possible to cut the number of heart attacks.} ~~is~~ that true? The lunch was taking place during 1987 and I thought about where she had been recently, flying the world, the honoured guest and friend of President Reagan, having spent an unprecedented 11.5 hours in secret discussion with Gorbachev. How to convince someone like that in five seconds flat? "I think so, Prime Minister," I offered, "The doctors feel it's possible. They have certainly done it in the USA, very substantially, with a government programme like ours." Really? she said, interested. Then she floored me completely, saying gaily that she had been taking an interest in blood pressure. Did I know that all the world's leaders had low blood pressure? Was there any reason for that? My mind boggled. Lamely I suggested that maybe those with high blood pressure hadn't stayed the course, had keeled over before they got to the top. Only the low blood pressure people were left. She nodded again. Some weeks later I heard her using a version of my Derby argument without batting an eyelid, and I breathed a sigh of relief.

GOVERNMENT IN THE LIFE

Governments with big majorities are often accused of ignoring the wishes of the electorate. They are sometimes accused of trying to behave like benevolent dictatorships - pushing through measures which they believe to be good for the rest of us. But make no mistake, democracy is never far away. The Tory voters would never approve the dismantling of the National Health Service, and every politician in touch with them knows it.

* * *

Even if they do not have privileged access to her, the Prime Minister does support her junior ministers, occasionally in surprising ways. During late 1987 ministers at the DHSS were having a hard time, particularly as the Secretary of State, John Moore, had been taken poorly with pneumonia in November and was not really well again for some time. She came to sit next to me on the front bench in the Commons debate of December 21st 1987 where I was the closing speaker. As Londoners hurried to do their Christmas shopping, we settled in for a typical set piece debate on the NHS called by the Labour Party. However, the Leader of the Opposition and his front bench were at the movies that night, for the premier of Richard Attenborough's film "Cry Freedom". Their junior spokesman, Harriet Harman was therefore not well supported on her own benches as she rose to make her closing remarks, and was somewhat pedestrian and predictable. I felt the Prime Minister shifting somewhat impatiently beside me. I glanced

at her out of the corner of my eye, waiting for my turn, nervous as hell. "You make mincemeat of her, my dear," she said encouragingly - a remark not calculated to soothe my nerves. Harriet ran badly over time, leaving me only a few minutes. It was essential that I finish on the dot of ten o'clock, so that the vote could be taken at once, and yet I had hours of debate to respond to. The adrenalin was running; I was on my feet. I chucked my notes away and just laid into the folks opposite. They started to howl, my own side started to cheer; there was so much noise that it didn't matter much what I was saying, as long as I looked on top of it. The microphones would pick most of it up. "Four minutes more!" hissed the well-known voice at my elbow. "Keep going!" I looked round, startled. She was clearly enjoying herself. "Speak to the mike! Two minutes more! Don't stop!...One minute!....Right - that's it. Well done." And the vote was called, and we all trooped out to an unexpectedly large majority of over 120.

The whips commented to me afterwards that not everyone had the Prime Minister acting as timekeeper, usually the job of the whip on the front bench. At that beleaguered time, her personal support was very much appreciated. But then, she's like that.

* * *

~~Returning to the Commons in the evening, I would sometimes go and eat, sitting with colleagues and friends, listening to their concerns and worries about the NHS in their area, or~~

PRIME MINISTER

MRS. CURRIE'S BOOK: POLITICS AND HEALTH 1986-88

Edwina Currie has written to you enclosing the synopsis of her proposed book. She intends it to be a serious contribution to social history and, based on the synopsis, it has the potential to be just that. She will want to develop and illustrate the theme that preventative medicine is an expression of personal responsibility which is very much at the heart of what she, and you, believe in. Although it will be to some degree autobiographical, it is not intended principally as a memoir.

Nevertheless there are some potential pitfalls:

(i) Will it be written in a serious style avoiding the striking but less accurate phrase?

(ii) She is being offered help by the Department of Health in the form of an administrative assistant who looks out papers for her. (Her request for someone to make notes and summaries was declined.) In view of this, it will be slightly more difficult for the Government to distance itself from the result.

(iii) She needs to strike the right balance between pointing to the weaknesses in the United Kingdom's health record and hence the areas where action is needed, e.g., heart disease and cancer, while not overlooking the successes, e.g., perinatal mortality and life expectancy.

(iv) There is always a lag between the completion of a text and publication, so that what might have looked innocuous initially comes out at a controversial time. Around the time of publication the Government could be producing a Food Bill.

(v) She needs to avoid resurrecting the salmonella incident.

(iv) I assume her ambition is to get back into the Government. She must avoid being impetuous and making it difficult for you should you also wish that.

There are several ways in which these potential dangers can be minimised. She has accepted that she is required to submit the text to Sir Robin Butler. Sir Christopher France has offered to check the text for accuracy, and can no doubt use the opportunity to offer advice. I don't think you need to write back to her, but it might be helpful if Mark Lennox-Boyd indicated that you were happy with the idea of the book but at the same time made some of the points above.

Content to proceed in this way?

AT

AT

3 February, 1989.



file from

(69)

10 DOWNING STREET

From the Principal Private Secretary

SIR ROBIN BUTLER

MR. TEBBIT'S MEMOIRES

The Prime Minister has seen and noted your minute of 30 September about Mr. Tebbit's memoires.

N. L. WICKS

3 October 1988

from

Pine Minutes ²

Norman Tebbit has
sent you a copy of his
book which is in your
box.

Ref. AO88/2851

MR WICKS

N.C.W.
30.9

Mr Tebbit's Memoires

On page
194.

Following my letter to Mr Tebbit of 19 September with comments on his book, including the request, which the Prime Minister endorsed, that he should omit the account of the Falklands Cabinet, I have received a reply saying that "the delay in your response to my request for clearance of the text of my book was such that the publishers had no option but to go ahead with printing".

This response does not stand up. Mr Tebbit's publishers submitted the book on 12 August. My office replied to Mr Tebbit that I was on leave until 5 September and would be in touch as soon as possible thereafter. Neither Mr Tebbit nor his publishers let us know that this timetable was unsatisfactory or asked for our comments by an earlier date, so they clearly had an option other than just to go ahead with printing: they could at any time have let us know the date by which my clearance was needed. I have written to Mr Tebbit and said this; but I hope that, if Mr Tebbit tries to tell the Prime Minister that his failure to make the excision for which she asked is due to the Cabinet Office's delay, she will give him short shrift!

R.E.B

ROBIN BUTLER

30 September 1988

CONFIDENTIAL



*File
no 89*

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SUBJECT CC MASTER

SIR ROBIN BUTLER

When you saw the Prime Minister this morning you sought her advice on a particular point on Norman Tebbit's biography, a draft of which had been sent to the Cabinet Office for clearance in the normal way.

You told the Prime Minister that in his book Mr. Tebbit referred to the fact that the Prime Minister had asked each member of the Cabinet during the Falklands crisis whether they were in favour of sending the task force to the South Atlantic. You wondered whether such a reference would breach the confidentiality of Cabinet discussions, and could prompt questions of the other members of Cabinet.

The Prime Minister said that she did not think that the book should refer to this detail of the Cabinet's discussion. It would certainly prompt questions of other members of Cabinet about their reaction to the question which the Prime Minister had put to them. She agreed that Mr. Tebbit should be asked to remove this passage.

N. G. W.

NLW

16 September, 1988.

CONFIDENTIAL

do

PART 1 ends:-

PAB to NW 6.11.86.

PART 2 begins:-

NW to Fels 16.9.88

PREM 19/3438/2

FIRST DRAFT OF SIR ARNOLD WILKES' BOOK "STERLING AND INFLATION IN THE EIGHTIES"



INFLATION AND THE INTERNATIONAL MONETARY SYSTEM
The Economic Consequences of Fixed Exchange Rates

CONTENTS

1. Floating and Anchoring Currencies
2. Ideas on Money and Exchange Rates
3. Money and Exchange Rates in Practice
4. Monetary Policy and International Co-ordination
5. Monetary Systems for Europe
6. Exchange Rate Policies and Politics
7. A Monetary Constitution for Europe

Sterling and Inflation in the Eighties:

Code :F:\AAW

Date : Dec 11th 1989

Chapter 1.

Floating and Anchoring Currencies

Two Fixes - 1924 and 1987

In the long record of financial history, moneys have normally been either commodities, such as silver or gold, or titles to specific quantities of such metals. In fact, since 1717 Britain has spent more than 200 years with a gold convertible currency. During wars and their aftermath, gold convertibility was usually suspended but was resumed again after a period of inconvertible paper currency. Under the exigencies of World War I, Britain decreed the gold-inconvertibility of the pound and allowed sterling to float. The post war inflation and rapid deflation, as well as the 1923 hyperinflation in Germany, gave graphic evidence of the fragility of irredeemable paper currencies. An anchor was required. In the mid 1920s, therefore, it seemed entirely natural to return to the standard which had served the Western countries well in the last half century - gold. After eight years of a floating exchange rate, in 1925 Churchill, then Chancellor of the Exchequer, had chosen to peg the pound at the equivalent of the pre-war parity of \$4.87 (the

United States dollar was convertible into gold at \$34 per fine ounce).

In one of the great economic tracts of the 20th century - "The Economic Consequences of Mr. Churchill"(1925) - John Maynard Keynes argued that the return to the prewar gold parity for sterling would entail the most painful deflation of British prices and wages. Keynes said that at a stroke it would render uncompetitive much of industry, and particularly the great export trades such as coal. Keynes proved to be quite right. In particular the pressure to reduce wages and make coal exports profitable lead to the strikes of 1926, which embittered workers and exacerbated class conflicts for many years. True, Britain continued to grow in 1926-28, but at a low rate compared with the United States and Germany. Finally the high value of sterling exacted its toll in full measure when the world economy took a sharp downturn in 1929. The dole queues lengthened dramatically and output fell sharply. Only when Britain went off gold, in 1931, did the economy show signs of recovery. With a floating rate from 1931, Britain's recovery proceeded until overtaken by the rumblings of World War II.

The return to a golden anchor had validated all Keynes' dire predictions. He saw the advantages of an anchor, but he condemned the tight golden chain which

would pull the ship underwater; he wanted enough chain to manouvre the ship of state. Keynes knew that World War I had seen the end of the old gold standard. Countries were no longer prepared to follow the old golden rules; allowing the money supply to contract when they lost, and to expand when they gained, specie. Governments wanted to have their cake and eat it. More than ever before World War I they wished to tailor their domestic monetary policy to their need to create jobs, rather than allowing the gold flows to dictate monetary contraction and further recession. This fundamental dilema was put succinctly in 1923 by Keynes in yet another great tract.¹ If there is a conflict between the policy requirements for domestic conditions and the policy needed for international obligations, then, argued Keynes, domestic objectives should take precedence. Certainly in those years between the two world wars, Keynes was proved to be right.

In the 1980s, alas we faced the same dilema but with no Keynes. The menu of choice, however, had been widened. In the 1920s Churchill's choice was between floating and joining the gold standard at a truly fixed rate. It was expected that the parity would "never" be adjusted (except under the then unthinkable conditions of

¹. A Tract on Monetary Reform, 1923, reprinted in Keynes, Collected Writings, Vol IV, London Macmilan for the Royal Economic Society.

another World War), and the rate was to be kept within the "gold points" - about 1/2 percent. By the 1980s, however, we had experienced the "fixed but flexible" - or pseudo-fixed - system of Bretton Woods and, in the 1970s and 1980s, the European "snake" and its successor, the European Monetary System (EMS). These systems were eventually quite quite free from any gold anchor. They provided for much more variation about the par value (plus or minus 2.25 and even 6 percent in the case of the EMS). Furthermore, after consultation and some sort of agreement, the par or central value could be realigned. With a bureaucratic logic, these "fixed but flexible" systems were thought to capture the best of the truly fixed anchor and the best of the free flexible float. The central banks could keep their power to create money at their (or their government's) discretion to control demand, while at the same time an anchor (albeit a rather draggin anchor), not to gold but to a trusted currency such as the Deutschemark in the 1980s, would prevent inflation or deflation getting out of hand. Thus the great nations of continental Europe (and Eire) flexibly fixed their currencies to the mark. Because of its special status as a widely used international currency and because of North Sea oil, sterling did not join the ERM.

During the 1980s there have been many campaigns to induce Britain to join the Exchange Rate Mechanism (ERM)

of the EMS. It has been widely represented as a touchstone of the degree of commitment to the European Community or to the objective of a monetary union of Europe. Much of the support for joining the EMS rests not so much on economic argument as on political conviction and concern about "missing the Eurobus", two-tier Europe, and on a forlorn Britain excluded from the great blocs of the rest of the world. But as so often the case, political persuasion and debate, in its search for allegiances and support, ignores critical differences in economic analysis and policy. One of the main points of this book is that in economic terms one can see much virtue in either absolutely free exchange rates and, alternatively, in a monetary union with a unified currency; yet the pseudo-fixed system of the ERM is an anathema and inherently flawed. Consequently in economic terms, it is quite sensible to have serious reservations about the ERM/EMS but to be an enthusiast for some particular forms of monetary union.

The unity of Europe was also a major difference compared with Churchill's interwar uncertainties. European union was far from Churchill's mind, whereas today Eurounion proceeds at a rattling pace. In 1925, Churchill looked towards what appeared to be the only safe anchorage the world had known - gold convertibility. Keynes may well rail against gold as a "barbaric relic" but it had always been the refuge of any responsible

government after periods with an inconvertible paper currency. The dollar then was "as good as gold" - with no fears about inconvertibility. And so the dollar was disciplined by the promise of the Federal Reserve Board to redeem dollars in gold.

In the 1980s, however, the gold anchor had long been cut loose by all states. Nor had any other commodities, or bundles of commodities, replaced gold. (This had occurred formally when the United States severed the gold link, but in reality convertibility had been much diminished in the years after World War II). When the British government decided to peg sterling in 1987, it was not to gold but to the Bundesbank's Deutschemark. And the Deutschemark had abolished gold convertibility almost two decades before.

The consequences of the fix of 1926 were severe. As Keynes so powerfully argued, the return to the gold standard at \$4.866 rendered British exports (particularly of coal) quite uncompetitive on world markets, so the only possible adjustment for British wages and prices to fall. And Keynes rightly predicted that the only way they could fall was by having a prolonged recession. In 1926 Britain began the downswing into the great depression. Only in 1931 when sterling was floated free off its gold anchor and depreciated did Britain begin to emerge from the slump. The cost of Mr. Churchill was

far greater than even Keynes calculated. And the divisiveness and distortions of that period remain with us, in muted form, even to this day.

In 1987 sterling was pegged at 3.00 (or strictly just below 3) Deutschemarks. True this was no official peg, but the markets were given to believe that 3.00 was the appropriate value and that the Treasury and Bank would jolly well see it stuck. Everyone believed it. Why 3.00 and not 3.30 or 2.70. It is not clear why this value was chosen as the pegging level - partly, one supposes, because it had been hovering near three at the time, or perhaps because it is nice round number. If one wished to provide a rationalization consistent with economic theory, one would have to argue that 3.00 was near and, under expected differential inflation rates, was likely to remain near the "fundamental real equilibrium exchange rate" (FREER) - an elusive concept that will worry me, if not you the reader, in chapter..

The 1925 fix was much more disastrous than that of 1987. Instead of the for six years of absolute fixity to 1931, the wobbly fix of 1987 did not make it through a second year. In 1926 Churchill fixed above the market, making sterling too dear, whereas in 1987 sterling was fixed initially below the market value making the pound too cheap. Instead of the National Strike of 1926 and the depression and deflation of the

1930s, the pegging of sterling in 1987 launched Britain into a boom and inflation. Soon the inflation and the rise in interest rates required to control the monetary growth and prevent that dreaded "free-fall" of sterling ensured that a marked slowdown, even a recession would be required in order to restore price stability.

The consequences of returning to gold in 1925 included a breakdown of the international trade and monetary systems, massive trade restrictions, ultimately exchange controls, and all the curious panoply of agricultural support, 'reconstruction' measures that are still with us in one form or another. The short fix of 1987, I believe, is likely to have no such long term consequences. It is plausible to suppose that it will be but a "blip" (but rather a large one) on the third Thatcher government's record, and that open commodity and financial markets will continue to be the proud result of the Thatcher renaissance.

Fixes, Floats and Fudges in Exchange Rates

Underlying much of the discussion of international monetary arrangements in the 1970s and 1980s has been the yearning for some system. The present arrangements where the major currencies, dollar, Deutschemark and yen, float more or less freely against one another, is often called pejoratively the non-system. Notwithstanding the obloquy

that has been poured on this non-system, certainly since 1982 it has served the world well in. first the disinflation of the early 1980s and secondly it has provided the stable environment for the longest inflation free expansion in most Western countries. Yet there is good reason for believing that however well the non-system has performed, if there is no acknowledged anchor for currencies, there are still dangers of runaway inflation.

The underlying rationale of the EMS/ERM was that, while we could not anchor to any commodity or gold, we could anchor to the currency with the best reputation and institutions to ensure stability...the "zone of stability" which was the original aim of the founders of the EMS. There is much to be said for this basic idea, provided that the rate is absolutely fixed. But, over the life of the EMS, exchange rates have not been fixed. They have wobbled in the band and moved at realignment. If the ERM/EMS rates had been really fixed, instead of pseudo fixed, then there would be no possibility of profit from speculative capital movements, and indeed one of the main indictments of the EMS would have been null and void.

There is, however, a fundamental divide on the issue of fixed and pseudo-fixed exchange rates and monetary policy. I argue that absolutely fixed exchange

rates is a good alternative to a free float. But then you must set up monetary institutions, such as a currency board, that are consistent with such fixity. There is no room for a monetary policy at all; in that sense monetary sovereignty is relinquished to Germany. This is a matter of both logic and fact, as is clear from the records of the many countries that have, over centuries, operated currency board systems. The only monetary role of a central bank is to exchange currencies at the fixed rate. I regard the pseudo-fixed system, with its wobbling in the band and the propensity to leap to a new level on a 'realignment' session, as the worst of both worlds. Furthermore pseudo fixed exchange rates are accompanied by a pseudo monetary policy. Both are indeed half-baked.

Another disconcerting feature of the EMS/ERM arrangement is its dependence on the proper behaviour of the Bundesbank as an anchor. Historically, over more than three decades, the independent Bundesbank has behaved, if not impeccably, then certainly far better than any other central bank in defending the value of its currency. But, apart from the question whether that is good enough, legitimate doubts may be voiced about whether history is a reliable guide to future performance. Will the Bundesbank maintain its true independence and will it be able always to resist political pressures, such as those arising from the unification of the two Germanys, or those which emerge

from international coordination similar to the Louvre accord ?² One notes that the Federal Reserve Board, the other major independent central bank, did succumb to political pressures to inflate in the 1960s and 1970s. Inevitably the Bundesbank, just like the Fed, depends on the discretionary behaviour of people, rather than on the automatic rules of the old gold standard.

An Inflation-free Currency for Europe

Mr. Lawson's idea that there should be competitive currencies to see which is the choice, not of the bureaucrats of Brussels, but of the private citizens of Europe is attractive. However I believe that there should be another competitor in the field - a currency which by its very constitution is neither inflationary nor deflationary. A currency which maintains its constant and true value in terms of a defined basket of goods, such as the average consumption basket of European citizens. We shall call this currency an ECOM, to indicate that it is a European commodity money. Such a currency could be written into the constitution of Europe. It requires no central bank, only a bank of issue or currency board.

²The retirement of that rock of monetary integrity, Dr. Helmut Schlesinger in 1990 will provide a good test of the robustness of the institution.

If the ECOM is successful in its competition with other currencies, then it has a fair chance of being adopted as "the" currency of Europe. Indeed governments may agree to allow their currencies to be subsumed, initially by fixed exchange rates with the ECOM, and then entirely abolished in the adoption of the ECOM as the European currency. The great advantage of the ECOM is that it does not involve any surrender of sovereignty to any Central Bank of Europe, to the Bundesbank, or to Brussels bureaucrats or European politicians. A Community state will surrender its monetary sovereignty to the principle of an inflation-free currency. That may well be a surrender which might be attractive to many of the twelve.

And not only the twelve. Since the departure from the old gold standard in 1914, the whole world has experienced persistent inflation (the only exceptional period being the period from 1929 to 1936.). The world cannot and, indeed should not, return to the old gold standard or any version of the gold exchange and Bretton Woods systems. Gold is indeed a barbarous metal, of dubious provenance and subject to all the vagueries of technology and taste. A currency based on preserving constant the unit of account for a wide basket of commodities is much more desirable than a monetary unit linked to merely one precious metal. Nor do we need

to keep stocks of commodities to operate the system. We can create paper assets which perform as surrogates for such commodities (unlike the old gold standard where stocks of gold were de rigueur). The attractions are clear. And if the Community were to make an obvious success of this ECOM, would not the United States, Canada, Japan etc be quick to follow ? Just as the old gold standard rose around the preeminence of a liberal Britain, so might the ascent of a truly liberal Europe promote the new Thatcher standard by the end of this century.

§ Such reflections are, of course, far beyond the economic consequences of Mr. Lawson. But Mr. Lawson can fairly claim to have opened wide (perhaps inadvertently) the debate on the monetary constitution for a liberal Europe. I hope that this book will add at least something to the debate.

Chapter 2

Ideas on Money and Exchange RatesExchange Rates as Allocators of Foreign Exchange

One of the main jobs of the exchange rate is to ensure that people, both domestic residents and foreigners, are just willing to hold the stocks of money, be it pounds, dollars, marks or yen, that exist at any moment of time. Just as the price of a bond is such that people are just willing to hold the outstanding stock, so the exchange rate ensures that people are content to hold the various moneys of the world. People will wish to hold a particular foreign money for many reasons: to pay for imports, to finance a visit, to buy assets, to make a remittance, or simply to hold as a speculation. These influences may change dramatically over time. But there is one ubiquitous influence that affects all these motives for holding foreign exchange; that is the price of the money or the rate of exchange. Like any other commodity foreign exchange in general obeys the law of demand, the lower the price the larger the stock of foreign money people will wish to hold.

These motives for holding foreign exchange change,

usually quite unpredictably over time. Domestic droughts and disasters create a demand for foreign currency to finance imports. Discovery of some cornucopia of exportable minerals (such as gold or silver) creates for that country a ready supply of foreign currency - in other words a foreign demand for the domestic currency. The stock of money of each country is largely determined by the monetary authorities. They may be taken as approximately given. Then the problem is to allocate these existing stocks among the competing demands.

In a free market system the authorities would simply allow freedom for any person or body to contract with any other, whether foreign or domestic, to sell foreign exchange at any mutually agreed price or exchange rate. Since the number of customers and suppliers is huge, the outcome is a very keen competitive market exchange rate. This rate will move continuously to clear the market, and, often, instead of being called a free exchange rate, it is dubbed a "flexible exchange rate"¹.

Dirigisme and Interventions

There are other ways of doing this job of

¹ Unfortunately the word "flexible" been taken over by those who eschew free exchange rates and embrace a bastard "fixed but flexible" exchange rates, such as those in the Exchange Rate Mechanism of the European Monetary System.

reconciling the demands with the existing stock. One way is to regulate the demands through some form of rationing. A common procedure is to regulate movements of capital and assets, "capital controls". But some countries practice more or less universal exchange controls and many limit the foreign currency and asset holdings of institutions. Although in some quarters there is a nostalgia for the days of fixed exchange rates supported by a battery of exchange controls, I believe that the vast majority of people are convinced that such instruments are inconsistent with the values of a liberal society.² Exchange controls are a viable if odious solution.

Another path by which demand and supply can be equated with a fixed exchange rate is through the monetary authorities of each country maintaining stocks of foreign exchange which they supply to the market when there is an excess demand, and which they take off the market when demand is less than supply at the fixed exchange rate. The problem is that the fixed exchange rate chosen may be or become consistently too low or too high to match demand and supply. Then the monetary authorities will go on accumulating foreign exchange, if too low, or run out of stocks if too low. At best

². I wish it were possible to dismiss any thought that exchange controls would conceivably be imposed by some future government of the UK. Alas it would be folly to ignore the contingency.

the operation of exchange equalization through official intervention, as it is called, can only be a temporary respite and not a permanent solution. But intervention (we often miss out "official") has many forms and ramifications. For most of this chapter we shall consider exchange rates in the absence of intervention, so that we can defer the forms of intervention at the end of this chapter.

Reconciliation through Aggregate Demand³

The last method is for the authorities to affect the demand for foreign exchange by affecting the aggregate demand of the whole economy. Thus, with the exchange rate fixed, in order to reduce the demand for foreign, the authorities would attempt to reduce domestic prices, relative to those of trading partners, so that people are weaned away from their demand for imports and foreign exchange, and the domestic currency is made more attractive for foreigners to hold. The main instrument for controlling domestic aggregate demand is monetary and perhaps fiscal policy (although in principle the tools of dirigisme can be employed also in macroeconomic management.) This holds domestic monetary and fiscal policy hostage to the fixed exchange rate.

³. Of course aggregate supply also plays a crucial role here. I am ignoring supply side effects only for ease of exposition and certainly not because I believe them to be nonexistent or even unimportant.

Of course all these solutions have been employed at one time or another - often simultaneously in what the authorities would assert is a judicious mixture. But there is one central point. Clearly since the exchange rate is the relative price of moneys, any discussion of exchange rates must encompass an examination of monetary policies. The exchange rate is largely, but by no means wholly, a consequence of the monetary policies pursued by the monetary authorities. True this rate may be maintained by official intervention, or defended by exchange controls. But the underlying free rate of exchange will be largely a consequence of relative monetary policies. Typically these monetary authorities determine interest rates on the short term money markets by using the power of the government as the biggest trader. Alternatively monetary authorities fix the quantity of reserve money available to the banking system. But whatever the actual mechanism used, monetary policy determines the stock of money, and the rate of growth of money in the system.

If "too much" money is created then, like any other glut, the price of money will fall. People will try to reduce the amount of money they hold by spending it. On goods and services and, if allowed by the authorities, on other (foreign) moneys. Thus the domestic prices of goods and services will tend to rise. But this rise will be countered, in part, by foreign trade. Imports will

increase and exports fall. The trade gap will open. To buy the additional imports more foreign currency is required and there is a smaller supply from the reduced exports. The value of the foreign currency will increase; the domestic currency will depreciate. The overexpansion of money has reduced the value of the currency in terms of the size of the basket of goods it can buy on the home markets and, through the exchange rate depreciation, on international markets.

Of course, factors other than monetary policy can affect the prices of goods and of currency. Boosts in real output, catastrophies, dislocations and recessions can affect the flow of goods and services. These effects change the flow of goods facing the monetary demand - the larger the flow the lower the price and the higher the value of the domestic currency. It is the increase in the supply of money relative to the increase in the supply of goods that is an important determinant of both prices and the exchange rate.

Confidence and Credibility

There is another much more nebulous set of influences that much affect exchange rates, particularly in the short run. They are to be summed up in the words, on the one hand, "confidence" and "credibility" and on the other, "expectations" and "uncertainty". In

the General Theory, Keynes argued that confidence was a main determinant of economic activity, but, realist that he was, he admitted that we knew did not know how to analyse it and its effects. Any market practitioner can feel in his bones whether confidence and credibility are high or low. Among the things he will take into account are perceived consistency of policies, using whatever historical or parallel evidence seems relevant. At this stage, however, the perceptive reader will accuse me of waffling merely to disguise my ignorance. True. I would claim, however, that we have made some progress in analysing expectations both of monetary policy, exchange rates and their consequences.⁴ But it is, I think, still true to say that our understanding of swings of confidence etc is very sketchy. As we shall see later, this is particularly unfortunate since much of the argument for joining the ERM/EMS and other fixed exchange rate systems hinge on the alledged acrual of credibility and confidence. This particularly applies, not so much to the goods market, but to the international market for financial assets - to which we shall shortly turn.

⁴. In particular, the idea of consistent or rational expectations takes the position that people will formulate their expectations such that they are consistent with the basic laws of economics which they believe are best applicable to the phenomena they are analysing. In principle people are maximizers. Those who will survive and prosper will form expectations that are consistent with the "best" theory. For a first formulation of this idea in macroeconomics, see my "Consistent Expectations and the Quantity Theory", Economic Journal, 1971. The subject has since become a major preoccupation of many economists. See Minford and Peel, Robert Lucas, etc

Real Exchange Rates (Goods)

In much of economics we are used to talking about money as a "veil" over the important system of exchanges of real goods and services. Money serves as a transaction medium, but it is the underlying exchange of one good or service for another that is the real stuff of economic life. The exchange rate records merely the price of money in terms of a foreign money. It does tell us the exchange rate between domestic and foreign goods and services.

If you are a casual reader or a pure economic theorist, the answer to this is obvious. Ignoring transport costs and trade barriers, it is ineluctable that the price of say a tonne of steel in Britain in pounds must be the same as the price of steel in Pittsburgh measured in dollars. If, per contra, the price in Britain were higher, then all steel buyers would rush to Pittsburgh, while the suppliers were deluging Britain with steel. The most delicate equilibrium requires the same real price. In the real world of transport and factoring costs, trade barriers, imperfect knowledge, sticky prices, etc, such an equilibrium is merely an abstraction. Prices, expressed in a common currency, do change over time. Indeed these price changes are the essence of the process of adjustment

to changing trading conditions.

They are so important that economists have defined them as the real exchange rate as distinct from the nominal exchange rate. As the nominal exchange rate measures the price of one money in terms of another, so the real exchange rate measures the price of traded goods in one country in terms of the price of traded goods in another country where the prices are both expressed in the same currency using the current nominal exchange rate. It looks simpler in algebraic form:

$$\text{Real Exchange Rate} = (\text{Stg Price in UK}) / (\$ \text{Price in US}) \cdot (\text{Stg value of } \$)$$

$$\text{or RER} = (\$ \text{ value of stg}) \cdot (\text{Stg Price in UK}) / (\$ \text{ Price in US})$$

This expresses both numerator and denominator in sterling. As the ratio rises so does the prices of goods in Britain increase relative to the prices in the United States. The UK becomes less competitive.⁵ The real exchange rate ignores any change in price that is exactly counterbalanced by a change in the nominal exchange rate. Suppose, for example, prices in the UK doubled whereas

⁵. It might be worth noting that, if we express the numerator and denominator in dollars, exactly the same result emerges. And the real exchange rate of the United States is the reciprocal.

American prices remained constant; but if the nominal exchange rate changed so that we got only half as many dollars for the pound, the competitive conditions would remain the same. (One can think of it as shifting from a 100p to a 50p unit of account: the relabelling does not affect the underlying realities).

To illustrate the use of the real exchange rate (RER), let us imagine that for some exogenous reason the world's taste shifts from goods that Britain produces (scotch) to foreign products (champagne). The real exchange rate needs to fall to induce the world to buy the flows of scotch and champagne. Assume that Britain is a small part of the world market for champagne so that the dollar price of champagne does not change, one way this can be achieved is by reducing the sterling price of scotch, holding the nominal exchange rate constant. An alternative is for sterling to depreciate against the dollar while holding the two prices constant. And there are obviously many alternatives between (and indeed outside) these two solutions. A flexible exchange rate gives another degree of freedom in the adjustment of real exchange rates for goods.

In the theoretical world of champagne and scotch, the prices one uses are obvious. Alas this does not carry over to the real bread and butter world. There are many possible theoretical RERs, depending on the

questions one is examining. And there are many limitations on the measurement of RERs due, primarily to the limited data available on price movements. Since the purpose of this book is to examine the the process of monetary policy on exchange rates and inflation, it is natural to define the RER in terms of the price indices of traded goods or tradeable goods. Rough approximations to these can be found in the wholesale price indices or producer price indices. But there are many problems of interpretation.

Real Exchange Rates (Capital)

The relative prices of goods are only part, indeed to many the least important part, of the story. The main "commodity" that flows across national frontiers are financial instruments, such as deposits, bills, CDs, bonds etc. The flows of foreign exchange business connected with capital export and imports far exceed (perhaps by a factor of 50) those concerned with goods and services. The fundamental idea of the real, as distinct from the nominal, exchange rate also applies to these capital movements. But financial instruments are different from goods and services. With a tonne of steel the price paid is the only monetary transaction. Financial

instruments, however, normally involve future money flows defined in a particular currency. These include not merely the interest or dividend payments but also the return of principal. Thus it is not only the current or "spot" rate of exchange that affects the relative price (the RER) but also expected future values of the exchange rate.

This problem of differing maturities of payments, however, is solved if there are suitable forward markets for foreign exchange. If a one year deposit in dollars yields 8 percent and a one year deposit in sterling yields 15 percent, then, in the absence of transactions costs, it will pay any investor to put his money in sterling if he can get a guarantee to buy dollars (sell sterling) in one years time at less than a 7 percent premium (7 percent discount) on the current spot rate. This rush into sterling will stop when the total rate of return (that is to say the interest rate minus any loss on buying one year forward dollars) on sterling deposits is equal to that on dollar deposits. This implies that, in equilibrium, there must be covered interest rate parity, that is, for one year:

Interest on sterling = Interest on dollars plus
forward dollar premium on stg

or Interest on dollars = Interest on stg minus

forward dollar premium.

This knife-edge equilibrium ensures that there is no incentive for switching from one currency deposits to another.

Covered Interest Parity- Reality and Causation

The covered interest rate parity equation is a pure or theoretical case. It is analogous to the pure case of Pittsburgh steel with no transactions or transport costs, perfect knowledge and no trade restrictions. Then just as the price of steel must be the same in each country, so in this case the rate of return which one gets on the same sum of money must also be the same in each country.⁶ But there is much more reason to take the case of the equality of return on money as much closer to reality than the case of steel and most other goods. Interest rates move with far more alacrity than the prices of goods. No stickiness there. For money transactions costs are much smaller, and transport costs are virtually zero. In free markets, therefore, the covered interest parity will be a close approximation to reality.

⁶. These equalities are the results of goods arbitrage, in the case of steel, and capital arbitrage in the case of money.

The equation does not imply anything about causation. It merely states what must rule in equilibrium. It does not tell us how that equality is brought about, or how interest rates, spot exchange rates and forward premia or discounts interact with one another. For those causal relationships one must look at the underlying relationships of demand and supply. Whatever story we tell, however, must be consistent continuously with the covered parity principle. The covered parity rule does tell us that obvious, but often ignored, fact that, in a free market, a government cannot simultaneously truly fix the exchange rate and at the same time vary interest rates as required for an independent monetary policy.

One perhaps might expect that the forward markets would give an accurate guide on the realized path of exchange rates. The markets reflect a sort of consensus of views about the expected path of the rate, and it is often said that markets are efficient in using all the relevant available information in making forecasts of the future. An interesting point, however, about the forward markets for foreign exchange is that they are poor predictors of performance.⁷ Indeed, knowledge of the forward market values is of no use in predicting the

⁷ Strictly it is not the forward rate that is the predictor of the future spot rate. The true predictor is the implicit discount (or premium) - that is the divergence of the forward rate from its interest rate parity.

future actual path of spot exchange rates. In fact the current spot rate is a better predictor of future spot rates than is the forward rate. These results are not really surprising. If there really were information in the forward rates about the actual path, then that information would be the source of profit; everyone would realize it and so drive the spot and future rates to values where all the profitable information has been leached out, leaving only the dross in the forward values. Nevertheless these forward markets do provide an invaluable way of hedging currency risk or taking a speculation on the outcome. As we shall argue, such markets enable one to overcome many of the alledged disadvantages of a float.

The Effective Exchange Rate

Up to now, the discussion has been simplified by supposing that there is only one exchange rate between domestic residents and a homogeneous mass called foreigners - between us and them. In the real world there are about 170 countries, almost all of which have their own currency. Thus there are some 160 exchange rates between sterling and other currencies. Obviously some, such as the US dollar and the deutschemark, are much more important than others, such as the kwacha or cedi. In order to get a simple measure of the movements in the nominal exchange rate, vis a vis all

other countries, one needs some weighting system in order to get an average exchange rate that reflects the importance of the countries. The best weighting system would be one that reflects the number of foreign exchange transactions in each currency. But, so far as I am aware, no such weighting system is used - probably because of the difficulty of getting reliable comprehensive data on foreign exchange transactions.

Instead the authorities have devised what is called an "effective exchange rate" which weights each constituent foreign exchange rate by the total amount of trade between Britain and that particular country. The effective exchange rate (EER) is in fact the trade-weighted exchange rate, and is reported as an index number. The real effective exchange rate (REER) is calculated in the same way.

For most of the discussion in the following chapters, I shall refer to the sterling

exchange rate without going into the complexities of the effective rate. But it should be understood that I am referring to the EER or the REER.

The Many Jobs done by the Exchange Rate

From the discussion of goods and money and capital markets as well as from the complexities of many

countries, it seems that the exchange rate performs a myriad of tasks. But it is useful to summarize them under two general headings:

First, the exchange rate moves to equilibriate the demand and supply of traded goods and services. Although for most primary commodities, such as grain, oils and metals, prices move speedily to clear the market, in manufactured goods there is usually some considerable stickiness in their prices. They move sluggishly in response to market forces. The exchange rate in a free market, however, moves with alacrity and speedily signals and eliminates the shortages and surpluses on the goods markets (but not on the labor market !). At the same time the exchange rate must ensure that, along with interest rates, there is a sufficient attraction to capital flows to finance the deficit on the current account of the balance of payments. The net capital inflow, from dollars to pounds, must be just enough to balance the whole account.

Second, the exchange rate must be such that the existing quantities of non-interest bearing money in both the domestic and foreign countries be willingly held. If there is too much of the domestic currency relative to the foreign currency, then the domestic currency will decline in value in terms of the foreign currency (that is it will depreciate). One might go further and argue

that it is also the critical factor that induces people willingly to hold the existing quantities of financial assets denominated in, respectively, the domestic and foreign currency. But in the case of financial assets generally, as distinct from non-interest bearing money, one must also take account of the yield in one currency on such assets. However it is clear that the exchange does a most important job in ensuring that people willingly hold the existing stocks of financial assets in the specific currency denominations of their choice.

Like other phenomena in economics, this simple price of one currency in terms of another does an enormously complex job of coordinating millions perhaps even trillions of decisions about producing and consuming goods, adjusting portfolios, investment etc. The free price system is a wondrous mechanism that can do all these things through the self-regarding behaviour of individuals. The millions of individuals rarely see one another, probably do not understand each other's language, and may even be highly antagonistic. Yet, through the price system, they achieve an immense harmony of cooperation and coordination. It is also clear that highly managed exchange rate and planning systems that eschew the use of free price adjustments have been dismal failures - as the experience of Eastern Europe and the Soviet Union attests.

Long Run PPP and Short Run Dynamics

Yet our understanding of the workings of the free market system is, to put it mildly, imperfect. In the field of monetary policy and exchange rates it is particularly important to be clear about what we do and do not know. Of course we step on much disputed territory. What follows is very much a personal interpretation. This is based on both my reading of theory, the evidence, and direct observation.

First and most important of all is that in the long run the purchasing power parities of currencies (PPP) must be roughly equal. Exchange rates must adjust to reflect the differences in the price levels. Thus a one-shot increase of the money supply will give rise to an increase in the price level and a depreciation in the exchange rate - both in the long run. Similarly an expansion of monetary growth, relative to those of our trading partners, which is expected to persist will give rise to a long run continual depreciation of sterling.⁸

There are many pertinent examples of this long run rule. For example the long run depreciation of sterling

⁸. Both statements must be qualified since differential real growth may have a significant effect. The monetary expansion is meant to be over and above that required to accommodate the increase in the demand for money accounted for by real growth of GNP. Also there may be systematic shifts in the long run demand for money. Again these should be accommodated in interpreting the effects of money on exchange rates and inflation.

against the Deutschemmark and the dollar attests to the fact that the monetary policies of Germany and the United States have been less expansionary and that the inflation rates have been, on the average, lower than those in the United Kingdom.

I believe that there is a broad agreement among economists that we can be fairly confident of the long run effects of monetary policy on the price level and on exchange rates. The former goes up and the latter down, more or less proportionately. But there is much less agreement on the short term dynamics of the adjustment process - again both in monetary economics and in exchange rate dynamics.

The basic problem is that, in the short run, there are many complexities and effects which are difficult to model and impossible to control. For example in the weekly or monthly adjustments, expectations and uncertainty must play a dominant role. Rumour and report of political events can play havoc with markets. Furthermore, short term movements in output, stickiness of prices, excess capacity will all have important, even dominant effects, in weekly or monthly movements.

Overshooting

One commonly accepted account of the transitional

reaction of exchange rates to changes in monetary growth suggests that, far from rising monotonically to its new equilibrium value, the nominal exchange rate will far overshoot its long run target, but in the long run it will return to its PPP level.⁹ The rationalization is most easily seen if we first assume that total real output is fixed throughout. An expansion of the money supply will have the effect of depressing interest rates. Everyone will expect that prices will rise and there will have to be a corresponding devaluation in the long run. But the fall in interest rates will give rise, in the very short term, to a capital flight which will in turn cause a sudden and sharp devaluation. The devaluation will cease when domestic resident can secure an overall rate of return, that is interest plus expected appreciation of the currency, equal to that which they can acquire abroad. In order to provide this expected appreciation, the sharp fall in the exchange rate must be sufficient to take it below the long run equilibrium value. Then all asset holders can look forward to an appreciation of the domestic currency up to the long run equilibrium. In short, the spot exchange rate must fall below its new long run equilibrium path, so that the future appreciation of the exchange rate will compensate

⁹. The phenomenon of overshooting is characteristic of many models of the monetary process. I discovered this to be true of Milton Friedman's permanent income demand hypothesis. See my article, "Professor Friedman and the Demand for Money" (check title), Journal of Political Economy 1965.

for the initial fall in interest rates.¹⁰

A quite crucial feature of this story is that the prices in manufactured goods and labor markets adjust much more slowly than prices in the markets for assets and in foreign exchange.¹¹ But the increase in demand due to the monetary expansion will be generated not only through the lower domestic interest rates but also through the devaluation. Since the sticky prices are fixed in the short run, this implies that the nominal devaluation is also a real devaluation. But prices will then increase over the adjustment period, and both the nominal and the real exchange rate will rise. Indeed over this period one will observe increasing prices and an appreciating exchange rate - exactly the opposite of the long run adjustment !

This neat picture is somewhat obfuscated if one allows for potential movements in output. There is some

¹⁰. There is another non-monetary reason for the real exchange rate to overshoot in adjusting to a new level. Because the elasticities of supply and demand for goods are normally lower in the short run than in the long run, the real exchange rate will have to move much more in the short than in the long run. This form of overshooting is inherent whatever the exchange rate regime. See Milton Friedman, "The Case for Flexible Exchange Rates", Essays in Positive Economics, University of Chicago, 1953.

¹¹ This argument implicitly assumes that trade is dominated by manufactures where stickiness is thought to be evident. If trade is dominated by commodities then it is a different story.

evidence that a monetary expansion boosts real output during the shortish run - between some 6 months and perhaps up to 18 months before it dies away and becomes negative. This expansion will tend to reduce the fall in interest rates, maybe even increase them, and so dampen the overshoot after 6 months or so of the adjustment period. But the 6-18 months boost to output will then reverse.¹² This will produce yet another downward force on interest rates and an appreciation of the the spot exchange rate lagged at least some 18 months behind the original monetary injection. Yet another late overshoot is possible, which is likely to occur just at the time that the sluggish prices are at last starting to move up.

Of course, any reader having got this far will conclude either that economists who produce models which capture this dynamic process must be fiendishly clever or that such economists dont know what they are talking about. Both are true. However plausible this account of the dynamics of

¹² Such a reverse must take place since it is illogical and quite inconsistent with the evidence to suppose that, by increased monetary injections, one can always raise output growth, albeit temporarily in the 6 to 18 month period, without growth dropping below its trend line afterwards. Any such scenario would enable a country to inflate and increase the long run level of its GNP. This reversal of the original output boost will, through the reduced demand for money, have a downward pressure again on interest rates which may in turn lead to a secondary exchange rate boost.

adjustment, it is far from being a reliable tested proposition. Casual knowledge suggests that exchange rates have fluctuated more than monetary policy and the overshoot hypothesis may be one of the explanations. But there are many more influences on the dynamics of exchange rates as we know from the fact of their short run unpredictability. I would be inclined, however, to regard the overshooting phenomenon as something to look for but not something to rely upon.

An Alternative - Short Run Perversity

This skeptical view is supported by an alternative view of the short run adjustment mechanism, which seems to me to have just as much plausibility as the overshooting hypothesis. Suppose, per contra, that domestic prices - such as the prices of real estate, cafe services and above all the prices of commodities - do respond rather quickly to the increased demand. Let us then begin again with a monetary expansion at home (in Britain). Instead of looking at the path of equilibrium through the need to induce people to hold existing stocks of financial assets, let us examine instead the flow equilibrium through exports and imports. brought about by an excess domestic aggregate demand.

With a domestic supply response not elastic enough, in the short run at least, to assuage the domestic

demand growth, the only way to satisfy the demand is through decreased net exports. In order to reduce exports the sterling price of those exportable goods, relative to the prices of non-traded goods, such as houses and haircuts, must be increased. The deficit on the current balance of payments will increase. And in order to ensure such an increase in the overseas deficit, the real exchange rate must appreciate during the adjustment phase. The, albeit transitory, movement of the exchange rate is perverse

This is exactly the opposite of the sticky-price-overshooting theory. In the long run however, the stories converge. In the appreciation case, the deficit on the current balance is eventually eliminated, via a transitory surplus, and the economy settles down at higher prices but at a restored relative price of tradeables to non-tradeable goods. It all comes out the same in the end.

But this should be little comfort to those who seek to track the short term oscillations of the exchange rate - or indeed to those who seek to hang the economy on such shifting values. I suspect that most professional economists in the field would be prepared to defend the sticky-price-overshooting version of the adjustment process.

The slow reaction of the prices in markets for manufactured goods, compared with the speedy reaction in

the markets for financial assets is a common theme of most accounts of the adjustment process. Yet there is no theoretical reasons why this should be the case. Nor has there been any extensive empirical investigation of the issue of price flexibility. Casual observation suggests that the prices of goods, particularly food, are highly flexible, often reflecting daily or weekly oscillations in supply. Similarly no-one can be in doubt about the boom and bust flexibility in the housing market. The reader may well reflect that this flexible price model tells a story which is rather similar to the experience of Britain in 1987-89; this is a theme I will take up again in chapter.7.

Exchange Rates as a Monetary Thermometer ?

As a result of this discussion, one might concede that, in the short run , the nominal exchange rate is of dubious utility as an indicator of the appropriate monetary policy. This conclusion should occasion little surprise. Just as we know little about the short run adjustments of the economy to a monetary expansion, so we know perhaps even less about the oscillations in the exchange rate. The exchange rate is one of the main channels through which the effects of a monetary expansion are transmitted to the rest of the economy and to foreign countries. And it is above all a monetary phenomenon. Our lack of knowledge of the dynamic

adjustment paths of prices, real output, interest rate structures, etc. should be mirrored in exchange rates. And so it is.

This discussion of the principles of exchange rate adjustment has ignored, or taken as constant, many of the important determinants of exchange rates in practice. Changes in the weather, in political prospects, in technology, in the marginal profitability of domestic fixed capital formation, in thrift, and in expectations and confidence all impinge, often quite dramatically, on exchange rates. Even after the event, it is difficult or often impossible, neatly to attribute an exchange rate movement to its causes. It is quite impossible to do so for current movements in exchange rates.

For example, in 1987/8 the upward pressure on sterling vis a vis the Deutschemark did not indicate that Britain was enduring a monetary squeeze compared with Germany; the contrary was the case, for reasons which we shall go into later.

Fixed Rates and Stability

It has been suggested that, by adopting whatever monetary policy is necessary in order to assure fixed exchange rates, compared with any alternative regime the economy will be much more stable and avoid sharp variations in output and inflationary or deflationary

pressure. Protagonists of this view lean heavily on the assertion that confidence will be much greater under a fixed exchange rate regime than under any alternative arrangement.¹³ As argued above, there are a great many aspects to the concept of confidence and certainly there is no tested theory which tells us how to analyse it. Statements about it reflect largely the taste of the asserter. There are, of course, a myriad of subsidiary assumptions underlying any such assertion about, for example, the soaring confidence that would allegedly ensue if Britain joined the ERM, albeit a pseud regime. We shall defer discussion of these assumptions, but it is worthwhile reflecting at this stage on the efficacy of a fixed exchange rate regime.

What is required of a monetary and exchange rate regime is, I think, broadly agreed. We would like a stable and low (say 0 to 3 percent) rate of inflation, and we would like a high and stable growth rate with only sufficient unemployment to enable the market to work efficiently. From our discussion of exchange rates and monetary policy, it seems unlikely that, even if the reserve currency to which the currency was fixed behaved in the most immaculate manner, a fixed exchange rate regime would promote such conditions. For example, if

¹³. Because of the repetition of this view in his innumerable articles in the Financial Times, Mr. Samuel Brittan is certainly the best known advocate of this fixation.

the overshooting hypothesis is true, then any accidental monetary expansion would, under a fixed regime, require a very large short term increase in interest rates in order to offset the power of the overshoot.¹⁴ This would then lead to a great contraction in the rate of growth of the money supply, with an attendant recession to follow. If, however, the perverse model is true, then any accidental monetary expansion would be followed by pressure for an exchange rate appreciation, which must be eventually reversed. Such paths are hardly stable or secure.

The Fundamental Equilibrium Real Exchange Rate (FERER)

Clearly one of the main ideas of a fix is that once done, it is possible to simply let the system run on a sort of auto-pilot. However the system critically depends on getting the fix right. As Churchill discovered it was disastrous to get the wrong value to fix upon. In order to assist statesmen in this process, economists have tried not merely defining but actually specifying an underlying equilibrium rate. The value beloved of the fixers is the fundamental equilibrium real

¹⁴. This is presupposing that the fixed rate overshoots in the same way that the floating rate, namely through the current account. But a modest amount of uncovered arbitrage could offset the current account swing and thus may obviate any large interest rate movements. Strictly, as we show later, such movements should be ruled out because of uncovered arbitrage of all kinds.

exchange rate (FERER).

The idea is that there is an underlying exchange rate which, ignoring transitory random variations brought about by swings in confidence and expectations etc, would give rise to a deficit just sufficient to balance the capital flow needed to exploit the greater profitability of capital in the receiving country. Somehow the FERER is the "right" rate.

I think that virtually all economists and many others carry around some ideas of of an appropriate rate. Yet it is impossible to define one that is useful for policy purposes. Of course all would begin with some idea about PPP in order to get an appropriate balance in the current balance, so that there is suitable room for the desired capital flows. Such a concept would ignore however many realities of economic life - and to the peril of the policy maker. For example, suppose there is a penumbra of political uncertainty, say a left-wing takeover with capital and exchange controls in train, then this would have a dominant effect on the market exchange rate, allowing for capital flight on an unpredictable time table. It is clearly impossible to put such ideas in the FERER.

If it is difficult to define an operationally useful FERER it is quite impossible to make any meaningful measures of the concept. We have only sketchy ideas

about the demand and supply conditions in international trade, as it obvious from the large errors which forecasters make in their predictions. Virtually nothing at all can be forecast about the profitability of capital in Britain and her trading partners, and the job of defining a neutral monetary policy and the associated interest rates is quite beyond any mortal's abilities. Ignorance rules.

It is therefore not surprising that the most eminent economists have ventured completely different views about the appropriate movement of nominal exchange rates. In 1988, for example, Martin Feldstein argued that the yen should appreciate against the dollar in order to eliminate a large US deficit, but, at the same time, Ronald McKinnon (with considerable support from the Wall Street Journal) was urging a devaluation of the yen in order to return to purchasing power parity. In the famous Louvre Agreement (February 1987) it was asserted that the dollar-yen and dollar Deutschemark are "consistent with the underlying fundamentals", although they required enormous intervention to keep them in place.

This suggests that, even if we knew how to define the FERER, we do not know how to measure it and use it operationally. And there is great danger in using simple calculations of PPP to decide on directions of

exchange rate movement towards equilibrium. Substantial variations in PPP can take place, and indeed have taken place over the years after World War II. (Graph of p.175 of Cato Conference) Such deviations can persist for a long time. (Indeed today, all frequent transatlantic travellers are convinced that \$160 in Washington buys much more than 100 sterling in London - and has done for some time.) One should beware of using any simple PPP calculations as guide to determining what is the " fundamentals".

The impossibility of defining and fixing the FERER is simply an illustration of the general proposition that it is impossible to fix any set of equilibrium prices. However this is no clinching argument against fixing the nominal exchange rate. It is perfectly possible to fix the nominal exchange rate and allow inflation, and the consequent effects on activity, freely to adjust and validate the nominal rate. This is the underlying rationale of truly fixed exchange rate systems.

Intervention - Unsterilized and Sterilized

The discussion of official intervention, one of the four ways of securing a reconciliation of demand and supply on foreign exchange markets, was deferred while we considered the various other equilibrating mechanisms. Now we consider the direct involvement of government or

central bank in the market.

The simplest form of intervention, unsterilized, is when the government sells or buys foreign exchange in order to affect the rate, with no concomitant open market operations in the bond market.¹⁵ Thus if the Bank of England sells pounds and increases its reserves of dollars, this would be intervention against sterling and in support of the dollar. The important point is that the private sector would acquire more pounds. This foreign exchange transaction would increase the sterling money supply of the United Kingdom. This will eventually increase the price level. Thus the selling of sterling for dollars is simply a way of increasing the money supply. Instead of buying long dated bonds, as in normal open market operations, the Bank buys dollar balances.

For the most part, however, governments want to intervene only to influence the exchange rate. They may be quite content with their monetary stance and wish to confine effects to the foreign exchange market. Thus they wish to sterilize the intervention and offset any effects on monetary policy. If the target of monetary

¹⁵. Governments have many occasions to enter the market in conducting ordinary government business, such as buying imports or providing or receiving aid. Such transactions would not be intervention in the sense that their purpose is not to influence the exchange rate.

policy is the growth rate of some monetary aggregate, then in the sale of sterling example, sterilization would take the form of open market sales of a sufficiently large number of long dated gilts in order to mop up the sterling created by the intervention. The money created by intervention is taken back in the gilt sales. The market ends up with the same amount of money, increased holdings of gilts and reduced holdings of foreign exchange.

Sterilization - forms and effects

This definition of sterilization, although much used in theoretical work, is not the usual one used by central bankers in their actual operations. For the most part central banks control short term interest rates as their main instrument of monetary policy. Thus it is natural to define sterilization in terms of maintaining the short term interest rates unchanged. In the Bank of England operations, for example, the Bank supplies or subtracts from the market daily just sufficient funds to maintain the short term interest rates thought to be appropriate for monetary policy. When a substantial intervention, such as selling of sterling, takes place, the Bank mops up any excess that appears in the daily money markets to threaten the maintenance of the interest rate. In that sense, therefore, the Bank always sterilizes - up to the point at which it is decided to

vary the short term interest rate.¹⁶ When interest rate changes are associated with intervention, then it is unsterilized.

But the important question is: does sterilized intervention work ? Does it really affect exchange rates substantially while maintaining unchanged the monetary stance ? From experience, there is no doubt that sterilized intervention does have some effect in the short run. The immediate effect of foreign currency sales appears on the markets and probably has some effect on the market's expectations. However it is very likely that this effects lasts only for a short time - days rather than weeks. As Michael Mussa says, however: "There is good reason to doubt, however, that pure (i.e. sterilized) official intervention can have a significant effect on the long-run behaviour of exchange rates...when the market becomes perused that the authorities are attempting to maintain a disequilibrium exchange rate, the magnitude of intervention required to sustain the rate

¹⁶. The two definitions of sterilization cover a multitude of other subdefinitions. Obviously with the quantity-of-money-constant definition, there are as many definitions of sterilization as there are concepts of "money". It is important also to note that because interest rates and money have no exact or unique one-to-one relationship, there is in practice bound to be some monetary effects of sterilized intervention. And the larger the intervention, the more likely that these effects will be large. It will also be clear that intervention with sterilization is likely to affect the term structure of interest rates, which will again have monetary effects. In other words complete sterilization is elusive and ultimately impossible.

rapidly grows to enormous proportions"¹⁷. In view of what happened in Britain in early 1988, it is easy to appreciate Mussa's point.

In short, sterilized intervention is an instrument useful only for playing short run games with the market. (In my view this is unseemly behaviour for a central bank, but many regard it as a useful weapon in the bank's feasible armoury.) It cannot have any long-run effect on exchange rates. The very failure of sterilized intervention, however, has its effects on monetary policy. When sterilized intervention fails to shore up, or keep down, an exchange rate, then the authorities are tempted, and often do, change monetary policy. As we shall see, this is what Mr. Lawson did in May of 1988.

¹⁷. "The Role of Official Intervention", in The Merits of Flexible Exchange Rates; an Anthology, ed Leo Melamed, Geoge Mason University Press, Fairfax, Virginia, 1988, p.331-360

Money and Exchange Rates in PracticeThe High Keynesian Consensus 1945-1969

Some thirty years ago, when I began to work on monetary economics, it was generally thought that money and monetary policy had little or no effect on the price level or the rate of inflation. In those days of high Keynesianism (or the "New Economics" as it was called in Kennedy's United States), it was thought that inflation was largely determined by the extent of unemployment and the fiscal deficit. Low unemployment would ensure that any fiscal stimulus from an expansion in the fiscal deficit would generate increases in prices rather than increases in output, inflation rather than growth. If however there was a lot of unemployment, then any fiscal stimulus would increase employment and output with little or no effect on prices and inflation. Most inflations were caused by "cost-push" factors such as trades unions demanding too big a wage increase or greedy business misusing their market power to push up prices or unconcerned foreigners increasing import prices.

In the list of dramatis personae, money was merely

a bit player. The authoritative Radcliffe Report (1959) had said unequivocally that the quantity of money did not matter very much because the velocity of circulation could be "infinite". Lord Kaldor opined that the role of money was simply to maintain 'orderly (financial) markets'. He likened it to his trousers which, he said, as he got fatter he let out the seams, rather than go on a diet. With such compelling imagery, the main point was that monetary policy should be accommodating so that the really important levers of fiscal policy, and the various direct controls over investment etc, were appropriately effective.

The policy objective of high Keynesianism was to pursue near full employment by ensuring just enough fiscal stimulus that would at the same time guarantee that there would be no inflation. The margin of the small army of unemployed would ensure that wage push would never get out of hand, and although business may exert its latent monopoly power or foreigners may demand more for their wares, such effects could not go on year after year. Competition, both domestic and international, would exert a discipline on such inflationary forces.

Foreign trade served as a temporary safety valve. Any overstimulus of fiscal policy would be partially dissipated in an expansion of net imports to meet the excess demand. The resulting deficit on the current

balance of payments would absorb at least part of the incipient inflationary pressure. Obviously this was only a temporary respite since one could only run a persistent deficit if foreigners were willing to lend enough money to finance it.

Foreign Exchange Rate Regimes

Now we need to look, at least superficially, at the foreign exchange regime. In order to sort out the various strands in the argument, it is convenient first to discuss what would happen if there were no restrictions at all in foreign exchange transactions. In these years Britain was on a pseudo-fixed exchange rate and not a really fixed one. There had been two devaluations in 1947 and 1967. But if Britain had been on a really fixed exchange rate, then, provided that no doubts arose about the credit worthiness of the government, Britain would have been able to finance these deficits by borrowing at interest rates little different from the lenders (say the United States). For if a pound always buys, and is always expected with complete confidence to buy 2.40 dollars, then the interest rates in Britain must be the same as those in the United States.¹

¹. Experience suggests that readers may have some difficulty in accepting this somewhat startling conclusion, namely that with absolutely fixed exchange rates, there interest rates in all maturities must be the same. If the rate of return was greater in the UK than in the USA, then it would pay anyone with dollars to transfer at the ever-fixed exchange rate into pounds and thus earn the higher interest confident in the fact

Under such conditions, namely no exchange or capital controls and absolute confidence in the maintenance of the dollar value of sterling, interest rates and monetary policy were out of the hands of the British government. Thus any inflationary pressure, whether generated by cost-push unions or natural calamities, cannot be countered by a tighter monetary policy. Only the instruments of fiscal policy were available.

The effectiveness of fiscal instruments, such as changes in taxation and public expenditure, appeared to be becoming weaker and even perverse during the 60s and into the 1970s.² The powerful instruments of monetary policy however had not been entirely emasculated by the Bretton Woods system of fixed exchange rates. First, the

that he can get back into dollars at any time. Such a massive capital inflow into sterling financial assets would ensure that their rates fell, and US rates rose, until they were again equal. Thus does capital arbitrage ensure the equality. In practice, however, there was a little flexibility since the exchange rates were fixed within a narrow band such as 2.78 to 2.82. Thus, even under conditions of free capital movements, interest rate differentials were possible and even considerable at the very short end.

². I reviewed the arguments and evidence of the decreasing efficacy, even perversity, of fiscal policy, and the increasing impact of monetary policy, in Britain's Economic Renaissance; Margaret Thatcher's Reforms 1979-1984, Oxford University Press, 1986. The last five years (1984-1989) have been consistent with, indeed have reinforced, these findings. The swing from fiscal deficit to large fiscal surplus over these years, particularly in 1987-89, certainly had no visible effect in depressing the economy. On the contrary the economy boomed along with the substantial increase in the rate of monetary growth. This argument is pursued in chapter....

authorities rationed, with various degrees of tightness, foreign exchange (dollars) to the residents. The authorities simply did not allow one to switch out of sterling into dollars, except for limited amounts and with good reason. (Good reason did not include expectation of a higher yield !). Second, and most important, was that sterling was never inflexibly fixed. Sterling was a pseud in Bretton Woods. The likelihood of a devaluation ,particularly high at various periods (e.g. 1956 in the Suez crisis, and from 1963 to the eventual devaluation in 1967) was always an ambient risk.

The size of the foreign exchange balances and other realizable foreign assets was an imperfect but useful indicator of the risk of devaluation

Capital Flows and the Demise of Bretton Woods

Thus in practice there was room for Britain to pursue its own monetary policy, primarily through fixing interest rates and controlling monetary expansion through various forms of credit rationing. It is ironic that it was the probability of devaluation, that is violating the fixed exchange rate rule of Bretton Woods, that enabled a member to pursue monetary policies that made it possible to stay in the system. In the 50s and through the early years of the 1960s, private capital flows were rather small; governments were the main money

movers. But by the end of the 1960s there was a substantial free-booting Eurodollar market in London which dwarfed the official flows. Thus while, up to say 1965 it had been possible for governments to help one another stay at the fixed parities by lending one another sums of foreign currency (as in the case of the United States loan to Britain in 1956) which dominated the market, after 1965 government funds were eclipsed by private flows. And of course the incentive for the private sector meant that private funds flowed against the official tide, eventually swamping it.

The most telling demonstration of the power of private capital flows to upset the desire of governments to hold exchange rate parities was in sterling's devaluation of 1967. The Labour government of 1964 inherited the pre-election monetary fling of Maudling (the Tory chancellor). The inflationary genie was out of the bottle, and although Mr. Wilson tried every trick, including high interest rates, draconian credit controls, a budgetary squeeze, stringent restrictions on foreign exchange, and even an import surcharge, the flight of private capital (led by the "gnomes of Zurich according to Mr. Wilson) could not be offset by intergovernmental borrowings. Sterling had to go in November 1967, from \$2.80 to \$2.40. Even so doubts persisted whether it had gone far enough and the hallowed Bretton Woods system was essentially a casualty of free capital movements.

Myths and Reality in Bretton Woods

Much nostalgia has been lavished on the Bretton Woods system.³ It is said that it provided a great stability and low inflation during the twenty four years or so (1947-1971) it was in operation. This misses important realities. First the Bretton Woods system did not really become effective until the end of the 1950s. Before then all the major currencies were inconvertible, so the private capital movements were precluded and, for example, many of Britain's old colonies were saddled with sterling balances which they could only use at the discretion of the British government. And clearly by even before 1967 everyone knew that the second most important currency was in turmoil. After 1967 one saw essentially the end of gold convertibility in the two tier gold window, where the United States would honour, albeith reluctantly, convertibility only for central banks. The system was moribund and then died in 1971. So the Bretton Woods system really lasted at most some ten

³. For example Mr. Balladur urged a return to a Bretton Woods type of system using some sort of commodity standard, rather than the dollar, in Wall Street Journal. February 23 1988. The article reviews also the alledged defects of the floating rate system but, alas his criticisms collapse when one considers alternatives to the floating rate system. Paraphrasing Churchill, floating rates are an awful system, but the alternatives are far worse.

years. It is indeed ironic that the great inflation of 1972-5 was generated under the Bretton Woods system, whereas the great disinflation of the 1980s was achieved when all the major currencies were floating.⁴

The story of Bretton Woods is one of the major reserve currency, the dollar, and the minor reserve currency, sterling, beginning by being undervalued.⁵ Gradually, however, expansionary monetary policies took their toll. The United States increased its rate of monetary growth from the early 1960s and the great inflation got under way. The dollar shortage, which had prevented convertibility throughout much of the 50s, became a dollar glut. At its fixed parities, with respect to European currencies, the dollar had become overvalued. At its gold parity, there was a big excess demand for the contents of Fort Knox. So in the last act of the Bretton Woods saga, the two reserve currencies

⁴ The conventional wisdom is that the inflation of 1972-5 was a consequence of the breakdown of Bretton Woods. The real culprit was the monetary expansion that began in the mid-1960s and continued through to 1972 or 1973. (The inflation was initially repressed through prices and wage controls in all the main OECD countries)

⁵ It is obvious why the dollar was undervalued in the decade or so after World War II. Low inflation due to responsible monetary and fiscal policies together with a domination of free-world production all helped. Sterling was a more dubious case. However the very large devaluation in 1947 did probably under value sterling until the British inflation, relative to those of our trading partners, eroded it by the latter half of the 1950s.

ended the 1960s as overvalued and unwanted. The United States which had been accused of dragging the world into recession in the 1950s, was then accused, quite rightly, of exporting its inflation through the Bretton Woods system.

Alternatives Foregone?

There were alternatives to floating, none of them very palatable however. One possible (Churchillian) solution would have been for the United States to pursue a persistent deflationary policy by reducing monetary growth to, say, zero. It is doubtful if this could have been done from 1971 onwards without substantial dislocation and unemployment. The United States would certainly have been accused of exporting its recession to the rest of the world. Another solution would have been for Germany, for example, to pursue inflationary policies to reduce the differential between the dollar and the mark. But Germany and many other countries were adamant about the need to avoid domestic inflation and resented importing inflation from the United States. Why should Germany pay for the mismanagement of the United States ?

It is interesting to reflect on whether Bretton Woods would have survived if the United States had not inflated in the 1960s. With responsible behaviour on the

part of the major reserve currency country, could not the Bretton Woods system have survived to this day? I very much doubt whether it could. The United States inflation merely hastened a death which was inevitable. The first reason is the burgeoning private capital flows which increasingly won the battle against official intervention. The second reason is that fixed exchange rates could never have taken the enormous strain caused by the oil price and other shocks of the 1970s. Lastly, fixed exchange rates generate such tensions between the participating governments. When the reserve currency is too strong, then its partners accuse it of inducing a recession, whereas when it is too weak, it will be condemned as an inflationist. And no currency is ever just right.

Floating and Monetarism 1971-1990

Just as there is no pure fixity of exchange rates. so there is no pure floating. It In a pure float the government would undertake no transactions in foreign exchange that were outside the normal processes of government taxation and spending and designed to affect the value of the currency. Even the most "hands-off" policy will often consider the timing of taxation dates and payment schedules in order to smooth the market process. It is convenient to consider, however, the pure

float as a theoretical category since one can analyse it much easier.. Most countries, however, pursued what was dubbed a "dirty float". Government intervened in foreign exchange markets, sometimes buying their own currency in order to prevent a reduction (or secure a rise) in its value or selling it in order to prevent a rise (or secure a fall). (Nor did they restrict intervention merely to their own currency. Indeed, if one has enough money, anyone can intervene in any traded currency to influence its value. But clearly the game is really restricted to governments who can dip liberally into the pockets of taxpayers to spend on their wizard wheezes.)

The unpegging of exchange rates meant that countries had much more latitude to pursue independent monetary policies. Under complete freedom from exchange controls, sterling interest rates could exceed United States interest rates if the pound were expected to decrease its value in terms of dollars. For example if the pound were expected to depreciate by 5 percent against the dollar over the year, then 12 month interest rates of, say, 14 percent in London and 9 percent in New York could happily coexist. The average expectation of return on a sterling or dollar asset would be the same.

Consequences of Floating

This is the first, and perhaps the most important, consequence of free exchange rates. It enables Britain to pursue a monetary policy which does not have to slavishly follow that of the major monetary power, whether the United States or Germany. British monetary growth can be determined by domestic conditions, and the appropriate interest rates will emerge, together with the expected change in the value of sterling, on the market. Or, alternatively, British short term interest rates can be fixed by government operations in the money markets to produce the monetary conditions which it believes is appropriate. One should beware, however, of claiming too much for floating rates. In the short run, there has been substantial interdependence - in for example the transitory reactions to the OPEC oil price increases of 1973 and 1979. Floating does not insulate us completely from short run shocks. It helps but it is no panacea. For the long run however there is considerable evidence that floating rates have given the independence of monetary policies, movements in prices and interest rates which one would expect. And in the control of inflation this is the critical test.⁶

Another important consequence of floating, however

⁶ See Darby, Michael R. and James R. Lothian "The International Transmission of Inflation Afloat" in Money, History and International Finance: Essays in honor of Anna J. Schwartz pp 203-36, edited by Michael Bordo, University of Chicago Press, 1989.

dirty, has been that it enabled countries to reduce or eliminate controls on both the flows of goods and of money and capital. With no desperate need to defend an exchange rate parity, there was no need for the desperate measures which Mr. Wilson had been induced to deploy in 1964-68. In Britain the floating rate eventually enabled Mrs. Thatcher to abolish all exchange controls, both overt and covert, in 1979-1980. Similarly the United States found it no longer desirable to employ the battery of capital controls which it had introduced in the 1960s. One may contrast this with the persistence of exchange controls and the growth of trade restrictions in the EMS from 1979 to 1987. Of course this does not mean that floating countries are bound to adopt more liberal regimes than fixed countries. Floating removes merely many of the incentives for dirigisme.

Alternatives to Floating

It is instructive for us in Britain to examine dispassionately what would have happened in the last decade if the world had been on some alternative regime. All the alternatives that have been suggested are variants of the Bretton Woods type of "fixed but flexible" or "stable but adjustable" pegs. From November 1982, the economy of the United States embarked on a sustained non-inflationary expansion. Both a very large trade deficit and a massive nominal and real appreciation

of the dollar ensued. The deficit provided the stimulus to the rest of OECD countries and pulled them out of the slump. It also allowed a considerable capital inflow into the United States in response to the high profitability of investment engendered, in part, by tax reductions.

If the United States had been constrained by a Bretton Woods type of system to keep the dollar down at its 1979 level (in effective terms), this would have required a massive injection of dollars into the world monetary system. It would have produced a monster of an inflation which would have destroyed confidence in an even more devastating manner than the inflation of the 1960s and early 1970s. It is likely that the system would have broken down with resort to controls and protectionism. Back to the dirigisme of the 1930s.

I suspect that it is widely accepted that there was no really feasible alternative but to float in the turbulence of the 1970s and 1980s. The inflation disparities were too large, the real economies required too much adjustment, the deficits too difficult to contain in a Bretton Woods straightjacket, however accommodating its binding. But in the 1990s many of the great disparities have been reduced considerably. Surely, it is said, there is now no excuse for the oscillations of exchange rates; best to eliminate or mute them in

some new Bretton Woods arrangement.⁷ One may presume that the discipline of Bretton Woods will prevent any large disparities and "disequilibria" developing. It is hard to accept this argument in the light of the fact that the old Bretton Woods had no such effect.

Variability of Real Exchange Rates

One of the enduring complaints against floating exchange rates is that there is much more variation in exchange rates than under a fixed or Bretton Woods type of system. This is of course entirely understandable with respect to nominal exchange rates. In a "fixed but adjustable" system nominal exchange rates will move on "realignment", as it is called in the EMS. But such movements should be infrequent. Generally the nominal exchange rate will be contained between the bands (2 per cent in the case of Bretton Woods and 4.5 to 12 percent in the EMS).

The more interesting question is the variability of real exchange rates. What is the effect of floating on the variability of competitiveness as reflected in the relative price ratios? There are no experimental data. Evidence can be adduced only from the historical record

⁷. This argument about the appropriate ambient conditions for fixed exchange rates was put by Mr. Lawson in his television interview with Mr. Brian Waldron in November 1989. Quote from transcript..

of before and after 1972. A first reading is clear. The amount of real exchange rate variability, measured in virtually any pair of currencies, increased substantially after 1972.⁸ (The ratio of the United States to the German price levels, adjusted for the nominal exchange rate, is shown in figure..) Thus it does not seem that flexible movements in nominal exchange rates adjust to offset differential movements in domestic price levels.

This increased variability is puzzling. There is no theoretical reason why this should be so. Several ad hoc answers can be unearthed and used to rationalize the result. First, it may be claimed that before 1972 the system had stored up, and papered over massive inconsistencies which had to be resolved over the next few years. This might have some plausibility for the mid 1970s, but the variability continued through to the end of the 1980s. Secondly there were the oil shocks of 1973 and 1979 and the great inflations that were associated with, though not caused by, these events. Massive adjustments were needed. This may be true. But one suspects that it is not the whole story. I am inclined to believe that one powerful explanation is the emergence and phenomenal growth of private international capital markets. From 1969 these markets

⁸. See Michael Mussa, "Nominal Exchange Rate Regimes and the Behaviour of Real Exchange Rates: Evidence and Implications", Carnegie Rochester Conference Series on Public Policy, 24, (1986) 117-224.

burgeoned. And the development of technology together with the gradual reduction of regulations has made speculation and cover less expensive.

I do not think that these explanations are at all adequate. This variability remains a puzzle and a challenge to the profession. To avoid misunderstanding it is necessary to stress that variability as such is not a bad or a good thing. It has to be judged along with all the alternatives available.

Chapter 4

Monetary Policy and International Coordination

Basic Ideas on Coordination

One of God's greatest gifts to mankind was the free price system. It enables the cooperation and coordination in production of the most complex products such as my word processor. Countless people have cooperated to produce and market this machine. Those who have so conjoined will never see one another and probably do not ever know of the others' existence. They may speak different languages, have different religions and mores. Yet they coordinate their efforts, not through the directives of some super manager, but through their free choice among the teeming options offered by the free market system.

The efficacy of the price system in achieving coordination and productive cooperating is well documented. Compared with a Gosplan, it is a marvel of freedom and efficiency. It is now widely accepted, even envied and emulated in Eastern bloc countries, as the only effective way of organizing societies and their economies. It is natural to enquire whether the free price mechanism, which has been so successful in organizing individuals

and businesses, could not be equally applied to nation states.

From the chapters above, it is easy to see that there is a similar form of coordination through the price system. First there needs to be freedom to make trades across national borders. Any severe restraint on this freedom will inhibit international cooperation. Secondly one has to ensure that the price system can work by maintaining a fairly stable price level. But that is nothing new since it is needed for internal purposes. No system can work efficiently if the unit of account is constantly and substantially changing its value. But different countries will have different views about what is the appropriate or tolerable rate of inflation. For example Germany would regard a steady underlying inflation rate of 4 percent as quite beyond the pale; whereas I suspect that most Americans would be content with such an inflation. Nevertheless the citizens of Germany and the United States can happily coordinate with a zero inflation in German and 4 percent in the United States, provided that no-one succeeds in fixing the dollar-mark exchange rate. Like any other price, the price of a mark in terms of dollars will adjust to the differential inflation rates.

Spillovers and Incentives

In this free price system there is no need for any explicit coordination of government monetary and fiscal policies. True there will be spillovers from one country to another. The flexible exchange rate is no cordon sanitaire. Any undue expansion of the money supply in the United States will have some effect on Germany. The additional demand in the United States will suck in imports from Germany. To pay for them dollars will flow into the accounts of German exporters. This will increase demand and prices in Germany. Some of the inflationary pressure in the United States will be exported¹.

But the pressure in Germany will be modest compared with that in the United States. If the inflation is made in the United States, then its main effects will be felt there, not in Germany. Thus, if the United States with its 4 percent inflation target, does expand the money supply by an amount which will give it, say, 6 percent inflation, then the United States government and Fed will have by far the greatest incentive to bring money under control once more so that it is in line with its 4 percent norm. Similarly by far the main effect of any undue expansion by the Bundesbank will be on the German, rather than the American, rate of

¹. It will be recalled that, in the short run, one cannot predict which way the exchange rate will move. Ultimately however there will be an increase in the dollar value of the mark.

inflation. Spillovers will be the second order effects. Thus coordination is achieved by each government pursuing its own interest of stabilizing its own price level. If each of the monetary authorities of the world designed policies to keep its domestic inflation down to its (presumed low) target, policies would be coordinated automatically through the medium of exchange rate and price and wage movements, and capital flows.

Granted the veracity of this argument, however, many observers will complain of the slow speed of adjustment, of possible overshoots, of speculative bubbles that bedevil markets, and of course of all the externalities. Surely it is possible to speed up the adjustment process, to avoid excess speculation and many of the other mistakes of the market. This is the normal version of the case for coordination, central monitoring, and even some central international direction. ²

Reality vs the Ideal in Coordination

The first point to note about this argument is that,

². Coordination has been given a great variety of meanings. At its most innocuous level it involves merely the exchange of information between governments. Such information must be confidential or otherwise there would be no point. (For my part I cannot see why governments withhold such information from the private sector if it is at all valuable for judging the future of economies). At the highest level, coordination has been used to describe an international or multinational plan with specific roles allocated to the participating states. Most people use some concept between these two extremes.

on its own assumption, it is logically impecable. Obviously if Germany and the United States knew all the effects, both domestic and internatinal, of their policies, they could get together and fashion a joint arrangement which was, in aggregate, superior to the sum of their individual efforts. This is a subspecies of a more general argument used by utopians, socialists, and many schools of economists: with perfect knowledge and foresight and unlimited powers of control, one can always improve on the free market. Externalities, social costs and all those aspects which the market ignores or distorts can be taken into account by a benign bureaucracy in regulating markets.

Most of us, however, are rather skeptical about the efficacy of benign bureaucrats in regulating markets. The rise of the Public Choice school has made us aware that civil servants and politicians are moved by their own aims and ambitions. But political temptations are only part, and I think the smaller part, of the story. The main reason is the limitation of knowledge. Economists know very little about the myriad of interacting processes that comprise markets. (Perhaps I should add that although economists know virtually nothing, they know more than politicians.) Chapter 2 told the story. But everyone will know how often economists

predictions are confounded.³ We are abysmally ignorant about the macroeconomic processes and the dynamics of forces that determine the fate of national economies. Any joint coordination of national policies would be based on pretensions which are completely unwarranted. Likely they would do more harm than good.

Persuasion and Sanctions

But even if one believes that economists are very clever and much more knowledgeable than I suppose, it is

³. One interesting example is the behaviour of the yen in 1989. Virtually everyone was predicting that, because of the large surplus, the yen would have to appreciate relative to the dollar. Indeed, at a conference in February 1988, Rudiger Dornbusch argued that "the superior performance of Japan in manufacturing and trade requires real appreciation as the classical response...a move away from PPP is required as an adjustment to these favourable developments for the Japanese economy." Many distinguished economists also thought that the yen must appreciate. (Incidentally I also thought it likely that the yen would go up in value.) In 1979, however, the yen's effective exchange rate fell by 10 per cent, and against the dollar the fall was even larger.

still difficult to see how coordination will be achieved in practice. How will all the ships of state be kept in line? What sanctions can be imposed? Although one may think of various shots across the bow, such as refusal to support a currency, the imposition of trade restrictions, etc, even the mere threat of such shots would surely scatter if not scuttle the convoy of cooperators. Coordination must depend on multilateral undertakings, goodwill, a community of interests, good faith and the salutary effects of the good example - rather weak reeds on which to lean in order to counter the self-interest of a national state. If a government believes that it is in its interest to pursue noncooperative policies, it will.⁴

There is an argument that coordination does help all participants to pursue non-inflationary financial policies. Suppose that the governments really do want to maintain responsible monetary and fiscal policies. But they have difficulty in convincing important groups of the electorate. In a round-up of the usual suspects the

⁴. For example, in the 1960s the United States followed an inflationary policy in response to short term political interests (to finance the Vietnam and poverty wars). It is doubtful if any solemn multilateral undertaking not to use inflationary finance would have had any noticeable effect on the behaviour of the administration. (There is of course another explanation: economic ignorance. The economists who advised on policy believed that there would be no substantial inflation because of the presence of unemployment, at least until the 1968 tax increase.)

trades unions would be first in the bag. These governments with the best of motives can then confront the trades unions with the fact of the coordination agreement. The government would say that it finds it impossible to agree to some outrageous wage increases because this would be inconsistent with its treaty obligations. As a general proposition, there seems to be something in it. We are all used to embracing rules which bind us in difficult cases. This argument has been adduced as one of the reasons for membership of the ERM by both Mr. Lawson and Mr. Brittan. It may well be true, but I remain doubtful. From my own inquiries, I have not yet found any wage negotiations that even considered, however remotely, the transitory variability of the exchange rate as one of the factors to be taken into account. Even corporations that have profits that much depend on the exchange rate appear to cover their commitments. for the year or so covering the wage contract. I believe it is up to the protagonists of the Lawson/Brittan view to offer some evidence for scrutiny if we are to credit their point of view with any substance.

On the international, as distinct from the European, coordination of economic policies generally, governments have paid considerable heed to the interest groups that command critical votes. Governments have not used the international agreement to confront such groups with the

spectre of a government bound by 'foreign entanglements'. As the Americans say, it would not play in Peoria. A short review of international coordination in the 1980s will help put British policies in their international context.

International Coordination in the 1980s

Perhaps the first substantial coordination of economic policies took place in the Bonn summit of 1978. From 1976 the Carter administration had embarked on a massive expansion, and by 1978 the inflation had risen to 9 percent with obvious signs of much more to come.⁵ Over the year the dollar had depreciated about 15 percent against the mark. At the summit the United States undertook to adopt more responsible policies (indeed it argued that they were already largely in place) and in return Helmut Schmidt agreed that Germany would adopt more expansive measures, particularly in fiscal policy. For the German economy, this proved disastrous. There was already the beginnings of a massive German boom; the summit measures added fuel to the flames. Germany embarked on her own inflation from which she only slowly, and painfully, recovered in the early 1980s. Not the most auspicious beginning of post Bretton Woods cooperation.

⁵. In fact the December to December consumer price index rose to 13.3 per cent in 1979.

With the advent of Mrs Thatcher, Mr. Reagan and Herr Kohl, international coordination was a secondary concern to the need to reduce inflation. Monetary control was the centrepiece of policy. Exchange rates were largely left to market forces, although it was occasionally used to corroborate whether monetary policy was suitably tight or too loose. Most of the summit countries reduced their fiscal deficits. The glaring exception was the United States. For reasons which are still the subject of much controversy, the federal government deficit rose in 1983 to about 6 percent of the GNP,

Virtually all summits of the mid 1980s, even the late 1980s, were variations on the original sin of the United States federal deficit. European and Japanese governments and central bankers have claimed that the federal deficit was responsible for high real interest rates, the high deficits on the current account of the US balance of payments (and their own unwanted surpluses) and for the 40 percent real appreciation of the dollar to 1985. The high dollar in turn fueled the protectionist movement in the United States, and undoubtedly frightened her trading partners.

There is little doubt that the soaring dollar, and the effects on both agriculture and the rust belt industries, wrought a profound change in the United

States policy on exchange rates. It threatened the vote - or perhaps the vote threatened. In any case, Mr. Baker, the new treasury secretary, thought that exchange rates should be managed to bring the dollar back to levels which he regarded as economically and politically acceptable.

Plaza and Louvre

The means by which the dollar was to be brought down, one would have thought, should have included the bete noir of the Europeans and Japanese - the federal deficit. However apart from the usual noises, Mr. Baker entered no undertaking to increase taxes or reduce spending. In September 1985, the meeting at the Plaza (hotel in New York) agreed that the main instrument would be coordinated intervention by the five central banks, but mainly the Fed and the central banks of Germany and Japan. All three would sell their stocks of dollars for marks, yen, even for sterling and francs.

The fall of the dollar was sharp and sustained. The participants of the Plaza agreement have proclaimed the success of concerted intervention. Examination of the evidence, however, reveals that the fall of the dollar began in February 1985, some seven months before the start of implimentation of the Plaza agreement. Inspection of the graph reveals that the dollar fell at

roughly the same rate in the six months before the Plaza agreement as in the six months after. It appears that Plaza had no discernable effect.⁶ But this in no way inhibited the participants from admiring their own perspicacity.

The fall of the dollar continued apace. By the end of 1986, fears of an undervalued dollar were rife. Overshooting and the inflationary consequences for the United States were the main impetus behind the Louvre agreement among the G7 countries in February 1987. By concerted intervention, Louvre aimed at supporting the dollar where it was, on the presumption that the rates were just right. The market however demurred. It anticipated a further decline. So the world's investors held off buying dollar bonds. Accepting their Louvre obligations the central banks of Germany and Japan bought the excess offerings of dollar paper to an amount of more than \$140bn in 1987.

The Louvre failed. In spite of sharp increases in US interest rates in mid 1987, contributing to the Wall Street crash of October 19th. In the next ten weeks

⁶. It is necessary to add the usual caveat; we do not know what the path would have been in the absence of Plaza. It is conceivable that the dollar was due to reverse and rise dramatically from October on, and the Plaza agreement saved us from such a continued overvaluation. In view of the expansionary monetary policy from 1985 on, this seems very unlikely, though, I concede, no impossible.

the dollar fell 7 per cent against the G7 currencies (except the Canadian dollar). There had been a considerable expansion of marks, yen and, yes, even pounds in order to prop up the sinking dollar. The effects of these monetary expansions have produced many fears of inflation igniting again - and indeed we have seen that insidious upward pressure on prices in 1989 with perhaps some more to come in 1990.

In many respects the mid 1980s have been reminiscent of the other periods, 1969-72 and 1976-1978, when there was massive intervention, more or less coordinated, by the central banks to manage exchange rates. Both ushered in a monetary expansion which culminated in the two deepest recessions of the post war years. In the 1985-7 period, however, the world was saved from any substantial excess mainly by the most responsible behaviour of the Federal Reserve Board. (In particular the courageous behaviour of the Fed's chairman, Alan Greenspan, must be given great credit for squelching the inflationary policy of his predecessor.) The speedy dethroning of exchange rate targets and the low monetary growth from mid 1987 onwards are good grounds for believing (in January 1990) the United States will have a stable and low rate of inflation over the early years of the decade.

In the Plaza and Louvre initiatives, there was, so far as one can tell, no systematic theory on which the policy was based. Policy was guided largely by domestic political considerations. The United States treasury secretary, James Baker, was reacting to the howls of rage from the rust and farm belts. Economists, however, have developed theories which support specific policy rules for international coordination. Perhaps the most persuasive model is that of Ronald McKinnon.⁷ His basic argument is that in the modern world there are so many low-cost opportunities for people to switch between the major currencies (the dollar, Deutschemark and yen) that policies which pay sole concern to domestic money supplies are likely to produce serious disturbances and misalignments.

McKinnon suggests that we fix the exchange rates of the major currencies at roughly speaking PPP. Then the three countries should agree to a constant expansion rate for the joint money supply of all countries combined. The base case is when the three money supplies expand at the same rate (say 4 percent). But supposing that portfolio holders lose their taste for dollars and wish to acquire Deutschemarks ? Then, according to McKinnon, the authorities should simply accommodate that currency

⁷ See Ronald I. McKinnon, "Monetary and Exchange Rate Policies for International Financial Stability: A Proposal" Journal of Economic Perspectives, 2 (Winter 1988: p 83-103.

substitution at the prevailing exchange rates. The Bundesbank would expand faster and the Fed would correspondingly reduce the monetary growth rate.

There is much to be said for this suggestion. But there is a fatal flaw. It offsets any transitory pressure on exchange rates brought about by changes in the demand for one currency in terms of another. This is not, however, the only cause of exchange rate strain. Many other real factors also affect market exchange rates. How can one identify simple portfolio shifts from these other real factors? I confess I do not know, even after the event let alone contemporaneously, what was the true cause of the exchange rate pressure. And we know that in response to real factors exchange rate adjustments are often the best way to adjust. Nevertheless if the authorities do want a system of fixed exchange rates, some policy similar to McKinnon's must be the basis. I suspect that the most likely result would not be fixed exchange rates but again a system of pseudo-fixity, and perhaps a decided inflationary bias similar to that which saw the end of Bretton Woods.

Alternative Policies of Coordination (II) - Williamson's Target Zones

John Williamson has attempted to avoid many of the

problems of rigidity in exchange rates in the Bretton Woods and McKinnon schemes.⁸ First, instead of the 2 percent band of Bretton Woods, he proposes a much broader band - perhaps as much as 20 percent - within which the exchange rate could move without raising the issue of mandatory intervention. Secondly the target zone should be given "soft buffers" so that, if some unexpected shock threatened to push the rate out of the target zone the authorities would cease defending the zone". Third the zone would be used as a "crawling" peg; this means that if the exchange rate were bumping against the lower bound for some (specified?) time, the whole target zone would be moved downwards by a predetermined amount. Fourthly there would be regular "reviews" of the real exchange rate target. Lastly, monetary and fiscal policy would be adjusted to avoid major interventions.

It is difficult to claim that the Williamson system lacks flexibility. Indeed suitably interpreted it seems

⁸. John Williamson and Marcus Miller, "Targets and Indicators: A Blueprint for for the International Coordination of Economic Policy", Policy Analyses in International Economics, No. 22, Institute for International Economics, Washington DC, September 1987. See also Jacob Frenkel and Morris Goldstein, "A Guide to Target Zones", IMF Staff Papers, 33, Washington DC, 1986, and Gottfried Harberler, "The International Monetary System and Proposals for International Policy Coordination", Deficits, Taxes and Economic Adjustments: Contemporary Economic Problems, p 62-98, Ed by Phillip Cagan, American Enterprise Institute, Washington DC 1987.

little different from a free float. But it is different. It invokes intervention and "reviews" when any large exchange rate movement takes place. For example it would have induced intervention and reviews of the Deutschmark in 1977-8, of sterling in 1979-81, and of the dollar in 1981-5. What such intervention and reviews would have accomplished is, of course, another matter. Would they, for example, have undermined the anti-inflationary squeeze of the early 1980s in the United States and in Britain ? We do not know the answer, but it can be said with certainty that the Williamson framework would have had some effect in modifying the disinflationary policy.

There is so much room for interpretation and dissent in the target zone proposals that it is difficult to see it as an appropriate basis for any agreed system of coordination. Financial commentators, such as Hobart Rowan and Samuel Brittan, have lavished their approval on the target zone proposals.⁹ It was reported that the proposals, in some form or other, were widely accepted as the way forward. After the collapse of the Louvre agreement, however, the proposals seem to have lost some of their glitter. I suspect that this is

⁹. See, Samuel Brittan "Reference ranges rule, O.K.?", Financial Times, June 2 1988. Brittan appears to think that "reference ranges" differ from "target zones" in having what are called soft edges - namely there is no commitment to intervene, only an obligation to consult.

in part due to the recognition that we do not know much at all about the so-called fundamental equilibrium real exchange rate. Experts disagree on the concept and the measures.

In my view, if the target zone is effective, then it will give rise to massive speculative capital movements which are such a bane to any pseudo-fixed rate system. Perhaps the signals of impending devaluation are more blurred than under Bretton Woods. But a complete obfuscation of signals would be similar to flexible rates. Thus if it is effective it is bad, if it is ineffective it is otiose.

Appropriate Coordination

Is there any role for coordination ? Looking at the performance of coordination during the last decade or so would give one pause. Herb Stein has characterised most of the coordination recently as each country telling other countries how they should conduct their economic policy. Nevertheless I think there is a case for coordination. But it should have modest goals and a minimum of mandatory measures and sanctions. Clearly it is a good idea for ministers of finance to keep each other informed of their views about domestic policies, and, indeed, their views about each other's economic policy. There is a role for friendly discussion and

persuasion. But there is also a great need for tolerance. Each country will have different ideas about the best way forward. None is the custodian of the "correct" model. Humble pie should be the daily diet of ministers and their advisers.

There is room for deals to be made, provided they are in the mutual interests of the parties and do not involve any binding commitments on future governments, or discrimination against any excluded party. Meeting of the G7 or summits are not the appropriate place for ministers to play political games in pursuit of maximizing strategies. Similarly they are not the occasion, as have occurred frequently in the last eight years, for grandstanding accusations of one government by the others. Quiet informed exchange of facts and opinions is the best way forward. ¹⁰

¹⁰. For a detailed blow-by-blow account of the Plaza to Louvre, see Yoishi Funabashi, Managing the Dollar: From the Plaza to the Louvre, Institute for International Economics, Washington DC (1988).

Chapter 5

Monetary Systems for EuropeAntecedents- The EPU and Sterling Area

Since World War II various forms of monetary cooperation have appeared in Europe. The first effective one was the European Payments Union. This was fashioned in response to the dollar shortage in the 1940s and 1950s. In the framework of Bretton Woods, it enabled the members of the EPU to have limited convertibility with one another while discriminating against the dollar (using the scarce currency clause of the Bretton Woods agreement) in their exchange controls. The EPU undoubtedly introduced a degree of multilateral clearing and trade. It was a great improvement on the bilateral deals of the interwar years. By the end of the 1950s, however, the dollar shortage was largely over - at least for the major European countries. Full external convertibility became the norm for Germany, France and the UK as well as for the many other smaller European countries. There was thus no need for the EPU.

There were other attempts to have convertible currencies within blocs. In the aftermath of World War II, Britain ran such a system in the sterling area.

Some countries, generally members of the commonwealth or empire, based their currency on sterling. The currency board system was the model for such arrangements. Such boards held sterling to exchange at the fixed rate for the colonial or commonwealth currency. In practice much of the reserve was held on deposit in London. The sterling area worked quite well for some years. It fell apart however in the mid 1960s. Sterling was obviously precarious and no basis to build a currency. The devaluation of sterling in 1967 put the finishing touches to its corpse.

The Snake

The breakdown of Bretton Woods saw attempts to resuscitate it, in the Smithsonian agreement of January 1972. It soon failed. Concurrently the idea of monetary union in the EEC, mainly the brainchild of Raymond Barre, had been incorporated in the Werner Report of 1970. The basic proposal was to reduce currency fluctuations in Europe and to establish a machinery to "coordinate" economic policies. In the early months of 1972 the European countries entered into an agreement to keep their currencies in line with one another, floating as a group against the dollar. The four major currencies - Deutschemark, sterling, franc and lira - were joined by a number of minor currencies in forming the "snake". Each country had the responsibility of

keeping its currency in line with the others and there were understandings, but no undertakings, that there would be assistance forthcoming in time of need. There was no arrangement to coordinate financial policies, as Barre had urged in the Werner Report. In the view of many observers, this was a fatal flaw.

Unfortunately the snake soon slid into the crises that beset all countries from 1973. The snake could not digest the rapid and variable rates of inflation together with the large capital movements. Three of the major currencies - sterling, franc and lira - defected, leaving only the Deutschemark and its satellite currencies. The snake became very bloated and permissive with few pretensions to being a fixed rate system.

The EMS and the ERM¹

The creators of the European Monetary System in 1978 were Chancellor Helmut Schmidt and President Giscard d'Estang. The motives for joining have been much

¹ It is noteworthy that the issue of monetary union is not mentioned either in the Treaty of Rome or in the Single European Act. It is easy to see why it did not appear in 1957, when currencies were still inconvertible, but it is not so easy to see why it was not accorded a central place in the 1985 SEA. It is at least plausible to suppose that the governments would have been more reluctant to agree to an SEA that had, as an explicit aim, monetary union.

discussed. It has been argued, for example by Samuel Brittan, that Helmut Schmidt was simply searching for a way of dealing with the flight from the Carter dollar into the mark and wanted a convenient way of diffusing the inflow to his European partners. I suspect that President Giscard d'Estang saw it as an opportunity to link France more closely to the mighty German economy, and at the same time he believed that it would give some French control over the tide of German monetary policy. And it was a step on the way to a world of managed exchange rates - a consistent theme of much French policy. Possibly it was seen as a way of reviving the ideal of a united Europe - a much tarnished ideal in the Europe of the late 1970s. It is also interesting to note that, at inception, the independent Bundesbank was against it, probably because of the unhappy experience with defending parities in the 1970s. Gradually the Bundesbank became "cautiously positive".² Many of the smaller countries, such as Eire, went along with the EMS idea because they conceived it as a form of help from the mighty German economy. And to the Netherlands, it was little change from their existing fix.

². For this assessment, see Gottfried Harberler, "The International Monetary System, The European Monetary System (EMS) and a Single European Currency in a 'Single European Market'" in "Geldwertsicherung und Wirtschaftsstabilität", Festschrift für Helmut Schlesinger zum 65. Geburtstag, ed Norburt Bub, Dieter Duwendag, Rudolf Richter, Fritz Knapp Verlag, Frankfurt, 1990

Whatever the motives, the leaders and their expert advisers had noted the problems with the snake, and believed that these could be solved by creating mandatory help with intervention. This arrangement - exchange rates contained in a band and mandatory assistance - comprises the Exchange Rate Mechanism (ERM). All the countries of the ECE are members of the EMS and are entitled to join the ERM. However they are not required to join the ERM. Thus Britain, Greece and Portugal are members of the EMS but do not participate in the ERM. In common parlance it is said that these countries have not joined the EMS. Although not strictly correct, this usage is so widespread that I will occasionally use it in this book. Thus a member under exchange rate pressure could rely on short term support from other members.

In principle a weak currency country can have access to automatic and, in principle, unlimited credit through the Very Short Term Financing Facility.³ This mutual support system has varied over the life of the ERM. And different countries have given it different interpretations at different times. There have been

³. See Rainer Masera L'unificazione monetaria europea, Bologna; il Mulino 1987, for a detailed account of the institutional changes of the September 12-13 1987 EC Council of Finance Ministers. The Very Short Term Financing facility was also lengthened, and there was an agreement to monitor exchange rates and monetary conditions in each of the EMS countries (including, one presumes, the UK).__

numerous complaints however about the mechanism of central bank intervention in the foreign exchange markets. In particular Germany has felt the weight of the burden of support.⁴

The Band and Realignments

The normal requirement of the ERM is to maintain the exchange rate around the central value plus or minus 2.25 percent. Italy (until January 1990) and Spain, however, have elected to maintain their exchange rates within a plus or minus six percent band. Within these constraints, however, countries have pursued more restrictive policies. Thus the Netherlands, so closely tied in to the West German economy, has virtually locked itself to the Deutschemark. Other countries outside the EMS and ERM, but closely integrated with the German economy, have also pegged their currencies with some rigidity to the German mark: the most notable example is Austria. And it is generally true that members try to avoid straying near the limits of toleration. Rarely does a member allow its currency to bump along at the lower level of the band.

⁴. See Helmut Schlesinger, "Zur weiteren Entwicklung der wahrungspolitischen Kooperation auf internationaler und europaischer Ebene", Deutsche Bundesbank, Auszuge aus Presscartikeln, no 84, Frankfurt, November 17, 1988

The EMS allows for the "realignment" of currencies at new central parities. In the ten years from 1979 to 1989, there have been 11 parity changes.

(Table of Exchange Rate Realignments Dollars Deficits and Trade p 217 to be inserted here)

These realignments were much more frequent in the early days when there was a need to adjust to very different rates of inflation. From January 1987 there has been only one adjustment of the central values, the devaluation of the lira in January 1990 as it entered the 2.25 per cent band. But it is widely thought that the disparities have become so large that a substantial realignment cannot be long delayed.

The process of realignment was meant to proceed from a deliberation on the fundamentals, in particular relative growth and inflation rates. In practice the currencies have often been pushed, often precipitously, into a realignment in order to counter speculative capital movements. The market has a number of signals it can read to see when a realignment is imminent. Ministers and central bankers become agitated and leaks soon spring forth. This provides a rich nectar for the busy bees of private speculators.

Aims of the EMS/ERM

The EMS was created to achieve " a zone of monetary stability in Europe" that would eventually develop into a European Monetary Fund. What is meant by monetary stability ? Certainly the basic idea was exchange rate stability. But that can be interpreted in various ways. The first is that the EMS would reduce the day to day, or weekly and monthly variations in exchange rates. Much of the casual criticism of the floating system by traders and vacationers was in terms of the difficulty of planning short term operations. The second is that there will be more long term stability in exchange rates. That is to say the exchange rates will not sink or rise consistently year in year out. The corollary is that there will be little divergence in rates of inflation - this is the so-called "convergence" objective.

There is little doubt about which is the most important goal. It is useful to reduce the variability of exchange rates, provided that one does not thereby introduce even more damaging distortions elsewhere. But, for the majority of transactions, it is always possible to buy cover in the thick forward market for short periods ahead. On the other hand it is impossible to buy any cover for inflation losses (with the rather limited exception of indexed gilts.) The long terms stability of exchange rates, provided that it is not

behind a barrier of controls, is clearly the most important objective. But it needs to be interpreted in a subtle way. The underlying objective is, of course, stability of prices or, at least, stability of low (circa 2 percent) inflation. Then to achieve, say, zero inflation in the long run may require a long term appreciation against the dollar or even against the European Currency Unit (a basket of European currencies) or against the SDR (a basket of the five most important currencies). In short if the world or Europe or even Germany goes on an inflationary, or deflationary, binge long term stability of the exchange rate is a recipe for importing such price movements.

EMS and German Hegemony

This discussion highlights a central issue: who actually runs the EMS/ERM ? Like most multinational institutions, the EMS was set up formally as an institution with equal participation by all members.⁵ National prides demand no less. In a democratic institution all nations were to be equal. The reality, however, was quite different. Some were more equal than others. In the event Germany became the price leader and in effect dominated policy. This German hegemony has

⁵. The institutions of Bretton Woods, however, did not accept the system of equal voting. The votes in the IMF and World Bank were according to the share holdings of the participating governments.

been much resented by France and Italy, among others. Because of their reluctance to realign, French financial policy is largely determined by the Bundesbank, over which the government of France has virtually no control and little influence. Indeed, because of the statutory independence of the Bundesbank, the German government has only influence not power to affect monetary policy - so even if France brought pressure to bear on the German government, such pressure would be much dissipated by the time it found its way from Bonn to Frankfurt. Bundesbank ruled. ⁶

This should have surprised no-one. Germany was the biggest and richest economy with the most liberal markets in continental Europe. The German reserves were unmatched, and, corresponding to its role as a major exporter of goods, Germany had become an important exporter of capital. Above all the Deutschemark was

⁶. The dominance of the Bundesbank is a common theme of most contemporary accounts of the EMS, see for example Jaques Melitz, "Monetary Discipline and Cooperation in the European Monetary System: A Synthesis", in Francesco Giavazzi, Stephano Miscossi and Marcus Miller (eds) The European Monetary System, Cambridge University Press, London 1988. This view has been disputed by Michele Fratianni and Jurgen von Hagen in "German Dominance in the EMS: the empirical evidence", Open Economies Review, Vol.1 No.1, p67-88, Kluwer Academic Publishers, Dordrecht, 1990. Primarily from analysing interest rate policies, they argue that the Bundesbank policy is largely independent of the policies of its fellow ERM countries. But that does not mean that the Bundesbank dominates the others. France and Italy, through realignments and financial controls, can diverge from the Bundesbank line if they so wish.

rightly seen as the most inflation-free of all the major currencies (including the dollar).

The Bundesbank enjoyed credibility as the guardian of monetary propriety. The other countries believed that by joining the ERM they would also acquire creditbilty for their currencies and credibility for their policies. But this would be possible only if the Bundesbank were seen to be in a position to maintain its responsible policies. And it was widely accepted that the Bundesbank's independence, as well as the abiding fear of inflation in Germany, was a critical element of that credibility.

Here was a central dilemma. In order to have more "democratic" control of the EMS policy, what the French call symetry, it is necessary to allow French, Italian etc due influence in formulating German monetary policy. But such influence would clearly erode and eventually destroy the independence of the Bundesbank on which the whole edifice of credibility is built.⁷ Thus if the EMS is to achieve its major function, it must be dominated by the elite and unelected Bundesbank, and democracy be dammed ! Obviously such a concentration of power has caused much tension. For example in January

⁷. The central banks of France and Italy, like the Bank of England, are simply creatures of the government. In Europe only the central bank of Switzerland has an independence approximating that of the Bundesbank.

1987, because France differed so much with the Bundesbank's restrictive policy, France refused to intervene when the franc fell to the floor. In the event the Bundesbank, fearful of wrecking the ERM, bought francs to put it back in the fold.

The resentment of German power and influence is a worrying resuscitation of an old theme of European politics.

As we shall see, this fundamental dilemma is inherent in any system similar to the EMS. And it gives rise to similar types of political tensions. There is little to be done that would resolve the inconsistencies of objectives. One ideal way would be for France, Italy etc to acquire, in their own right, a credibility as convincing as that of the Bundesbank. Not only is this idle speculation, but of course there would be no need for an EMS for achieving the convergence of inflation rates. Then there would be a possibility for more non-German participation in policy. But still the union would be dominated by Germany. This has led some commentators, among whom one must number several Presidents of France, to suggest that the only way to solve the problem of German monetary hegemony is a return to a gold standard. But later I shall suggest other solutions.

It may appear that, as the leader of the EMS,

Germany has substantial freedom to pursue its own monetary and fiscal policy. It looks like Deutschland uber alles - or at least alles participants in the ERM. But, paradoxically, Germany is also a prisoner of the ERM. Because of the reluctance to realign, Germany is prevented from pursuing a monetary policy that the Bundesbank believes is consistent with its obligation to avoid inflation. Just as in the late 1960s and to August 1971, the United States complained that, as the anchor of the Bretton Woods system, it alone could not devalue the dollar against the mark, so, as the linchpin of the EMS, Germany cannot unilaterally revalue the mark against its main trading partners in the ERM. The Bundesbank has some apparent freedom to raise interest rates, but pressure to prevent such a rise from France and Italy is as likely to be as intense as the resistance to realignment. Germany is hardly the dog that wags the ERM tail. As Karl Otto Pohl must know, it is the tail that dogs the wag.

The Performance of the EMS - Exchange Rates. ⁸

⁸. There is an enormous and rapidly growing literature on this subject. My selected reading would include Michele Fratianni, "The European Monetary System: How well has it worked ?", in Dollars, Deficits and Trade, ed James A Dorn and William A Niskanen, Cato Institute, Washington DC 1989, Roland Vaubel, Comments on Manfred Wegner, "The European Monetary System: A Regional Bretton Woods or an Institutional Innovation" in J. Vosgerau (ed) New Institutional Arrangements for the World Economy, Springer-Verlag, Berlin 1989, and Patrick Minford, European Monetary Union and 1992, Selsdon Group Special Paper, London 1989.

It is extraordinarily difficult to make assessments of the performance of the EMS that command everyone's confidence. The normal method of judging the EMS is to pursue two sorts of comparisons. First one may compare what happened to participants before 1979 and after - a time series approach. Secondly from 1979 a comparison may be made between those countries involved in the ERM and those which stayed aloof - a cross section approach. The time series has the advantage that one can compare the same country, with all its many constant individual characteristics, before and after. But of course countries would have changed their performance in the absence of the EMS, and consequently we do not know how much of the change to attribute to the ERM membership. The cross section comparisons suffer from the fact that countries will vary in performance considerably, and participation in the ERM will be one factor among many others. Nevertheless these two approaches do give some basis for judging performance. A third - the modelling approach - has been tried by Patrick Minford. In order to produce a standard for comparison, he models what would have happened in the absence of ERM membership, thus giving a "counterfactual" account against which to compare the real record.

One quite remarkable result of these empirical enquiries is that they all tell broadly the same story. First, let us look at exchange rate variability. The

most obvious point is that bilateral exchange rate variability between ERM participants is less than in the years before 1979. This was one of the aims of the EMS and it has been achieved. This does not mean, however, that there has been any gain in stability of effective exchange rates or that exchange rate variability with other OECD has not increased. Indeed the second result confirms that, whatever stability had been achieved in bilateral rates was more than offset by increases in variability with respect to non-ERM currencies.

The summary on variability of nominal rates is really quite simple: the ERM provided some intra ERM stability which was more than offset by increased external variability. And this result carries over to real exchange rates. Thus the increased external variability in nominal rates was not fully offset by differential rates of inflation. All these conclusions held whether one compared experience before 1979 with that after, or whether one analysed the ERM countries compared with those outside. ⁹

⁹. The bases for these statements is contained in Horst Ungerer, Owen Evans, Thomas Mayer and Philip Young, The European Monetary System; Recent Developments, International Monetary Fund, Occasional Papers 48, Washington DC 1986. Note that Ungerer's analysis ceases with 1985, so it covers the period when the major countries were not conducting massive intervention, and in particular Britain was not shadowing the deutschmark. From 1986 onwards the results have been confounded by many attempts to influence the dollar, yen and deutschmark in the Plaza, Louvre I and Louvre II accords. Even so, analyses that cover the whole decade do not materially change the general results. See Michele

The Performance of the EMS - Inflation, Trade and Growth¹⁰

But one of the abiding claims for the EMS is as a discipline on inflation - the participants acquire the credibility of the Bundesbank. Perhaps so, but it is not evident from the statistics.

In the ERM countries the (weighted) average inflation rate decreased more slowly than in the rest of OECD countries. Even confining the discussion to Europe, the decline in the ERM countries was less than that in other OECD European countries. Furthermore the inflation rate in the ERM was, in 1986, rather higher than that in the other OECD countries. From 1987 on, these relationships become blurred by the sterling shadowing of the mark and, overall, the various interventions and monetary policies induced by the Louvre and other "agreements".

What about the variability of inflation. Contrary to assertions frequently made by the pro-EMS lobby,

Fratiani and Jurgen von Hagen, "The European Monetary System Ten Years After", Discussion Paper 419, Indiana University Graduate School of Business, Indianapolis, September 1989.

¹⁰ The best summary of all the experience on inflation and growth rates is to be found in Roland Vaubel, Comment on "The European Monetary System: a Regional Bretton Woods or an Institutional Innovation" in J.J Vosgarau (ed) New Institutional Arrangements for the World Economy, Springer-Verlag, Berlin 1988

convergence on inflation took longer in the EMS than in the rest of the OECD. Furthermore over the life of the ERM (to 1986) the dispersion of inflation rates has been much larger in the ERM countries than among the major OECD countries. Indeed, comparing the 7 years before with the 7 years after 1979, among ERM countries the dispersion of inflation rates increased, whereas in the other OECD countries the dispersion fell.

The argument that stability of nominal bilateral exchange rates should, according to the EMS apologists, promote trade by reducing the exchange risk. The growth of trade within the ERM compares, however, most unfavorably with the growth of trade with non-EMS countries.¹¹ The (unweighted) average of the five old EMS members growth of trade with one another from 1979 to 1984 was 0.6 percent compared with 4.1 percent with non ERM countries

Finally growth. The growth of real investment and GDP was much slower in the ERM countries than in the other OECD countries. And after 1979 growth and investment declined more than in the other OECD countries: and in European non-EMS countries investment

¹¹. See Paul de Grauwe, Memorandum in : Memoranda on the European Monetary System, of the Treasury and Civil Service Committee, Consequences of UK Membership of the European Communities, House of Commons, London 1985.

growth actually increased.

(Put Table No. 1 from de Grauwe (1987) in here)

The EMS - Modelled Results

All these conclusions are from the actual historical record. And they are properly subject to the argument that we do not know what would have happened in the absence of the EMS in the years following 1979. It might be suggested that, if the EMS had not been created the performance of the ERM countries would have been much worse. Although there is no irrefutable way of dealing with such allegation, Patrick Minford has performed a great service by modelling the EMS in its world context.¹² The results are complex but clear. As Minford puts it: "...the EMS system gives somewhat poorer overall stability than floating to the 'dependent-currency' participating countries - that is France, Italy and the UK...the reason...is that the EMS, with its deflationary bias for the dependent-currency countries, causes them to over-react in a deflationary direction to the shock (of 4 percent increase in monetary growth for two years)."

¹². The results are to be found in A. Hughes-Hallet and Patrick Minford, "The European Monetary System - does it achieve its aims", Konstanz Seminar on Monetary Theory and Policy, 1989, Liverpool University, Liverpool. The Liverpool model of the world economy has been used extensively to explore many issues of fiscal and monetary policy.

The (shock) increase in monetary growth would be associated, in the absence of the EMS, with a fall in the nominal and real exchange rate. There is an increase in the inflation rate, but demand increases and output and net exports increase. In the EMS the constraint on the movement of the exchange rate means that prices and wages increases cause an appreciation of the real exchange rate. Thus the dependent countries suffer from the reduction in net export demand due to the real appreciation and from an increase in inflation. These are, of course, the transitory effects. Ultimately the dependant country must either devalue (realign) or deflate, in order to counter the effects of the original monetary expansion.

Minford's model does seem not to conflict with the descriptions by Vaubel, Fratianni etc. The EMS induces a perverse appreciation of the real exchange rate and induces unnecessary output losses in adjusting to the monetary shock. On the other hand countries that are not Bundesbank dependent gain somewhat from the overvaluation of the French franc and Italian lira etc. The obvious example is Germany, but also the United States and Japan are able to secure some of the markets of France, Italy etc.

EMS adherents will, of course, argue that these model runs are not really relevant, since the EMS will

be more likely to prevent a monetary shock than if one is outside the ERM. Such an allegation requires more than assertion to give it credibility, especially in view of the behaviour of the United Kingdom during the shadowing of the Deutschemark in 1987-88. Indeed, on that occasion "joining" the ERM club actually caused the monetary explosion.

The EMS and Persistence of Overvaluation

Granted that there is more inertial inflationary pressure in France and Italy, it is possible that this Minford mechanism explains some part of the chronic overvaluation of the franc and the lira. And this overvaluation has occurred in spite of the use of exchange controls, on occasion most restrictive controls, during the life of the EMS. It is never easy, however, to demonstrate that an exchange rate is above the value that would emerge on a free market, but the persistence of the large German current balance of payments surpluses with respect to its EMS participants does suggest that the overvaluation has been chronic and substantial.

I suspect that the reason must be sought in the lore of politics. There is no doubt that, politically, realignment, however justified, is viewed as a policy failure. The long reluctance of politicians to concede to a devaluation contributes to chronic overvaluation of the dependent currencies. But there is the additional

question: when they do devalue, why is it that the devaluation is such that the currency is just about brought into line with its deteriorated purchasing power? Why do not they devalue sufficiently so that, on the average up to the time of the next realignment, the currency is not persistently overvalued? If, for example, one examines sterling's devaluation in 1949, most authorities were clear that in PPP terms it was overdone (from \$4.20 to 2.80). Sterling was then undervalued for some years. At the time it was thought that this was an appropriate policy, since one had to ensure that the markets would certainly not expect another devaluation to follow for many years. So it turned out. One suspects that the reluctance of ERM members to devalue sufficiently is that the central banks believe, rightly or wrongly, that such devaluations would signal a country's choice of a lax policy on inflation. The country would be thought to be not merely making up for past laxity but also preparing for new monetary expansions. If so the persistent overvaluation of the currency is a high price to pay for such a reputation and credibility.

Germany and Credibility

One of the oft-repeated arguments for ERM membership is the "credibility" argument - members latch on to the stability of the Bundesbank. The view that by hanging

on to the tails of the Bundesbank members reduced the costs of disinflation has been discredited by the data. Countries outside the ERM did rather better. But we must ask the additional question: what does Germany gain from being in the ERM ?

Initially the Bundesbank strongly opposed the EMS. In one of the rare capitulations of the Bundesbank to political pressure, Helmut Schmidt foisted it on them. There is no doubt that Schmidt saw considerable political gains to be garnered from polishing up a very tarnished image of the Common Market. The relaunch of European integration was one of the achievements of both Schmidt and Giscard d'Estang. Of course the creation of a free-trade area and the removal of controls on capital and labor flows could have gone ahead, I believe rather more easily, without the apparatus of the EMS. But it was an important political symbol. As the Bundesbank surmised however, the economic benefits to Germany were, and remain, much less clear.

The Bundesbank's responsibility was defined in its constitution as the defence of the domestic value of the mark. It had never relished the role of the mark as a reserve currency. The demands on the mark as a reserve currency may often be inconsistent with the policy of domestic stability. But the emergence of the mark as a one of the three great currencies meant that

it could not avoid some of the problems of being, for example, one of the main custodians of speculative flows out of the dollar. In such circumstances, the EMS might be seen as a way of diffusing those flows to other members. However, the other members of the EMS (excepting the Netherlands) maintained not merely exchange controls but also a formidable battery of other credit and capital regulations which were designed, inter alia, to ward off such speculative flows. Ironically the non-ERM member, the United Kingdom with its wide open capital markets in the 1980s, that was, after Germany, the next most important recipient of speculative flows. If the price of the ERM was continued capital controls, then German was, on this score, a net loser.

The Bundesbank behaviour with the EMS is almost certainly different from the policy it would have pursued in the absence of the EMS. The pseudo-fixed system ensures that, if Germany pursued an expansionary monetary policy, the inflationary costs would be more spread over the other members than if there was a floating rate regime. Thus there would be less incentive for the Bundesbank to keep money tight, and more incentive to inflate.¹³ This raises expectations of a higher average

¹³. See Francesco Giovazzi and Alberto Giovannini, Limiting Exchange Rate Flexibility: The European Monetary System, Cambridge, MIT Press 1989.

rate of inflation throughout the EMS. Not only does Germany not gain from her membership, but also the credibility gain is more disputable.

In general, one may conclude that the fears expressed by the Bundesbank, and over-ridden by Helmut Schmidt, were well founded.¹⁴

A Fundamental even Fatal Flaw in the EMS

In the old gold standard system, there were automatic mechanisms which, in response to some external event such as a physical calamity or to some internal "error", would restore the equilibrium of the system. For example the loss of an a country's main grain crop would give rise to increased prices and net imports which would be financed in part by exports of gold. This would reduce the reserves and the money stock to bring the price level back into line with the rest of the world (where both gold reserves, money stock and

¹⁴. On the effects of the EMS on Bundesbank behaviour during the Plaza and Louvre accords, see Yoishi Funabashi, Managing the Dollar: From the Plaza to the Louvre, Institute of International Economics, Wahsington DC (1988).

prices would rise). It was a self-correcting system.¹⁵

There is no inherent self-correction in the EMS. On the contrary, in its pure form the system will provide perverse signals. In order to demonstrate such perversity, I fear that we must specify more precisely how an ideal EMS works. Of course such an ideal will not include either exchange controls or, more important, those barriers and restrictions which are imposed on domestic institutions which prevent or inhibit the residents choosing freely the denomination of their assets and debts. I shall therefore assume that, in this broad sense, there are no exchange controls. Since the objective of the EMS was to provide an "area of stability", let us assume that the exchange rates between participants are actually fixed for a specified period, then realigned. The actual period during which they can be presumed fixed will vary according to the divergencies in inflation rates - the smaller the diversion the longer the time between realignments. Let us suppose that the period is one year.¹⁶ If everyone knows that exchange rates are fixed for that year, then nominal interest

¹⁵ In his post-resignation interview with Mr. Brian Waldren on television's Weekend World, Mr. Lawson, when commending "managed" exchange rates, mentioned the gold standard as an illustration of a managed system. Of course the main point about the gold standard was that it was not managed; it is the prime example of an automatic self-regulating system.

¹⁶ The reductions in the dispersion of inflation rates over the period 1985-9 have resulted in a period of three years, up to January 1990, when there were no realignments.

rates on financial instruments which originate and mature in that year will be approximately the same for all participants in the ERM. Arbitrage will ensure this near equality. For if the rate of interest in Italy substantially exceeds that in Germany, then it will pay all asset holders to switch to lira, to borrow in Deutschemarks and invest in lira for that period of fixity of the lira-mark exchange rate. This is no more than the application of the "law of one price" to financial instruments. (In this case, because of the fixed rate of exchange, the cost of forward cover for the transaction is zero)

Thus the EMS forces countries to have the same nominal interest rates. If, however, Italy is inflating at a rate of 7 percent and Germany at a rate of 2 percent (both over the relevant period of fixity), then there is a problem of perversity. With the same interest rate at, say, 5 percent, the real rates of interest for Italy is minus 2 percent and for Germany plus three percent. Thus Italy will have an expansionary monetary policy, while Germany will pursue one of restraint. But this will exacerbate inflation in Italy and yet restrain further the already low inflation in Germany. This is the opposite of "convergence", namely it induces divergence.

Realignment Dynamics

Such perverse forces cannot continue for long. As the date, assumed known and fixed, for realignment approaches, so the interest rates, for shorter and shorter maturities, will reflect the expected depreciation of the lira. It will pay speculators to borrow lira and buy mark financial asset to cash in on their appreciation at the realignment. This will cause lira interest rates on maturities that cover the realignment date to rise well above corresponding German rates; the difference will reflect the expected change in the exchange rate. When the maturity is overnight corresponding to the realignment, lira rates of interest may rise to hundreds of percent. Of course the interest rate differential is at last in the right direction; the high inflation country with the high rates and the low inflation country with the low ones.

It is unlikely, however, that these interest rates would be the pattern which would be chosen by a Minister of Finance who, unconstrained by membership of the ERM, was pursuing a domestic disinflationary policy. But, more important, after realignment and with Italy still inflating at 7 percent and Germany at 2 percent, the system reverts again to the status quo ante. With the exchange rates fixed for the next year, Italy and Germany will have the same interest rates and the same perverse effects on monetary growth.

This sort of effect can be observed in the Lawson decision to peg sterling to the mark at 3.00 in early 1987. With British interest rates at about 5 percent above those in Germany, a fixed exchange rate gave rise to a great influx of capital. This put considerable pressure on British interest rates and, in spite of the manifest inflationary pressure, they were brought down to 7.5 percent. Although, as we shall see, the authorities allowed the mark-sterling rate to rise from March 1988, this was an overshoot before the inevitable high interest rates and devaluation (or "realignment").¹⁷ The details of that story will be told in chapter 7.

Uncertain Realignment and Moving in the Band

This model of the ERM is a caricature. It delineates, even exaggerates, the strengths and the weaknesses of the pure EMS. But as a working institution the EMS is anything but pure. For example the exchange rates can move within the band, so that in principle there can be a 4.5 percent devaluation (or 12 percent in the case of Spain). Participant countries

¹⁷ I discussed this process in Britain's Economic Renaissance (Oxford 1976), and, in application to the current situation in Britain, in articles in the Financial Times April 6th 1988, The Times, June 3rd 1988, and finally in the Independent, "Money on a Roller-Coaster", July 14th 1988. [By the end of July, I was asked to keep quiet and cease publishing. I did.]

however usually try to keep their rates somewhere in the immediate vicinity of the central rate, presumably because any bumping against the limits would signal the likelihood of a realignment. This brings us to the assumptions we made in the model, namely that the time of the realignment is known with certainty. This is not the case. Although they are not complete surprises, the realignments of various dimensions can be predicted only with large uncertainties attached. It is however usually quite easy to predict the direction of the realignment - the French franc and the lira will go down against the Deutschemark. Thus the shadow of devaluation is cast forward in time and increases interest rates in Italy relative to these in Germany. But again whether that devaluation-shadow effect is consistent with what a prudential Finance Minister would require to cope with domestic conditions in Italy is another matter.

One may reflect that it is odd that it is the uncertainty of exchange rates in the ERM that makes it possible for Italy to pursue disinflationary monetary policies and for Germany to avoid deflationary policies. The EMS was to be an island of stability and certainty in a sea of floating flotsam. But it is only the uncertainty that keeps it above water.

Exchange Controls and the Consequences of Freedom

Participants in the ERS can pursue deviant interest

rate policies if they are protected by suitably high controls. Behind the controls the authorities can increase interest rates, knowing that they can regulate the import of capital. Such exchange controls have been characteristic of France and Italy during the life of the EMS. They are required to be eliminated by mid 1990. Indeed overt exchange controls have been substantially reduced over the years 1987-89. As one would expect the Eurofranc and Eurolira market rates have more closely approached the rates of interest on domestic markets in France and Italy. And in January 1990 Italy embraced the 2.25 percent band. All this suggests that the equality of nominal interest rates will become more of a reality of the ERM.

In 1990, it has been suggested by Messrs Francesco Giavazzi and Luigi Spaventa that now overt exchange controls have been eliminated among the main participants of the ERM, governments cannot risk a realignment.¹⁸ Any hint of a realignment will cause such speculative capital flows, untrammelled by controls, that governments will not be able to maintain domestic stability. It is conceded that there will be downward pressure on real interest rates in the inflating countries and this will push up inflation in the short run. But it is argued that the

¹⁸. See Francesco Giavazzi and Luiga Spaventa, "The 'New' EMS", CEPR Paper No. 369, Centre for Economic Policy Research, London, 1990

appreciation of the real exchange rate, together with rigid nominal exchange rates, will so influence expectations that business men will become convinced that they cannot raise prices and that they must resist trades union pressure. Thus will inflation be conquered, convergence will be complete and the old central rates maintained.

This argument may well be correct. It leans very heavily on expectations all accommodating to the fixed exchange rate. We know very little about expectations and they may behave in the manner the authors claim. One must have grave doubts that any such adjustments occur. We have a long historical record - Britain in 1926-1931 and in 1987-90, Chile in 1979-83, and many other examples - to show that too high a real exchange rate distorts the economy, raises the relative prices of domestic goods and depresses the prices of traded goods, rather than defeats expectations of inflation. Furthermore, for their system of fixed parities to be validated, it must mean that over some period the inflationary countries must inflate at a value less than that of Germany. For example, if Germany's inflation rate is 2 percent and Italy has been inflating for, say 3 years at 6 percent, then to recover lost ground in the next three years, Italy must have a deflation of 2 percent for those years. Possible, perhaps, but hardly plausible.

Similarly it appears that the Italian authorities, while conceding that the lira interest rate is constrained by the ERM to be negative in real terms and a powerful stimulus to demand and inflation, would be simultaneously intoning their absolute opposition to "long run" inflation as manifest in their determination to hold the nominal exchange rate. It is analogous to the drug addict who swears off drugs, but only after the next fix. I find it difficult to believe in such an inconsistent package of policies. It will be accepted only by the most credulous.

Messrs Giavazzi and Spaveta are really describing a knife-edge type of equilibrium. Suppose for example that Italy and Germany have converged so that they have the same rate of inflation. Then they may comfortably have the same nominal and real interest rates. There is de facto union, and exchange rates can remain fixed. Everyone may well be convinced that they will remain so and expectations will be validated. The ERM will be required to cope with incidental increases in the demand for money by one country and the reduction in demand by another country, by maintaining the same interest rates. But this state of perfection is hardly of interest. We know that we cannot identify all the trials and tribulations and offset them to produce such a model of stability. What we need is a system that will deal

with perturbations and shocks, such as monetary mistakes and natural disasters. Suppose, for example, someone makes a mistake and there was an accidental increase in the Italian inflation rate. Then, alas, we have all the inconsistencies and perversities discussed above.

Covert Exchange Controls

Although overt exchange controls have been largely eliminated in the EMS, this does not mean that there is complete or even substantial freedom to move capital and currencies over borders. Continental Europe has substantial control over national banking systems and over financial institutions. These are most apparent in the cartel structures that are characteristic of banking and finance in France and Italy. French bankers conceded, albeit privately, that their their high margins and high costs are due to a cartelized market which the government continues to sanction because it makes it easier for government to maintain covert control.¹⁹ Similarly it is well known that Italian banks have extensive cartel arrangements, and that government controls percolate throughout all large banks.

¹⁹ See Guy de Jonquieres, "The break with French tradition", Financial Times January 17th 1990. He quotes a foreign banker as saying "The authorities have'nt bitten the bullet by signalling to the local market that it has to compete internationally". France's high tax on capital income may well encourage a larger outflow over the longer term.

Perhaps more surprising, however, is the extent of covert exchange controls in Germany - apart from Britain and perhaps the Netherlands, the most liberal member of the Community. German insurance companies, which control probably more than 70 percent of long-term savings, are not permitted to buy non-Deutschemark denominated assets. By regulation they must have a complete currency match for their obligations. They can only hold 5 percent of their portfolio in equities (and necessarily mark equities). In a corporatist society, the purpose of these regulations, although ostensibly prudential, is to ensure a recycling of capital, usually via the intermediation of the banks, as loans to the large firms of German industry. Similarly there are restrictions imposed on foreigners (that is non citizens of the Federal Republic) holdings of Bundesbankobligationen.²⁰

Whatever the reason for these restrictions, the effect is to prevent the free flow of capital within the

²⁰. It may appear surprising that these covert exchange controls have not played a more important role in Treasury and other discussions about the EMS. In Britain's Economic Renaissance, Renaissance, I talked about the "restraints on the free flow of capital" but I was not aware of the true state of affairs until 1988. Most commentators ignore them and just remark on the remarkable reduction of exchange controls - with no great effects on the EMS. It is noteworthy that, at the summit meeting in Madrid in June 1989, the Prime Minister, in setting conditions for the time to join the ERM, required that such regulations and controls be eliminated

Community. They act as exchange controls, and perhaps even more effectively than the conventional exchange controls, in preventing any mass flight of capital or in stemming the tide of an inflow. Even more important is their role in maintaining a corporatist system in the continental members of the Community. But that is another story.

Conclusions

The various forms of exchange rate regimes which have been practised in Europe since World War II have all depended on exchange controls, both overt and covert. So far the EMS is no exception. Unlike the other regimes, the EMS has persisted for more than a decade and has not yet collapsed. On the contrary it is planned as the basis of a Monetary Union of the Community. The evidence suggests that the EMS has not been helpful in reducing inflation rates, in promoting overall exchange rate stability, in securing high growth and investment, and in stabilizing interest rates. In part this may be due to the perverse incentives generated by the ERM. The essence of the ERM prevents automatic adjustment mechanisms in response to shocks, and induces perverse oscillations in monetary policy. Ironically the ERM mechanism works well when there are the same inflation and interest rates in all countries - but then why bother ?

Exchange Rate Policies and PoliticsThe Medium Term Financial Strategy

As the EMS started on March 13th 1979, Britain had to have an election within the next three months. The economy was in a parlous state. Neither party had any intention of joining what most thought to be an offspring of a snake. Experience since the breakdown of Bretton Woods showed that it was extraordinarily difficult to maintain nominal exchange rates at levels which differed substantially from the market. The massive outflows and inflows of money in 1975-77 had made their point.

The first Thatcher government saw its first main task as that of securing financial stability. In particular the high inflation, at an underlying 15 percent, had to be brought under control. The main instruments for bringing inflation under control were evident from the beginning; the rate of growth of the money supply, which in the first half of 1979 had been running at some 16 per cent, had to be brought down. Mr Lawson was one of the main architects of the document that set out Britain's Medium Term Financial Strategy. This envisaged a steady downward trend in the rate of

monetary growth (of M3) and a decline in the fiscal deficit that was consistent with the monetary targets. If anyone suggested that Britain should tie itself through a fixed exchange rate in order to reduce inflation, I can attest that the suggestion did not get very far.

To the modern reader this may seem odd. In the many attempts that have been made to control inflation (albeit near hyperinflations) in Latin America, in Israel and now in Eastern Europe, the conventional wisdom is that the exchange rate must be controlled and usually that it should be fixed. But even in France and Italy in 1979-81 where inflation was in the teens, a fixed (or strictly pseudo fixed) exchange rate was thought to be a central plank of a disinflationary policy. It was a way of converging on the low inflation rate of Germany.

Why not in Britain ? And indeed why not in the United States ?

The first answer is that while an exchange rate fix may be useful for bringing really high inflations down, it is clearly not a necessary or even useful condition for controlling inflation rates of circa 10 to 20 percent. The disinflationary policy with a flexible exchange rate will have lower costs than the policy of fixing the rate. (The evidence on the higher growth rates and lower inflation rates of the non-ERM countries

reviewed in chapter 5 is relevant here.) The argument, however, may be that one needs an anchor for the currency in order to ensure that the appropriate monetary squeeze is properly applied; one can, so to speak, trust the monetary authorities to stick to an exchange rate target whereas, because of political pressure it is very difficult for them to pursue the appropriate policy of monetary restraint. That view is clearly not merely discredited but shown to be perverse by experience both in the UK and the USA. As we saw, both sterling and the dollar soared to new heights as the monetary squeeze took effect. If an exchange rate fix had been employed in the UK, then the monetary squeeze would have been quickly reversed in order to stop sterling rising above its upper bound. The fix would have had the opposite effect on monetary policy to that which was intended.¹ The inflations would have been refueled rather than doused.

¹. I confess to being most dubious about the advantages claimed for an exchange rate fix as a necessary element of a monetary reform program. It has failed in Argentina, Brazil and Chile in the 1980s. The seemingly effective case in Israel turns out, on examination, to be quite different from appearances. Israel fixed to the dollar in 1985, but this was just at the peak of the dollar value. From 1985 the dollar fell precipitously, and this ensured that the effective exchange rate of the shekel also fell. The nominal fix was not an effective fix. By 1989, however, the inflation rate of Israel had risen again to 20 percent. Bolivia is also a case where the exchange rate fix appeared to work well - but again it was over the same lucky time period. The essential element in both, albeit partial, successes was the reduction in the monetary growth rate.

Secondly, and this is peculiar to the UK not to the USA, Mrs Thatcher first major act in international economic policy was to abolish exchange controls in 1979. No such liberalization would have been possible if Britain had been on a fixed exchange rate regime. And since the effects of the abolition of exchange controls were unknown (and incidentally turned out to be quite different from forecasts), it would have been folly on a grand scale to give any commitment to any fixed regime. In addition, it was widely argued, Britain was a large oil producer, and one could not anticipate, nor be expected to counter, the effects of variations in the oil price on the exchange rate. For my part, I doubt whether the oil-price argument was entirely valid, or if so was at all powerful.² Most observers, however, believed that oil was most important, and there is no unequivocal evidence to discredit that view. So it was prudent to eschew the ERM and all its uncertainties.

The Role of the Exchange Rate 1980-1982

The exact role of the exchange rate in economic policy is subject to many subtle interpretations. During

². For arguments on this point see my Britain's Economic Renaissance: Margaret Thatcher's Reforms 1979-1984, Oxford University Press and American Enterprise Institute, London 1986, particularly p.142, and 160 et seq.

this period, however, there was a general attitude, albeit with different degrees of emphasis, to the exchange rate which was broadly shared by the civil servants and ministers. First the exchange rate was not a target for policy. This applied to the whole range of instruments: interest rates, funding operations, and fiscal measures. All instruments were concentrated primarily on domestic targets and indicators. The exchange rate was left very largely to market forces. This did not mean that there was no intervention at all, or even that it was restricted merely to smoothing operations. The Bank of England did, on occasion, intervene in markets quite heavily, but virtually always sterilized through the money markets. The prime purpose was to prevent what was usually called a "free-fall" in the exchange rate having an effect on the market for gilts. But there was no target rate. Indeed from the Budget on March 11th over the next nine months (to Dec 11th) the effective exchange rate fell about 10 percent.

Although the exchange rate was not a target, it would have been foolish simply to ignore it. The exchange rate may tell us something about the severity or laxity of monetary policy. This may be a useful indicator when, as sometimes happens, the usual indicators of monetary growth are badly distorted or, for some reason, unavailable. Such conditions occurred in 1981. The deregulation of financial markets caused a great

growth of M3 and other broad money aggregates - the targets of the MTFS. And there was industrial action by the civil service which caused long delays in the production of the monetary statistics; but of course the exchange rate was readily available.

So the exchange rate loomed large in the discussions of policy. The decline in sterling's dollar exchange rate (about 18 percent from March 10 to Sept 29 1981 the primary reason for raising interest rates from 12 to 16 percent. In retrospect the squeeze was overdone. The steep decline in narrow money (both M1 and non-interest bearing M1) in the third quarter of 1981 undoubtedly caused a marked slowdown in the recovery in 1982. The exchange rate had misled us into the belief that the monetary laxity was far greater than it was in reality. As for the reasons for such a misleading indicator, it was like "rounding up the usual suspects". First the United States had embarked on a severe monetary squeeze which made the normal dollar comparison particularly wayward, secondly there were rumours about the price of oil, and lastly, as reflected in the opinion polls, the government appeared to be distinctly shaky. All had a depressing effect on the exchange rate, which had nothing to do with domestic monetary policy.

From September 1981 through to October 1982 it

appeared that the authorities were on an exchange rate target of sorts. The effective rate remained in the relatively small range 90 to 92 over this whole period (1975=100). But from the overt statistics it could have been just as readily asserted that Britain was on a Friedmanian path of stable monetary expansion. Monetary growth (Mo) remained in the 2 to 5 percent range. Indeed all the monetary aggregates were in the target range for the financial year 1982/83.

Election 1983

Not only was Britain not on an exchange rate target, I believe that everyone, except the most absurd ideologists, knew that such a target, or even the market perception of such a target, might well be disastrous in the environment of a closely fought election. The scenario was stark. The Labour party platform was clearly to resocialise Britain. Inflationary expansion was one of its main planks. Increased taxation, renationalization, and a substantial spread of controls were among the main instruments for change. And various promises had been made to reintroduce exchange controls and bring back much of the capital that had fled the country so that it could finance job creation at home.

Such a program is a warning to any asset holder to get out while the going is good. The warning is the

more to be heeded, the higher the Labour party scores in the opinion polls and the more it appears that the policy is expropriatory. This is a great temptation to Labour. The more socialist the policy, the greater the capital flight. If the government were on an exchange rate target, it would have to raise interest rates - probably very sharply. But this would squeeze business, lower output and probably throw more on the dole. Not the sort of scenarios in which governments are reelected. The alternative of avoiding the monetary squeeze and letting the exchange rate find its own depreciated level does avoid the election-induced recession.

The government followed this strategy by letting the exchange rate fall 15 percent both in nominal and real terms from November 1982 to March 1983.³ Interest rates rose 2 percentage points, Mo's growth rate was reduced, and this was enough to ensure the gentle but persistent disinflationary pressure. In the event, the run up to the election was smooth. Although it has been claimed that devaluations do even more political damage than monetary squeezes, the 1983 election discredits that view.

It appears that a socialist opposition has an enormous advantage in inducing capital flight, interest

³. This fall in the nominal exchange rate was even more sharp than the fall in 1981.

rate increases, and wrong footing governments economic policy. But, like most things, it can be carried too far. True the more rabid the socialist program, the greater the capital flight. But the more extensive the expropriation, the less the electoral support. If its purpose is to maximize the probability of gaining power, then the Labour party will pitch its program to balance this reduction in the vote against the gain in support derived from the perversion of the government's policy. In the events of 1983, I believe that the Labour party, largely because of internal tensions, badly miscalculated the trade-off. Their program of old fashioned unreconstructed socialism put off the voters so that the party never really looked as though it had a chance of gaining power.⁴ The Tories won.

The EMS and the 1982 Decision

The EMS, and exchange rate targetting, had hardly figured in the election at all. Labour were far more vitriolic than any Tory about the iniquities of any community constraint on their sovereignty. Nevertheless in

⁴. It is worth noting that the government had taken many precautions against capital flight. First there had been an extensive issue of indexed gilts which would protect the holders against a Labour (or Conservative) inflation. Secondly, the government developed "Maggie Mae's" a conventional gilt with the option of switching, after the election into an indexed instrument. In the event, the capital flight was minimal.

1981 the issue of Britain's membership had been raised, largely at the behest of the existing members of the ERM.

As was widely reported in the media, in January 1982 a No. 10, a meeting, chaired by the Prime Minister, was held of the Chancellor, the Foreign Secretary, and the Governor with their advisers to consider the case for entry. It was decided that 1982 was not an appropriate time to join the ERM. Of course this did not mean that there would never be good reason to join. Circumstances may change or the ERM may change. The issue was left open; one should join only when and if it was appropriate.

That decision was fortunate. Had Britain joined the ERM at the average mark rate of 4.331 (for first quarter of 1981), it would have required very large increases in interest rates to hold this parity.⁵ Even with the 2 percent increase in interest rates that actually occurred, the Deutschemark rate had slipped to 3.684 by the first quarter of 1983 - the eve of the election. But in the ERM for such a short period there would have been much reluctance to realign substantially enough to put to rest the speculative capital raiders. In my judgement, had we have joined the ERM in early 1982, the pressures

⁵ As we shall show, the interest rate would have to have risen to at least 17 and probably 20 percent to hold that central value of 4.331 Deutschmarks.

would have been quite insurportable. .

The New Chancellor

Mr. Lawson must be considered among the best prepared chancellors of the century. As Financial Secretary in 1979-82 he had been closely involved in the Medium Term Financial Strateg and Funding Policy, including the introduction of indexed gilts., and the funding policy. He had also been Secretary of State for Energy in the crucial period 1982-3. ⁶

The basic policy of the government was to continue with Sir Geoffrey Howe's gentle but persistent downward pressure on the monetary instruments to bring inflation down. The exchange rate was one of the factors to be taken into account in judging the tightness of monetary policy. But there was no targetting of the exchange rate and no shadowing of the EMS. Both these trends can be easily seen in charts... and ...(Pepper's charts III and V Note that chart III will have a notional trend value added continuing the trend fall over 1983-1986 to 1989 where it will approximately intersect at a growth rate of zero). The growth of Mo was on a gently

⁶. I believe I first met Mr. Lawson shortly after my attack on Heath's policies. in 1972. Then I had always thought he was a kindred spirit. After the fall of the Heath government, Mr. Lawson was an important discussant in developing a new economic policy.

declining trend from the middle of 1983, when it was about 7 percent per annum, to the last quarter of 1986, when it was about 3 percent. If this downward trend had been continued then the growth of the monetary base would, by the end of 1988, have been approximately zero.

In my view the policy over the period 1983-1986 was about as close as one could get to ideal. The underlying inflation rate fell, with a bump or "blip" in 1985, from about five percent to some 3 percent in 1986. Had the policy been continued, so that zero Mo growth rate was achieved by the end of 1988 and thereafter the monetary base had remained unchanged, it is likely that the inflation rate would also have been approximately zero. Mr. Lawson had on various occasions said that the ultimate aim was to eliminate inflation completely and over the years ensure a stable price level. Here he was within two years of achieving that once elusive goal.⁷

The Curious Case of Hong Kong 1983

The remarkable story of how this opportunity was

⁷. In a memorandum dated Dec 6th 1985 I said "If monetary growth (Mo) is held at its present level (i.e. virtually zero) for a period of two or three years, then it is likely that inflation will fall to about zero before the end of the 1980s and perhaps even by 1988.. At last we shall have price stability". I had left my government employment in 1984, but, as an interested citizen, I still offered my views.

missed can only be related from my partial point of view. The conversion of Mr. Lawson to an enthusiast for Britain's entry into the ERM took place between February and November 1985. It may well be that the experience of fixing the Hong Kong dollar in October 1983 had a influence on his views.

Until the breakdown of Bretton Woods, Hong Kong had been on a currency board with a fixed sterling exchange rates. The sterling parity was maintained by the Hong Kong Currency Board always being ready to exchange Hong Kong dollar notes against sterling notes at a fixed exchange rate. During the next decade, the Hong Kong dollar could be characterised as floating amid the jetsam of the 1970s. But there was no discipline of monetary control to replace the currency board. The escalation of the US dollar, the recession, inflation, justifiable doubts about government monetary policy and the political uncertainties generated by the end of the lease (1997) caused a number of runs out of the Hong Kong dollar. These finally culminated in a massive flight in September 1983. The Thatcher government reacted with exemplary speed and decisiveness. The Currency Board was reinstated. The Hong Kong dollar was fixed at a parity of 7.8 Hong Kong dollars for a US dollar. Immediately the run ceased and capital flooded back into Hong Kong. The policy was a great success.

It was clearly best to engineer a rapid return of a currency board system. Although there were many questions about the adequacy of Hong Kong's reserves, whether it should be fixed to the dollar or the SDR (I do not think that sterling was a serious possibility), and exactly how the Currency Board would operate, the need for a speedy decision was clear. The policy was duly agreed. Mr Lawson did wonder, and with good cause, why I, an avowed British floater, could be so enthusiastic in proposing a fix for Hong Kong. I explained my penchant for clarity in policy and the perils of pseudo systems. I doubt whether my explanation had any effect whatsoever, but I suspect the subsequent euphoric experience of Hong Kong did dispose Mr. Lawson, and perhaps many others, to be more favourably inclined towards a pseudo-fix for sterling.

Preparing for ERM 1985

The year 1985 began with the Chancellor saying that in monetary policy most attention should be paid to the exchange rate. However, in February he was still opposed to Britain then joining the ERM; but by September the campaign to join was in full swing. Corresponding to the elevation of the exchange rate into proposed ERM entry, was the downgrading of monetary indicators. Sterling M3 had been downgraded somewhat in 1981 with some attention being given to the exchange rate. In

1982 narrow money in the form of M1 had entered the target list, and the exchange rate gained even more prominence. After Mo replaced M1 in 1984, the exchange rate was accorded primacy among monetary indicators.

This became quite clear in early 1985. Base rates were increased from 9.5 percent in December 1984 to 14 percent in February. The reasons could not be seen in any sustained acceleration of Mo. True there was a spike in December, but this was soon corrected by a trough in January.

(INSERT here Pepper's Chart IV)

Nor could one point to any clear explosive behaviour in sterling M3, PSL2 or any of the broad aggregates.⁸ On the other hand, the dramatic fall in the dollar exchange rate to near to one-for-one in February (a near 20 percent fall over the year), and the reduction of 15 percent in the effective rate were powerful reasons for the Chancellor imposing his monetary squeeze.⁹ Yet

⁸. The annual rate of growth of sterling M3 had increased from 8.2 percent in September 1984 to 10.0 percent by February 1985. By the end of the year, however, the growth rate was near 14 percent. The Chancellor was, in my view rightly, convinced that sterling M3 was a misleading indicator of monetary stringency. One should not ignore it, but in view of the rapid changes in credit markets, it was very difficult to interpret.

⁹ Note that the reduction in the exchange rate of the Deutschmark was only from 3.889 to 3.608 - about 8 percent - during the year ending February 1985. By July 1985 the mark was at 4.014.

there was no question, at that time, of joining the ERM. Exchange rates were too turbulent and monetary conditions appeared to need tightening (at least according to the exchange rate interpretation).

But there is no doubt that joining the ERM at a propitious time had become a central plank of the Chancellor's policy. This became clear in early June 1985. Several city commentators had been arguing that "monetarism was dead".¹⁰ Were there parallels between 1972-4 and 1985- ? Retail price inflation had reached 7 per cent in May and June 1985 compared with 5.1 per cent in mid 1984. The growth rate of M3 had begun to accelerate. In their attempts to contain the growth rate of M3, the authorities had accumulated a massive "bill mountain", which many thought, erroneously, represented a great monetary laxity. In my view the fact that the monetary base had been well contained

¹⁰. For example, Phillips & Drew, "The Death of Monetarism", Market Review May 1985, and de Zoete & Bevan, Weekly Economic Survey, Issue 85/19, May 16th 1985. Of course the "death" of monetarism had been pronounced many times. In my recollection the earliest declaration was by John Kenneth Galbraith in 1980. The City commentators, however, presented serious argument to support their case. The most sophisticated analysis of the situation was given by Gordon Pepper in Greenwell's Monetary Bulletin, No. 172, May 1985. He argued that the growth of M3 was primarily due to the increase in the real interest rates, and was not a harbinger of inflation. But he did strongly, and in my view rightly, condemn the inefficiency of the demand-side control of monetary aggregates.

(see the Pepper chart IV), was good evidence that there was no inflationary Armagedon coming in 1986-87. The absence of any take-off of inflation in asset prices, particularly land and houses, was additional evidence to support the argument that monetary policy had not been loose. In the performance of both Mo and asset prices, the situation in 1985 was quite unlike that in 1972.

But whether and when to join the ERM was another matter on which there was no agreement. I had made my views clear in the manuscript of my Britain's Economic Renaissance. I do not know whether the Chancellor read my manuscript. But so far as I was aware, there had been no critical discrediting of my arguments about capital movements, exchange controls, and perverse policies. I had conceded the argument that the ERM could be a discipline on any government (the possibility of a Labour government in 1987-8 was not all that remote at that time), and on wage demands by powerful unions. Although this case had superficial plausibility, I did not see that membership of the ERM had in fact given rise to any more stiffening of government sinews, compared with countries outside the ERM.

The October-November Attempt to Enter the ERM

During the next few months, the Treasury and the Bank prepared the arguments for and against entry into

the ERM. By November the inflation rate had subsided to 5.5 per cent and was expected (and did) fall to about 2.5 per cent by June 1986. One of the conditions for ease of entry had been satisfied. The mark-sterling exchange rate had been fairly stable over 1984. 1985, however, was a year of great instability. The rate of 3.5 in February was clearly reckoned to be too low and a threat to antiinflationary policy. By July 1985 it had exceeded 4, and this was thought to be too high and put too much pressure on industry. In early November the rate had slipped to half way between these two values, at 3.75.

It was argued that joining the ERM (and I believe everyone had in mind the narrow band of plus or minus 2.25 percent) would reinforce the counter inflationary strategy. It would be not only an anchor but an observable and credible anchor. Businessmen would know that they could not look to a slide in the exchange rate to bail them out of their own mismanagement. This, of course, was a repeat of the 1982 brief. But in addition there was the waywardness of the monetary targets, particularly sterling M3.¹¹ (In fact the misleading nature of M3 had been argued by me from the end of 1980 and thereafter) It was said that it was

¹¹. In his Mansion House speech in October 1985, the Chancellor had announced that the sterling M3 target had been suspended, and that "The inflation rate is judge and jury"

very difficult to present monetary policy in a credible form. An exchange rate target would solve all such psychological and presentational difficulties. Thus solved, there would be such an effusion of confidence in the conduct of the authorities that the uncertainty premium which was attached to interest rates would fall.¹² Much weight was placed on the additional stability in the (Deutschemerk) exchange rate through expectations generated by the ERM, and there would be less room for speculation. The counter-arguments, of course, had already appeared (for example in my Britain's Economic Renaissance) and, in spite of their spare coverage by the media, I imagine they were also again reviewed. And the contra-arguments won the day.

What if Britain had entered the ERM in 1985 ?

It is interesting to reflect on what would have happened if Britain had entered the ERM in early or mid November. The parity or central rate at which one enters a fixed exchange rate system is always a critical decision - as Churchill found in 1925, the Chileans discovered in 1979, and Hong Kong observed in 1983. We

¹². For a number of repetitions of these arguments see Samuel Brittan's articles which began with his conversion in the Financial Times, November 14th 1985 with "Now, alas, it is time to join the EMS" (he meant the ERM).

can get some idea of what would have happened if Britain had entered the ERM at 3.75 by observing what actually happened to the mark-sterling rate from November 1985. By the end of December the rate had sagged to 3.53, by mid 1986 to 3.00, and by the end of 1986 it was hovering around 2.80. In 13 months sterling had fallen about 27 percent.

In order to give some idea of the effect of the ERM on Britain's policy I shall assume that there was no realignment in the first year or so of entry. The 2.75 rate is held. The question is then, how far would interest rates have to rise in order to hold the central rate at that level? Some estimates can be made by applying the so-called "4 to 1" rule, namely that a 4 percent depreciation in the exchange rate is counterbalanced by a 1 percent increase in base rate.¹³ This would imply that, holding the ERM central value at 3.75 would have required increases of $(27/4)$ 6.75 percentage points in interest rates over and above the 10 to 12.5 percent that were in effect throughout. This would have meant interest rates of some 17 to 20

¹³ See Charles Goodhardt, "British Monetary Policy" (check title), Economic Journal 1989. The rule refers not to the Deutschemark but to the effective exchange rate index. The fall in the effective exchange rate over this period was of the order of 20 percent. But the defence of the central parity in the ERM is effectively with respect to the mark, so in these very rough calculations I have assumed the same rule applies to the mark-sterling rate as to the effective rate.

percent.

Many EMS protagonists would claim that this estimate does not take account of the beneficial effects on expectations, including the greater certainty and credibility of being in the ERM.¹⁴ It seems dangerous to rely so much on a subject we know so little about, namely expectations. But, in any case, exchange rate pressure which induced such high interest rates would clearly generate expectations of realignment or perhaps even withdrawal, or, worse still, of incipient exchange controls.

In retrospect the widely reported intransigence of the Prime Minister to entering the ERM was a godsend. If we had entered, then raising interest rates to new highs in late 1985 and throughout 1986 would have jeopardized, even ruined, the conservatives in the elections of 1987. After such a very tight monetary squeeze through 1986, there would have been a recession - and most likely a deep one - in 1987-88. This would have been exacerbated by the capital flight and escalation of interest rates discussed above. No doubt that, in the event, the government would have taken some evasive action, such as realignment, as the dire

¹⁴. This is a moot point since the "4 to 1" calculation was over the period of which included the period of shadowing the Deutschemark.

consequences of the decision to join the ERM became apparent. But, willy nilly, any such actions would be acknowledgment of an error of policy, and hardly a basis for asking for another term in government.

It is easy to conclude that Mrs Thatcher was lucky in just happening to be right. The market exchange rate might have remained more or less constant and so there would have been no trouble in maintaining the ERM central rate up to the election. Before mellowing with such comforting thoughts, one should review the history of exchange rates since 1972 (as in the Pepper chart V). There are few periods where one could describe the exchange rate as being stable without a pronounced drift. (We must acknowledge, however, that 1984 was relatively stable with a small drift from near 4.0 to 3.5 - a near 10 percent devaluation). Alternatively the underlying market exchange rate might just have gone the other way and massively appreciated. But, as we shall see in 1987-88, this is exactly what did happen and with the shadowing of the Deutschemark, this delivered a substantial inflation in 1989.

The "End of Monetarism 1986

Without the restrictions imposed by the ERM, 1986 was a good year. Growth was about 3.5 percent and

inflation was way down, partly because of the collapse of the oil price and partly because of the reductions in mortgage interest rates. (It is odd that few commentators observed the coincidence of the collapse of the Deutschemark exchange rate and the fall, rather than the rise, of inflation.) But even as early as 1986 the writing was, albeit faintly, on the wall.

At various stages since 1983 the Chancellor had announced that the ultimate objective was stability of the price level - that is to say zero inflation. Indeed the joining the ERM policy was thought to be consistent with this aim, since the objective of the Bundesbank was a stable price level. A stable price level required a reduction in the rate of growth of M_0 from its ambient 3 to 5 percent in 1985 to zero. This monetary growth path consistent with the objective of zero inflation by 1990 is shown in (chart V of Pepper); by 1988 the quantity of M_0 is stable, and its growth rate zero. From 1983 to mid 1986 the trend rate of growth of M_0 was gently declining, and had it continued to decline at that rate, the goal of zero inflation would have been reached in 1990. The actual record, however, shows a marked increase of some 2 percentage points above the trend line in the last half of 1986.

At least as far as M_0 is concerned, this marked a turning point in the policy of persistent pursuit of

lower inflation which had been manifest since the 1983 election. It was not a dramatic reversal. The change was initially small, almost imperceptible. Yet, as can be seen in (Pepper chart III), the divergence between my target path of zero inflation by 1990 and the actual growth rate of Mo expanded inexorably throughout 1987 and 1988. Finally in September 1988, the growth rate of Mo was over 8 percent and the difference from my preferred path was as much as 7 percentage points.

If ever one is to date the "end of monetarism", then I think that the middle of 1986 has a good claim. Of course it may be argued that this was nothing more than the usual pre-election expansion to give the voters an aura of prosperity in which, it is hoped, they will reelect the incumbents. But it was more than that. The boost persisted for three years, long after the election.

There are many possible explanations of this change in policy. First there were growing doubts about the relevance of the monetary aggregates. Although Treasury officials had demonstrated that Mo was an efficient guide for monetary policy, various commentators had repeated that the City could not conceivably regard such small change as an appropriate target. If the City could ignore Mo, why not the Chancellor? Similarly one could explain away the burgeoning broader aggregates and

particularly sterling M3. In a financial system that was changing its very structure so dramatically, M3 was a dog that had barked too often to be taken seriously. But I suspect that the most seductive influence was the general attitude among the G5 finance ministers that exchange rates were too important to be left to the whims of markets. All right-thinking finance ministers agreed on the need to topple the dollar in 1985 - hence the Plaza agreement. Among the G5, Mr. Lawson was clearly the most clever and most experienced. [It must have been quite heady stuff to redraw the financial map of the world.] And Mr. Lawson must have connected the Plaza and Louvre exchange rate targetting on a global scale with the domestic problem of the UK.

The Untarnished Attraction of the EMS

It must have appeared the logical next step to take Britain into the ERM and, most important, to play a full role as the second most important financial power in Europe, first in influencing policy of the Bundesbank and secondly as the honest broker between Germany and France in developing an integrated financial system for Europe. All these considerations might explain the persistence of the drive, [by hook or by crook,] to get Britain into the ERM.

In this endeavour, Mr. Lawson had powerful allies.

The banking community was quite firmly in his camp, although some managers were worried about the effects on interest rate variability. The City was said to be enthusiastic for a fixed mark parity and entry into the ERM, no doubt because City arbitrageurs relished a safe bet at realignments. The CBI had stated clearly its full and complete support for entry. This at least offset the much more skeptical view coming from the management of industry - the Institute of Directors. And above all, as a highly successful reforming Chancellor, Mr. Lawson had fullsome support on the conservative benches in the House of Commons.

In view of the behaviour of the sterling-mark exchange rate in 1985-86, and the obvious difficulties Britain would have encountered had she joined at the November rate of 3.75, one would have thought that this would have given the Chancellor pause [before saddling up for another ride on the tiger.] Clearly it did not. Nor can I find any satisfactory explanation for ignoring the lessons of 1985-86. [It is inconceivable that the treasury official did not carry out "what if..." exercises on this period.¹⁵] I suppose he may have

¹⁵. [It has been reported (Keegan) that senior officials in the treasury were entirely surprised by the Chancellor's announcement at the IMF in January (?) 1987 that exchange rates were the main guide for monetary (interest rate) policy. The decision to shadow had not been a considered in depth or detail by officials. It was represented as the consequence of a number of discussion between Mr. Lawson and Sir Terence Burns, with offstage assistance from that most distinguished financial

delete

surveyed the evidence and drawn quite different conclusions from those which I adduced above. For example accepting the facts as I outlined, he may have believed that the magic ingredient of expectations and confidence would clearly bail sterling out of any difficulties, as had apparently happened in Italy, notwithstanding Britain's open financial markets. More likely he ignored the economic arguments on the grounds, alas not unjustified, that the economists had usually been useless on predicting exchange rate movements. He may have felt more at home with his hunches.

Shadowing the Mark

And his hunches, tactically, were good. When sterling began shadowing the mark in early 1987, the Deutschemark rate had fallen below 2.8, even though base rates were relatively high at 11 percent. Sterling had then hit its nadir. At this value the mood of the market was that sterling had reached its bottom. A policy to maintain the rate around 3.0 was both attractive and easy. Indeed it was combined with a fall in base rates from 11 at the turn of the year to 9 per cent for the

8 journalist, Mr. Samuel Brittan. This report is consistent with the picture of Mr. Lawson as a gambler who likes to keep his cards close to his chest.

election in May. Sterling soon appreciated in February to 2.9 and thereafter it rarely deviated more than 1.5 per cent (0.05 Deutschemark) from 3.0.

The economic ambience of this policy seemed like a new golden age. Growth proceeded at between 4 and 6 percent, according to the measure used. Investment boomed with a 7 percent growth. Inflation remained low, a little over 4 percent, but the tax price index was only about 2.5 per cent. A great tax reform was introduced in the March 1987 budget and continued in the budget of 1988. Marginal personal tax rates were reduced to a maximum of 40 percent, and many loopholes and anomalies were swept away. Yet, such was the ebullience of the economy that revenue increased dramatically and the deficit in the public sector turned into a surplus. Debt retirement began. Interest rates fell.

The pre-tax real rate of return on assets in the corporate sector had been rising since 1981 (when it was 2 percent) and finally by the end of 1987 it had reached 12 percent. It was expected to rise even further, and so it did - to over 13 percent in 1989. Such high rates of return had not been seen since 1964. More important they clearly exceeded the rates of return

in other OECD countries.¹⁶ Much of this improvement was due to supply side changes, which were expected to continue.¹⁷ This meant that there was a great attraction for investors, both domestic and foreign, to invest in Britain, either through foreign direct investment or through portfolios. The demand for sterling was boosted by this investment effect. There was perhaps an even larger demand created by the interest differential between the United Kingdom and overseas. United States treasury bills in January 1987 were yielding only 5.85 percent compared with about 11 percent on sterling bills. The risks of a three month devaluation of sterling were clearly low, so sterling attracted many buyers.

The increase in the demand for sterling bouyed up the exchange rate at 3.00; there was initially no difficulty in holding it there. The authorities did intervene largely to prevent the rate rising above the 3.0 limit. This took the form of selling sterling and buying convertible currencies. Intervention statistics remain a secret. (It is interesting to note however that the convertible currency reserves increased over 1987 from \$13.78 billion to \$35.73. One may conjecture that much of the increase was in anticipation of a need to to

¹⁶. See "Company Profitability and Finance" in Bank of England Quarterly Bulletin, Vol 29, no.1, August 1989, page 377.

¹⁷ These have been analysed in detail by Patrick Minford in von Fuerstenberg (ed) (CHECK ref)

prepare for defence of a fixed exchange rate whether in or out of the ERM. ¹⁸⁾ The intervention was formally sterilized in the sense that it was not allowed to have any persistent direct impact on the money market rates of interest. Bills were sold to take sterling off the market. Thus the bill mountain, such a source of concern in 1985, melted away.

Many studies have shown that sterilized intervention has little lasting effects on exchange rates. Since most of it was sterilized in 1987, the persistent pressure for an appreciation of sterling continued. The only way to prevent it was a reduction in interest rates relative to those in other OECD countries. First however there was a little diversion due to the Louvre (February 1987) agreement. In May the United States authorities were driven to raise interest rates sharply to stop the decline of the dollar (again after a failure of massive internationally coordinated sterilized intervention to do the trick). US rates continued to rise throughout the year until the stock market crash of October 19th. In July British interest rates were increased by one percent, but thereafter they did not follow the dollar

¹⁸ Gordon Pepper shows that the net effect on M4 of foreign exchange reserves in 1979 was 7.2 billion sterling. He concludes, however, that although the authorities failed to "sterilize" (in the sense of having no direct effects on M4) all the intervention in 1987, they did manage to catch up in the first quarter of 1988.

up further. And following the October crash, base rates resumed their downward path to 8.5 at the end of 1987.

It is ironic that during 1987 the attempt to put a floor under the dollar and the attempt to put a cap on sterling both failed. Both were fought with the biggest intervention funds ever deployed. Both substantially sterilized their intervention, and discovered it was ineffective. Both were driven back to monetary policy, to higher interest rates in the United States and lower ones in Britain.¹⁹

The massive interventions in Britain came to an end in the first months of 1988. It was rumoured that more than \$2bn was spent on intervention in one day. Intervention was scaled back to the normal smoothing operations. There was a well publicized disagreement between the Chancellor and the Prime Minister. Just before the March budget, the Prime Minister made it clear that you "cannot buck the market". That was manifestly true. In any case the 3.0 Deutschemark fix was finished on March 4th. By the end of March the mark rate was at 3.125.

The October Excuse

¹⁹ More important internationally was the reduction in the yen discount rate to 2.5 per cent in order to prop up the dollar. This contributed to a massive real estate and stockmarket inflation in 1989-90.

But this did not mark the end of the expansionary policy. In a vain attempt to put a somewhat higher cap on the exchange rate, interest rates were reduced again to their low of 7.5 percent in May 1988. The only conceivable rationalization for such a policy was that the exchange rate appreciation, both overt and incipient, showed that monetary policy was still "too tight". Yet every other indicator suggested that monetary policy was too loose rather than too tight. The labour market was showing distinct signs of strain and unemployment was falling by about 50,000 a month. The prices of assets - and particularly real estate - were rising strongly. The current balance of payments had turned markedly into the red, and there was a clear import boom. Investment boomed ahead at record rates. The monetary indicators were all pointing to an inflationary surge. The Mo figures suggested that there would be a two percent increase in underlying inflation coming in 1988-89, and the broader money aggregates were suggesting even more alarming forecasts of price inflation. Only the exchange rate could be adduced as evidence that monetary policy was still "too tight".

What possible excuses could there be for ignoring this weight of evidence ? One such excuse, according to the Economist, and many other supporters of the monetary expansion, is that monetary ease was the

appropriate response to the October 19th 1987 crash. This would then avoid the mistakes made following the crash of 1929 and 1931. But the appropriate response to a crash is not inflationary expansion. The problem in October might well have been a run on the banking system or some other form of liquidity run. This calls for the Central Bank to stand ready to discount paper to stem the run, not to flood the market with money. In the event, the Federal Reserve Board of the United States handled the October crash in an exemplary manner which should have been a model for the United Kingdom. In the Economic Report of the President, February 1988, (page 39), it was shown that, in spite of October's troubles, the Fed actually tightened monetary policy in 1987 - because it feared that the expansionary policies of 1986 would promote inflation. This is exactly what was needed in the United Kingdom.²⁰ There was nothing that prevented such a prudent policy being pursued. The Governor in his Durham speech in April 1990 observed that there had been errors of policy. I agree.

The Monetary Squeeze from June 1988 on

From June 1988 monetary policy was sucessively tightened by raising interest rates frequently but by

²⁰. Most of the other major OECD countries appear to have acted with a prudence similar to that of the United States. Britain was the odd man out, followed by Japan.

only half a percentage point. This was new. Normally in a squeeze the interest rate is put up substantially - usually by 2 percentage points. Then the market is much less certain about the next move of interest rates, whereas using the innovation of Mr. Lawson, the market was certain of the direction of the next interest rate movement. By August base rates were up to 12 percent.

The question remained, however: were the Authorities still operating with an exchange rate band as the target? Albeit the band had moved to 3.1 to 3.3 or so, but the rate was kept in that band until a September 1989. But the evidence of incipient inflation became more evident with every passing day. House prices boomed, labour shortages were spreading, unemployment was falling as fast as ever, and all the signs of overheating were there for all to see. The need for a substantial increase in interest rates, whatever the exchange rate consequences, was manifest. Fortunately the exchange rate pressure was reversed and became downwards and so provided a convenient argument for increasing interest rates in one percent steps from 12 percent in October 1988 to 15 percent one year later; thus, at last, there was the coincidence of the exchange rate giving an appropriate direction to monetary policy.²¹ The market

²¹. There is still room for debate about whether the monetary squeeze from 1988 onwards was too tight or still too loose. There was no doubt at all that interest rates of at least 12 percent were needed in order to get the growth of the monetary base under

was quite convinced that it was virtually only concern about the Deutschemark and German interest rates that was driving interest rate policy in the UK. Indeed the Chancellor and the Governor had given the market good reason for believing that exchange rates were the main determinant of interest rates.²² And once the belief is ingrained in market lore, it is very costly to try and change it.

Britain was on the back of the tiger. As the exchange rate fell, or threatened to fall, in the autumn of 1989, so the interest rate was driven up by market expectations. The authorities had the choice of validating expectations or changing them. However desirable it might be to avoid riding the tiger, the alternative was to fall into its jaws. The government would certainly be chewed up if they had announced a substantial change in their macroeconomic targets. Even though 15 percent interest rates may seem like riding the tiger into a recession, the alternative was even worse.²³

some sort of control.

²² In his speech at the Party Conference in October, only days after the increase of base rates from 14 to 15 percent, the Chancellor made it clear that the Conservative Party would not be "the party of devaluation".

²³ Reports appeared in the media that I was opposed to the increase in interest rates to 15 percent in October 1989. Other reports said I supported the increase. My position was that we were in no position to change the market expectations, and that moving up to 15 percent was the least bad alternative.

The Foreign Exchange Reserves

(THIS MAY NOT BE SUITABLE AT THIS JUNCTURE - POSSIBLY NOTE OR APPENDIX?)

So far we have ignored the consequences, particularly the costs, of fixing the exchange rate on the foreign exchange reserves. One of the little known consequences of the first Thatcher government's financial program was the privatization of a substantial fraction of the official foreign exchange reserves. In 1979-1980 the authorities held more than \$18 billion in convertible currencies.²⁴ By 1984 this had been run down to about \$7.5 billion. This reduction was possible because the authorities did not need any substantial reserves if sterling were floating. If it were a free or pure float, then, apart from the needs for normal operations, there is no need for any official reserves. But Britain was on a dirty float and the Bank always liked to smooth the path of sterling, so some balances were needed for these operations. We can conjecture that if Britain joined the ERM, then considerably more reserves would be required. One notes that France and Italy maintained reserves of 18. and 23 percent of their exports in

²⁴. See Bank of England Quarterly Bulletin, table 17.1. Note that I am including only convertible currencies and excluding gold, and the IMF reserve and special drawing rights.

1984, whereas Britain's reserves were only 6.5 percent. It is reasonable to suppose that, were Britain to join the ERM, reserves of about three to four times the \$7.5 billion, that is \$22.5 to \$30 billion (for 1984 export volumes and in 1984 prices) would be required. Bringing them up to 1989 values, one would get a required reserves of \$30 to \$40 billion. (Just to confirm this figure, the official reserves in 1988 rose to \$40 billion at the end of July and to over \$42 billion by the end of the year). The ERM, therefore, would require us to have additional reserves of some \$20 to \$30 billion - let us assume hereafter that the extra reserves amount to \$25 billion. ²⁵

What are the costs of keeping these reserves? The real rate of return on the reserves is roughly the real short term interest rates in the money markets of New York and, to a lesser extent, Frankfurt and Tokyo; a figure of around 2 percent seems appropriate as the average value of the return to be expected. If these funds had not been required for padding the reserves, they would have been employed by the private sector, as in 1980-1984, as capital assets. We know that the average real rate of return on capital employed in private industrial and commercial companies in the UK in

²⁵. In 1984 I ignored the \$2.5 billion floating rate note issue which the treasury issued for the specific purpose of increasing the reserves. Obviously this issue had potential ERM entry in mind.

1988 was about 12 percent.²⁶ If these were the rates of return of alternative investments forgone, then the costs of the reserves were about 10 percent of the \$25 billion, or \$2.5 billion a year. Of course the alternatives forgone may be overseas investment, either in portfolio form or in the acquisition of real assets or direct capital formation. We do not know the full rate of return on these investments, mainly because of the lack of information on capital gains.²⁷ But from the information available, it appears that over the Thatcher years the rate of return has been very very high at some 15 to 20 percent, and substantially larger than that

²⁶. Bank of England Quarterly Bulletin, Vol 29 No 3, August 1989, p.377. A more conservative calculation may take the point that a 12 percent rate of return cannot be sustained and that a 10 percent, or even an 8 percent, rate would be more appropriate in the long run.

²⁷ See "External Balance Sheet of the United Kingdom", in Bank of England Quarterly Bulletin, vol 28 no 4, p 520-527. The net asset position grew from 12.1 stg at the end of 1979 to 113.2 and 89.5 billion stg at the end of 1986 and 1987 respectively. Such assets are obviously in part acquired by the cumulation of current balance surpluses, but this can only account for some 17 billion stg in the published statistics. (The reader may well believe that the current account balance is much underestimated in the official statistics. But even if we double it to 34 billion stg, it still cannot account for the bulk of the additional net foreign assets.) The balance is largely accounted for by the yield, and in particular the capital gain including currency revaluation, on such foreign assets. On certain assets the Bank has calculated the full rate of return on assets (not net assets) - see chart 6 p.525. This suggests that the full rate of return has been about 20 percent over the period end 1979 to end 1986. This appears to be the nominal rate of return, so the real rate of return would be somewhat below this, but almost certainly in excess of 15 percent.

on domestic investment. Thus the cost of the reserves for the ERM is between \$2.5 and \$5 billion (or 1.5 and 3.0 billion stg)

Thus, in maintaining these additional reserves, the ERM will cost us some half to one percent of GNP each year. Whether this is considered large or small depends on the alternatives. One possible alternative is to go the whole hog and switch to a Deutschemark currency or to a currency board system. (This is the logical consequence of Delors stage 2.) Instead of pound notes, Deutschemark notes would circulate and we would be on a full Deutschemark standard. The Bundesbank would hold reserves; we would simply hold some of their currency. At present currency and coin in the UK amount to about 17 billion stg, or some \$26 billion. This capital value of the seignorage is about the same as the additional reserves for joining the ERM.

If a currency board substitutes sterling currency at a fixed rate for Deutschemark notes, then the \$26 billion equivalent can be at least partly invested in short term mark financial assets. So the cost of the ERM is about the same as the cost of a full currency board system.

Conclusion on the Lawson Years

There is no doubt that it was an error to launch a country that had suffered much in quelling, if not

conquering, inflation in 1979-82 into a renewed inflation in 1988-90. Opinions differ on when this inflationary policy started; some trace it back to 1985 with the surge in the growth of sterling M3, some only to 1987 or even 1988. But in prospect the warning signs were flashing in 1987 and were clearly bright red in the first months of 1988. I believe, however, that there is substantial agreement that the inflationary pressure could have been reduced if Mr. Lawson had pursued more monetary stringency in 1987-88. X

The role of the exchange rate in the general conduct of monetary policy and in particular the shadowing of the mark was quite critical in exacerbating the inflationary pressure. The ambient influences arising from the Plaza, the Louvre and the crash of October 1987 no doubt much affected the authorities' decisions, yet they cannot serve as an excuse. The primary motive for the expansionary policy was to contain the exchange rate at 3.0 Deutschemarks. This was the main explanation for the inflationary policy of the latter half of 1987 through to the summer of 1988. Then the inflationary pressures became too obvious to ignore, and so the long delayed monetary squeeze began, but was not fully in place until October, 1989. On normal expectations, one would not expect to see any turnaround in the rate of inflation until the turn of the year 1990/91.

Although it is not possible to venture any estimate of the costs of the policy errors (as the Governor called them), it is possible to measure the direct costs of the additional reserves required to defend a pegged rate. These were approximately 1.5 to 3.0 billion sterling or \$2.5 to \$5.0 billion. This is roughly equivalent to 1 to 2 pence off the standard rate of taxation. This would be the direct "reserves" cost of Britain's entry into the ERM.

A Monetary Constitution for Europe ?Introduction

In this final chapter, I try my hand at sketching a monetary system which will ensure stability of the general price level. This, albeit in a wobbly sort of way, Western Europe enjoyed under the gold standard for centuries. The norm for a civilized society was a stable currency and not inflation. After these many decades of depreciating currencies, it seems that the world yearns again for that ancient stability. Anchors are needed. Institutions such as the Federal Reserve Board, the (old) Bank of England, and the Bundesbank have provided such anchors in various periods of the historical record. But all have, at times and to varying degrees, failed to give that that rigidity when under pressure.

Rather than relying on authorities and institutions, one would like to rely on rules. It is rather easier to agree on rules and procedures than to agree on policies and outcomes. Furthermore those rules should be transparent and unavoidable, rather than, as under the gold standard, obscure and escapable. In this chapter I discuss the problems and prospects of basing a European

currency on a commodity basket. Thus one unit of money will always be able to purchase certain quantities of commodities which represent the budgets of consumers. I also consider some paths from the present situation to the commodity currency, and how commodity money may exist side by side with present national moneys and ECUs

Of course this is not a complete monetary plan for Europe. It is merely a mixture of some ingredients of a monetary constitution. It is really half-baked. But it is proposed simply to test the ideas, not to inflict on suffering humanity. The underlying spirit of these ideas is that the people of Europe should be free to choose whatever currency they wish in order to carry out their business. Governments should impose neither restrictions nor penalties. Competition between currencies is the best way of preserving both our freedoms and reliable units of account. But also, in cooperation with the private sector, the governments of the Community should promote a monetary unit which, by virtue of its own operating rules, is free of inflation.

The Need for a Stable Currency

Money performs three basic functions: it serves as (1) a store of value, (2) a unit of account, and (3) the medium of exchange. Inflation erodes all three functions, but to very different degrees. As we know

from many historical inflations, money still serves as an intermediary in exchange even though inflation is very high. For example, in the many Latin American inflations that have occurred in the 1980s, although the increase in the price index may be as much as 30 per cent per month, the currency is still used for the host of small household transactions. But no-one keeps notes as a store of value and virtually all contracts are not in terms of the currency as a unit, but are calculated in US dollars or perhaps in some agreed indexed form of money.¹ The separation of the unit of account from the rapidly depreciating medium of exchange involves considerable costs - as anyone who has lived in Argentina, Brazil, etc can readily testify. One main business is to minimise any currency holdings so that one is not substantially expropriated by the State. And it seems that everyone gives up many a useful employment to become a currency dealer. The main business is getting rid of currency as quickly as possible.

Maintaining a constant unit of account is as important as maintaining constant standards of physical measurement - where a kilogram and a metre are always the same. With money it is more difficult since, unlike

¹. Deflation, it will be noted, increases the attraction of money as a store of value and increases, if anything, its use as an intermediary. As a standard of account, it may suffer somewhat, but not if the deflation is gentle (as in the United States after the Civil War)

distance or weight at sea level, there is no natural and immutable definition of the value of a monetary unit. Money exchanges against a host of goods and services. In the past the definition of money has been in the form of goods, such as ounces of silver or gold of specified purity. Thus there is usually just one particular good, defined and widely used as money. This is ideal only when the price of gold (say) in terms of representative baskets of other goods and services in the economy does not much change. Then gold is good surrogate for all goods. But, over the years, gold has not behaved so well. Gold discoveries and new technologies have reduced the price of gold relative to other goods, and so induced inflation. At other times, the stocks of monetary gold have stagnated and so, as production of other goods increased, given many years of deflation. (See Table 7.1 Wholesale Price Changes under the Gold Standard) The legendary stability of the gold standard is indeed legend. Allan Meltzer has shown that predictability of the price level and GNP was far, far less under the gold standard than under the floating rate system of the 1970s.² Little wonder that Keynes described gold as a "barbarous relic".

²."Some Evidence on the Comparative Uncertainty Experienced under Different Monetary Regimes", in Alternative Monetary Regimes, ed Colin D. Campbell and William R. Dougan. Baltimore, Johns Hopkins University Press, 1986

A Broad Commodity Money

The natural question is whether it would be wise to include more goods in the definition of the monetary unit. Other precious metals are obvious candidates. Bimetallism, for example, became an active issue in Britain in the 1850s as people became concerned about the gold discoveries inducing inflation. Bimetallism involves fixing the ratio of the prices of gold and silver at the mint - and both are given the status of legal tender. Under propitious circumstances - in particular where the mint ratio is approximately the same as the free metal price ratio - the bimetal standard can function as such. But if, for example, many new easily accessible silver deposits are discovered, then the price of silver will fall relative to that of gold, and so silver currency will drive out gold; at the fixed mint ratio, Gresham's Law works - bad money drives out good. This is the normal fate of bimetallism.³ Nevertheless, throughout history the periods of bimetallism have exhibited much more stability than those of gold monometallism.⁴

³. The United States went on a bimetallic standard in 1792, but as the price of gold rose relative to that of silver, so silver drove out gold and the United States was on a de facto silver standard for some 40 years.

⁴ See Michael Bordo, "Bimetallism" in The New Palgrave Dictionary of Economics, ed John Eatwell, Murray Milgate and Peter Newman, Macmillan, London 1987.

An obvious way out of the Gresham's Law effect is to avoid fixing the mint ratio. The unit can be defined simply as a basket of the two metals - say one ounce of silver and 0.02 ounces of fine gold. The price ratio could then fluctuate. The coins would be composed of an alloy of gold and silver in the fixed ratio. No doubt there are many technical difficulties in minting and maintaining such coins. But for our modern economies this does not matter since we circulate bits of paper rather than coin. Under this metallic commodity standard, the currency note would be a claim to the 1/0.02 ounce mix of the metals. The monetary authorities would stand ready to convert notes into the metal mix, and vice versa. This requires the authorities to hold stocks of silver and gold sufficient to meet any convertibility demands. Any shortfall of such stocks will be reflected in people's suspicion that the authorities will not honour their obligations and the currency will become inconvertible. There have been too many cases in history where convertibility has been suddenly revoked to allow any monetary authority to get away with small stocks of the precious metals.

A Commodity Money without Commodities

The idea of a commodity money that is not based on the narrow basis of silver or gold stocks, but is

founded on a broad range of representative commodities or services has surfaced periodically in discussions about monetary anchors. The attraction of convertibility into a basket of commodities, or even services, is that one avoids the idiosyncracies of gold or silver supplies and all the political problems associated with the gold producers or owners. Furthermore it seems quite absurd for scarce resources to be devoted to digging a hole in the ground to extract gold, only to return that gold again to the deep vaults of the world's central banks. Convertibility into the ordinary useful commodities of trade appears much more attractive as an anchor in the real economy.

Obviously the commodity basket must be very large to accommodate normal lot sizes of wholesale trade. Similarly the commodities must be readily storable and of identified uniform quality, just as under the gold standard the gold content was of a given purity. And the monetary authority would clearly enter the lists as a major commodity dealer.

The prospects of a monetary authority sitting on large stocks of commodities, and the likelihood that one would add to the present grain mountains, cheese hills and oil lakes has been sufficient to chill the enthusiasm of most of mankind. Although some economists have also been entranced by the prospects of introducing a world

Commodity Reserve Currency to replace the old role of gold and which, in addition, would enable the world authorities to intervene massively in "smoothing" the oscillations in commodity prices and in reducing the variations in the incomes of producers of primary commodities.⁵ (Perhaps the main motive was to foster large intergovernmental transfers from the Western countries to the third world. But as we know from the fortunes of Messrs Mobutu and Marcos, this often takes the form of transfers from the poor consumers in rich countries to the rich rulers of poor countries.)

However it has also occurred to many economists, although I believe that Irving Fisher was the first to enunciate the idea, that one does not really require commodities as the reserve asset.⁶ Instead one could simply redeem the currency by supplying a financial asset which gave the holder sufficient resources to buy the

⁵. See Albert Gailord Hart. "Commodity Reserve Currency" The New Palgrave Dictionary of Economics, ed John Eatwell, Murray Milgate, and Peter Newman, Macmillan, London 1987. Lord Kaldor was the primary force behind these suggestions.

⁶. See Irving Fisher, The Purchasing Power of Money, 2nd edition, New York, Macmillan 1913. Warren L. Coats has developed these ideas in: "In Search of a Monetary Anchor: A New Monetary Standard", IMF Working Paper, October 11, 1989, Washington, DC.

commodities if he so wished.⁷ The point is that the value of the currency will be preserved through its convertibility into a reserve asset which has a value defined as constant in terms of the commodity basket. If, for example, one defined the reserve asset in terms of a fixed fraction of the basket of goods and services that enter into the retail price index, then one unit of the currency, convertible into the reserve asset, would be of a sufficient value to purchase that fraction of a basket.

The indexed reserve asset appears to be closely analogous to an indexed gilt-edged security. But there is a crucial difference. An indexed gilt has a fixed maturity, usually many years, at which time the principal is paid duly enlarged in proportion with the change in the retail price index. The authorities, however, do not guarantee to redeem the gilt at par, duly uprated for the retail price index, at any time. With an indexed gilt, one takes one's chance on whatever price one can get on the market for such bonds. For this commodity money, the authorities always redeem at slightly below the par value of the retail price index. The "slightly below" condition is to ensure that there is some

⁷. The seminal paper is Robert L. Greefield and Leland B. Yaeger. "A Laissez-Faire Approach to Monetary Stability", Journal of Money Credit and Banking, Vol 15 August 1983, p 302-15. See also Irving Fisher, Stabilizing the Dollar, Macmillan, New York, 1920.

disincentive against too ready redemption, and that the issuing authority earns sufficient profits to pay for the costs of operating the system.

A Stable Commodity Money for Europe

How would one provide this alternative of a stable European money ? I believe that it should be introduced as a parallel currency to the existing national moneys in Europe. In accordance with the liberal principles nominally embraced by the Community, all citizens should be allowed freely to use what every currency they would wish with no restraints of legal tender or overt and covert exchange controls. Thus they should be able to hold and transact in the commodity money. Thus people could choose to conduct business in any of the national moneys or in the Euro commodity money, the ECOM. With parallel national moneys, the reserve assets, duly indexed, could be denominated in any of the member currencies, or, if desired, in terms of a basket such as the ECU

There are many feasible alternative redemption arrangements, but some principles are fairly clear. First one would restrict redemption operations to wholesale quantities of money. Thus instead of exchanging ECOM against sterling, one would specify that the ECOM would be exchanged only for large treasury bills

(say of 100,000 stg equivalent). On one ECOM note it would promise that "this note is redeemable for a fraction (or number) of treasury bill(s) sufficient to purchase the basket of goods defined as one ECOM".

To see how the system would work, imagine that we begin in a nice equilibrium, but then there is some external shock, such as an increase in the price of oil, which brings inflationary pressure in its wake. Prices in ECOMs would then rise as people got rid of their ECOMs by spending them on goods and services. But the ECOMs are worth more than their value at the inflated prices, since they can be exchanged for an amount of treasury bills equivalent to the base value of the ECOM, and these treasury bills are worth more than the ECOM notes by the amount of the price rise. So people will be induced to redeem their ECOM notes; they will take their ECOMs to the EIB and receive treasury bills in exchange. This will reduce the quantity of ECOMs and so depress the ECOM prices of goods, until equilibrium is again restored with the ECOM value in the market at its original goods value.⁸ Private arbitrage will thus keep restore the value of the ECOM.

As an illustration, suppose that the reserve asset is an ECOM demoninated treasury bill. The private sector

⁸. For a clear account of the process of arbitrage, see Warren Coats 1989 op cit.

will hold both ECOM TBs and ECOM notes. The holdings of notes will depend primarily on transactions demand for money. The TBs, lacking the moneyness of notes (and in large denominations), will command an interest rate determined by market conditions - that is to say the yield on alternative assets, whether nominal or indexed. With the indexed character of the TB one would expect that the market rate of interest would be quite low - perhaps 1 or 2 percent. Let us begin in equilibrium where people are content with their existing holdings of TBs and notes. But then an exogenous inflationary shock occurs, and the ECOM note would tend to decline in value, say by 1 percent. But the indexed TB of 10,000 ECOMs denomination is now worth 10,100 ECOMs and these uprated TBs can still be purchased at a price of 10,000 ECOM notes. Hence the incentive for the private sector to convert their notes into TBs.⁹

Problems with the ECOM

There are obviously a host of problems in setting up an ECOM. Many of them are basic policy issues. For example, I have discussed linking the ECOM to the consumer basket - and obviously I would mean the weighted

⁹ It might be thought that yield on the TB would move to abort such arbitrage. True it may move slightly, but the yield will be constrained by the substitutability into parallel instruments - even ordinary treasury bills or perhaps indexed treasuries which do not have the status of reserve assets.

average consumer basket in the Community. The ECOM would be kept in line with the weighted average of retail price indices. This would have the advantage that no single country would have any incentive, in addition to those they have already, to distort the index. But there would be also the problem of "harmonizing" the indices and, preferably, calculating them more frequently than the present monthly figures. A more substantive issue is whether the retail basket is an appropriate anchor. It is probably better to index to the prices of things produced, rather than consumed, by the Community; then holders of ECOMs (as do indexed gilts) will not be shielded against changes in the terms of trade. But the retail price indices are much used throughout the Community and represent a more accepted unit of standardization of value.

In order to set up the EBI, the various central banks would contribute reserve assets, defined as outlined above, in exchange for shares on a pro-rata GDP basis. Analogous to the introduction of indexed gilts in the UK, it would be best to begin with a relatively modest issue of ECOMs - though there needs to be sufficient to give a sufficient momentum to the market. In its constitution the EBI would have the sole role of issuing and redeeming ECOMs.

It might be efficacious if there were developed

first an external eurocurrency as suggested by Jaques Riboud.¹⁰ This, in M. Riboud's proposal, would be a market in constant-value dollars. The Community could encourage this market and guide it by suggesting that the standard of value should be related to the weighted retail (or producer) price index for the Community. The ECOM could then take over the external unit of account, accepted and even hallowed by use, and then internalise it.

There is no doubt that creating an ECOM would not ease the task of the constituent monetary authorities in dealing with the liberation of financial markets to which all constituent countries are committed. But it is doubtful if it would make the task much more difficult. If, for example, Greeks can transact in Deutschemarks rather than drachmas, the possibility of substituting ECOMs will not be any great change. As people in Greece switch out of depreciating drachmas into either Deutschemarks or ECOMs, the Greek monetary authorities will have to reduce their drachma monetary expansion to keep inflation at its existing rate.

The value of the ECOM is preserved through ECOM currency being expanded or contracted according to demand arbitrageurs. But of course currency is the small change

¹⁰. Op. cit

of any modern monetary system. As we know, notwithstanding the success of this form of currency board control in Hong Kong, the City are most skeptical of any such form of control being effective. It remains to be seen whether the note issue of ECOMs will be sufficient for control.

A ECOM Monopoly for the Community ?

If there is to be a monetary union which develops as Delors envisaged through the EMS becoming more stringent, that is to say with narrower bands and virtually no realignments, then it must be based on the dominant role of Germany (FRG and GDR). There are obvious political objections to this arrangement which Delors tried to solve by building up a central bank of Europe (a European System of Central Banks) which would control Europe's monetary policy. But the Bundesbank, along with Britain, has strongly resisted any encroachment on its powers and prerogatives. In fact the Bundesbank must be the main agent controlling Europe.

The reluctance of countries in surrendering their monetary sovereignty to another sovereign state is entirely understandable. And this must be an especial concern if that state is a Greater Germany - so much the dominant power in the Community. It is, however, a different matter if monetary sovereignty is surrendered

not to any state but to the standard of an inflation-free currency. The government of Britain, for example, would not be giving up its sovereignty to any other legislature or to any foreign central bank. It would be surrendering its power to expropriate its citizens by inflation. Monetary policy would be depoliticized. Neither domestic nor foreign politicians and functionaries would have any control over the money of Europe.

This suggests that once the ECOM has been introduced and used for some time, it might well be that an ECOM currency union could be formed for Europe. If the ECOM displaced national currencies to any considerable extent, it would be a natural development to adopt the ECOM as the currency for the Community. Indeed, just as the gold standard was widely adopted throughout the world in the 1870s, so might the ECOM, in one or other its many mutations, be embraced by countries outside Europe - even the United States and Japan. But these are, of course, pipe dreams of an inflation free world.

Pros and Cons of the ECOM

When discussing the likely consequences of an ECOM system, one must always specify, as best one can, the best feasible alternative. A point by point discussion would try any reader's patience. It might be useful instead to lay out what I believe are the major issues

and indicate my judgement about where the balance of advantage lies.

Consider first for Britain the alternative of the free float and a monetary policy that maintains a constant quantity of Mo, preferably through the operation of a monetary base control system. This, I believe, would be superior to the ECOM arrangement. The constancy of the monetary base would ensure that there was no runaway inflation or crushing deflation. True, one would not enjoy the great price stability of the ECOM, but it is often more efficient to adjust to technological progress, changes in the terms of trade (increases in the price of oil, for example) etc., by allowing exchange rates freedom to move to their market value. The central point is that if markets are not allowed to adjust exchange rates, then the burden of adjustment will fall on other markets: commodity, labor, money, bond and stock markets. A change in exchange rates is likely to be the best way of making such adjustments.

The objections to this system of monetary-base-control with floating exchange rates, compared with the ECOM, are easy to list. The change in the velocity of circulation may be different from the 3 percent upward drift that we have conveniently assumed. (Although I believe it is consistent with the history of the last two or three

decades, there is no guarantee that trends can be extrapolated). The great advantage of the ECOM system is that the velocity adjusts endogenously, whatever happens to the demand for (base) money, to keep the price level constant. There is no opportunity for making mistakes in forecasting money demand; if there are changes in technology or monetary markets that increase the demand for money, then the ECOM system will ensure a response at the fixed price level. There will be no monetary excess or starvation of the economy.

An interesting question is whether it is indeed plausible so to divorce monetary and exchange rate policy from political control. In the case of monetary base control, I very much doubt it. In practice, in order to deal with liquidity crises and dramatic changes in the public's choice of a cash-deposits ratio, we must allow some over-ride discretion on the part of the monetary authorities. This has been demonstrated in many liquidity crises throughout history, and most recently in October 1987. In the ECOM system, however, there is no need for any such over-ride. Provided there is a wide enough spread of reserve assets (and substantial quantities of reserve assets can be sold by making their price attractive), the EIB will provide ample liquidity to prevent any deflationary slump. But would not governments be tempted to "improve" on the performance of the EIB ? Since we lack any relevant experience with

such as system we do not know the answer.¹¹ If the EIB and ECOM were the result of a treaty of the EEC governments, however, it would be difficult for any particular government to play fast and loose with its constitutional provisions; but one should not be so sanguine about the institutions of the Community.

Conclusion

In reflecting on monetary constitutions I have wandered a long way from the immediate issues of exchange rates and monetary policy. Yet it is important to inject new ideas into the problems of monetary systems in Europe. I do not believe that monetary integration of Europe is desirable unless there are considerable obvious gains to be so made. The only test of desirability is that people freely choose one currency as the vehicle for their transactions and wealth holding and accounting. The fabulous success of European civilization was founded on freedom. Liberty is as important in money as in anything.

¹¹. One form of "improvement" might be to specify the currency in terms of a constant rate of inflation, say 3 percent per annum. This could be done easily in the ECOM framework, and it might be argued that, because of downward rigidities in the prices, such a constant inflation would involve less frictional costs. In my view, however, adding 3 percent to all prices and wages will not solve problems of rigidities

Walter's Book

Intro 1 - ~~introductory~~ Introduction. Where Tom

p 1. Reference of ~~the~~ to Lawson's "EMS (ERM)
 ~~Introduction of~~ Chapter 1

p 2. Lawson's monetary desire was to be "irrevocably" linked to the Euro block, but ignores policy commitment to join ERM.

p 3 Lawson falls

Chapter 2 Ideas on Money and Exchange Rates

p 21 Lawson changed monetary policy in May 1981

Chapter 3 Money and Exchange Rates - Practice

Chapter 4 Monetary Policy and International Coordination

p 31 Lawson argument on wage regulation

Chapter 5 Monetary Systems for Europe

p 44 Unpublished article, outdated, mediocre economist

p

p 49. explain why ceased publishing.

p 52. ^{PM + G11} did not announce agreement to join ERM, but set out conditions

Chapter 6 The Lawson Years

p 54 (can attest)

p 57/58 identification of ~~the~~ positions = 1982 ERM discussion esp Second Pillar Sec.

p 57 News ascended to Bureau

p 58 How did it go in 1981 Budget?

p 59 Lawson role at that time

p 60 HHC and Henry

Full Time	5-1-81 to 31-8-83
Part time $\frac{1}{4}$	1-9-83 to 31-8-84
Part time $\frac{1}{2}$	1-5-89 to 26-10-89

p 62. date to notify via Larsen

p 62-63 identification of postcard

p 65 via Larsen record

p 66 clarifications

p 67 identification of postcard. esp footnote 67
esp Treasury officials

p 70 Larsen's growing error.

p 72 footnote 78 identifies his advice.

p 74. blame on Larsen

Sterling and Inflation in the Eighties:

The Economic Consequences of Mr. Lawson

Code : F:\AAW

Date : Dec 11th 1989

Chapter 1.

Floating and Anchoring Currencies

Churchill's Error and Lawson's Pseudo-Fix

The sub-title of this book deliberately recalls one of the great economic tracts of the 20th century - "The Economic Consequences of Mr. Churchill" by Keynes. The similarities are striking. After many years of a floating exchange rate, Churchill and Lawson chose to peg. Churchill to the dollar and gold, Lawson to the Dmark and the Bundesbank. Both looked towards a return to an "anchor" after years of drift: ultimately a restoration of the prewar gold standard and, in the 1980s, some Euro version of a Bretton Woods system. In each case the Chancellor was supported by the Bank of England, the influential media, the "quality press", many economists, and the preponderance of the chattering classes. There is the same 'macho' talk of "looking the dollar in the face" in 1925 and "anchoring to a sound mark" .

The differences are equally striking. Churchill and Montague Norman, the Governor of the Bank of England, were intent on returning to a really fixed exchange rate with all other currencies that embraced the gold-dollar convertibility. The leeway for flexibility was virtually nil. The gold-dollar standard ensured that sterling remained in a very narrow band about \$4.83?. Devaluation to another fixed parity was "unthinkable"; the only way off the gold standard was to float. X In Lawson's EMS/ERM flexibility (plus or minus 2.25 to 6 percent) was built into the system, and everyone knew that on occasion realignments of all the currencies would be needed to put right "fundamental disequilibria" or simple cock-ups. Then each country would fix at another pseudo fixed parity and the party would continue until the next realignment.

The other main difference is that in Churchill's day people still looked for a return to the truly international monetary system and free capital markets that had so blessed the world before August 1914. From the 1870s through to World War I, the gold standard was widely recognized as the only viable monetary system. In Lawson's time gold was recognized largely as a speculative metal; the gold anchor, having dragged the United States ship down, was loosened in the 60s and severed in the 70s. The golden anchor had gone. Messrs Schmidt and Giscard d'Estang lead other members of the common market, except the United Kingdom, to pseudo-fix their exchange rates to one another. Because of the dominance of the German economy, in practice this meant following the Deutchmark. But unlike the dollar in 1925, the mark had no anchor to any precious metal or to any other set

of commodities. So the Eurocurrencies float up and down together against the yen and the dollar. There have been suggestions, albeit rather half hearted, to set up a new Bretton Woods unhindered by pretensions to a gold standard, that would embrace the dollar and yen. But the world system remains a system of major floating blocs, with sterling bobbing up and down on its own. Mr. Lawson's overwhelming desire was to tie "irrevocably" Britain to the Euroblock.

The unity of Europe was also a major difference compared with Churchill's interwar uncertainties. European union was far from Churchill's mind, whereas today Eurounion proceeds at a rattling pace. Europhilliacs (or Europhiles) have identified the degree of enthusiasm for ERM/ERS participation as a "touchstone" measuring the degree of commitment to a United Europe (Economist Dec 9th 89).

The consequences of Messrs Churchill and Lawson were different. As Keynes so powerfully argued, the return to the gold standard at \$4.83 rendered British exports (particularly of coal) quite uncompetitive on world markets, so the only possible adjustment for British wages and prices to fall. And Keynes rightly predicted that the only way they could fall was by having a prolonged recession. And in 1926 Britain began the downswing into the great depression. Only in 1931 when sterling was floated free off its gold anchor and depreciated did Britain begin to emerge from the slump. The cost of Mr. Churchill was far greater than even Keynes calculated. And the divisiveness and distortions of that period remain with us, in muted form, even to this day.

In 1987 Mr. Lawson pegged sterling at 3.00 (or strictly just below 3) Deutschemarks. True this was no official peg, but the markets were given to believe that 3.00 was the appropriate value and that the Treasury and Bank would jolly well see it stuck. Everyone believed it. Why 3.00 and not 3.30 or 2.70. It is not clear why this value was chosen as the pegging level - partly, one supposes, because it had been hovering near three at the time, or perhaps because it is nice round number. If one wished to provide a rationalization consistent with economic theory, one would have to argue that 3.00 was near and under expected differential inflation rates, was likely to remain near the "fundamental real equilibrium exchange rate" (FREER) - an elusive concept that will worry me, if not you the reader, in chapter..

Whatever the reasons for the fixations, Churchill's was much more disastrous than Lawson's. Of course Churchill's absolute fix lasted for six years, whereas Lawson's wobbly fix did not make it through a second year. Churchill fixed above the market, making sterling too dear, whereas Lawson's was initially below the market value making the pound too cheap. In stead of Churchill's depression and deflation, Lawson launched Britain into a breakneck boom and inflation. Soon the inflation and the rise in interest rates required to control the monetary growth and prevent that dreaded "free-fall" of sterling ensured Lawson's recession and resignation

The consequences of Mr. Churchill included a breakdown of the international trade and monetary systems, massive trade restrictions, ultimately exchange controls, and all the curious panoply of agricultural support, 'reconstruction' measures that are still with us in one form or another. Mr. Lawson's folly, I believe, is likely to have no such long term consequences. It is plausible to suppose that it will be but a "blip" (but rather a large one) on the third Thatcher government's record, and that open commodity and financial markets will continue to be the proud result of the Thatcher renaissance.

Fixes, Floats and Fudges in Exchange Rates

Of course I cannot leave the matter there. Mr. Lawson has been one of the most gifted Chancellors of this century. His reform of taxation is only one of the great achievements of a great Chancellor. In this book, however, I am concerned with the effects of his stewardship on the international monetary system and Britain's role in securing an inflation-free currency, one of Mr. Lawson's noblest objectives. So in chapter... I shall suggest the outlines of a European monetary arrangement that will deal with many of the important issues raised by the Chancellor.

Some readers may be surprised to learn that there is little difference between Mr. Lawson and me on the basic issues, although there is a some disagreement on such matters as the efficacy of the present ERM arrangements, the wisdom of relying on Germany and Bundesbank independence, the process of economic coordination and so on. Nevertheless such differences are perhaps not unbridgeable as was suggested by the United Kingdom's strategy at Madrid in June (or July) 1989. I believe that the Madrid strategy was entirely appropriate. It emphasised that the countries, other than Britain have a long way to go in liberalizing their financial markets as well as the markets for commodities and labor. Before Britain can consider joining the ERM, it is important that the countries have liberalized their markets.

Where I believe we have a fundamental divide is on the issue of fixed and pseudo-fixed exchange rates and monetary policy. I argue that absolutely fixed exchange rates is a good alternative to a free float. But then you must set up monetary institutions, such as a currency board, that are consistent with such fixity. There is no room for a monetary policy at all; in that sense monetary sovereignty is relinquished to Germany. This is a matter of both logic and fact, as is clear from the records of the many countries that have, over centuries, operated currency board systems. The only monetary role of a central bank is to exchange currencies at the fixed rate. I regard the pseudo-fixed system, with its wobbling in the band and the propensity to leap to a new level on a 'realignment' session, as the worst of both worlds. Furthermore pseudo fixed exchange rates are accompanied by a pseudo monetary policy. Both are indeed half-baked.

An Inflation-free Currency for Europe

Yet the possibility of a single currency emerging from the free choice of Europeans is an attractive goal. And Mr. Lawson's idea that there should be competitive currencies to see which is the choice, not of the bureaucrats of Brussels, but of the private citizens of Europe is attractive. However I believe that there should be another competitor in the field - a currency which by its very constitution is neither inflationary nor deflationary. A currency which maintains its constant and true value in terms of a defined basket of goods, such as the average consumption basket of European citizens. We shall call this currency an ECOM, to indicate that it is a European commodity money. Such a currency could be written into the constitution of Europe. It requires no central bank, only a bank of issue or currency board.

If the ECOM is successful in its competition with other currencies, then it has a fair chance of being adopted as "the" currency of Europe. Indeed governments may agree to allow their currencies to be subsumed, initially by fixed exchange rates with the ECOM, and then entirely abolished in the adoption of the ECOM as the European currency. The great advantage of the ECOM is that it does not involve any surrender of sovereignty to any Central Bank of Europe, to the Bundesbank, or to Brussels bureaucrats or European politicians. A Community state will surrender its monetary sovereignty to the principle of an inflation-free currency. That may well be a surrender which might be attractive to many of the twelve.

And not only the twelve. Since the departure from the old gold standard in 1914, the whole world has experienced persistent inflation (the only exceptional period being the period from 1929 to 1936.). The world cannot and, indeed should not, return to the old gold standard or any version of the gold exchange and Bretton Woods systems. Gold is indeed a barbarous metal, of dubious provenance and subject to all the vagueries of technology and taste. A currency based on preserving constant the unit of account for a wide basket of commodities is much more desirable than a monetary unit linked to merely one precious metal. Nor do we need to keep stocks of commodities to operate the system. We can create paper assets which perform as surrogates for such commodities (unlike the old gold standard where stocks of gold were de rigueur). The attractions are clear. And if the Community were to make an obvious success of this ECOM, would not the United States, Canada, Japan etc be quick to follow? Just as the old gold standard rose around the preeminence of a liberal Britain, so might the ascent of a truly liberal Europe promote the new Thatcher standard by the end of this century.

Such reflections are, of course, far beyond the economic consequences of Mr. Lawson. But Mr. Lawson can fairly claim to have opened wide (perhaps inadvertently) the debate on the monetary constitution for a liberal Europe. I hope that this book will add at least something to the debate.

Ideas on Money and Exchange Rates

Definitions ?

Ask the man on the Clapham omnibus, "what is money?" and he will give you an immediate answer. It is what he uses to pay his fare. It is the stuff with which one pays ones bills. The Clapham answer is a useful one for even the most highbrow economist. Money is the medium by which we make payments in discharging our obligations.

Monetary Policy and the effect on Exchange Rates

Exchange Rates

An exchange rate is the price of one money in terms of another. A pound is expressed as, say 2.5 Deutschemarks, a dollar as 0.65 of a pound. A fall in the price of a pound, to 2.0 Deutschemarks is often called a depreciation of the pound in terms of the mark, or symmetrically it is an appreciation of the mark in terms of sterling. But those terms are simply synonyms for movements in the price.¹

The exchange rates have a special claim to being the most important of all prices in an economy. It is true that certain prices, such as that of oil, has an important influence on a wide variety of markets and activities. And the price of oil is determined by a wide variety of factors on the world markets. But the oil price does not come near to the ubiquitous effects of exchange rate changes. The exchange rate in any reasonably open economy enters into a very large fraction of transactions.

Exchange Rates as Allocators of Foreign Exchange

One of the main jobs of the exchange rate is to ensure that people, both domestic residents and foreigners, are just willing to hold the stocks of money, be it pounds, dollars, marks or yen, that exist at any moment of time. Just as the price of a bond is such that people are just willing to hold the outstanding stock, so the exchange rate ensures that people are content to hold the various moneys of the world. People will wish to hold a particular foreign money for many reasons: to pay for imports,

¹. I would warn the reader that exchange rates are subject to very misleading terminology in different parts of the world. If the price of a Mexican peso falls in terms of US dollars, the Mexicans would refer to this as the exchange rate of the peso "rising" not falling. The reason for such a usage is that in Latin America generally, and in Mexico in this particular example, the exchange rates are expressed in terms of the number of pesos one has to pay to get a US dollar. And if the value of the peso has fallen, then one needs more in order to buy a dollar. This is confusing. In this book I shall use the non-latino usage. In order to make it quite clear, in stead of talking about rising and falling exchange rates, I shall occasionally talk about the increase (decrease) in the (foreign) value of the domestic currency.

to finance a visit, to buy assets, to make a remittance, or simply to hold as a speculation. These influences may change dramatically over time. But there is one ubiquitous influence that affects all these motives for holding foreign exchange; that is the price of the money or the rate of exchange. Like any other commodity foreign exchange in general obeys the law of demand, the lower the price the larger the stock of foreign money people will wish to hold.

These motives for holding foreign exchange change, usually quite unpredictably over time. Domestic droughts and disasters create a demand for foreign currency to finance imports. Discovery of some cornucopia of exportable minerals (such as gold or silver) creates for that country a ready supply of foreign currency - in other words a foreign demand for the domestic currency. The stock of money of each country is largely determined by the monetary authorities. They may be taken as approximately given. Then the problem is to allocate these existing stocks among the competing demands.

In a free market system the authorities would simply allow freedom for any person or body to contract with any other, whether foreign or domestic, to sell foreign exchange at any mutually agreed price or exchange rate. Since the number of customers and suppliers is huge, the outcome is a very keen competitive market exchange rate. This rate will move continuously to clear the market, and, often, instead of being called a free exchange rate, it is dubbed a "flexible exchange rate"².

Dirigisme and Interventions

There are other ways of doing this job of reconciling the demands with the existing stock. One way is to regulate the demands through some form of rationing. A common procedure is to regulate movements of capital and assets, "capital controls". But some countries practice more or less universal exchange controls and many limit the foreign currency and asset holdings of institutions. Although in some quarters there is a nostalgia for the days of fixed exchange rates supported by a battery of exchange controls, I believe that the vast majority of people are convinced that such instruments are inconsistent with the values of a liberal society.³ Exchange controls are a viable if odious solution.

Another path by which demand and supply can be equated with a fixed exchange rate is through the monetary authorities of each country maintaining stocks of foreign exchange which they supply

² Unfortunately the word "flexible" been taken over by those who eschew free exchange rates and embrace a bastard "fixed but flexible" exchange rates, such as those in the Exchange Rate Mechanism of the European Monetary System.

³ I wish it were possible to dismiss any thought that exchange controls would conceivably be imposed by some future government of the UK. Alas it would be folly to ignore the contingency.

to the market when there is an excess demand, and which they take off the market when demand is less than supply at the fixed exchange rate. The problem is that the fixed exchange rate chosen may be or become consistently too low or too high to match demand and supply. Then the monetary authorities will go on accumulating foreign exchange, if too low, or run out of stocks if too high. At best the operation of exchange equalization through official intervention, as it is called, can only be a temporary respite and not a permanent solution. But intervention (we often miss out "official") has many forms and ramifications. For most of this chapter we shall consider exchange rates in the absence of intervention, so that we can defer the forms of intervention at the end of this chapter.

Reconciliation through Aggregate Demand⁴

The last method is for the authorities to affect the demand for foreign exchange by affecting the aggregate demand of the whole economy. Thus, with the exchange rate fixed, in order to reduce the demand for foreign, the authorities would attempt to reduce domestic prices, relative to those of trading partners, so that people are weaned away from their demand for imports and foreign exchange, and the domestic currency is made more attractive for foreigners to hold. The main instrument for controlling domestic aggregate demand is monetary and perhaps fiscal policy (although in principle the tools of dirigisme can be employed also in macroeconomic management.) This holds domestic monetary and fiscal policy hostage to the fixed exchange rate.

Of course all these solutions have been employed at one time or another - often simultaneously in what the authorities would assert is a judicious mixture. But there is one central point. Clearly since the exchange rate is the relative price of moneys, any discussion of exchange rates must encompass an examination of monetary policies. The exchange rate is largely a consequence of the monetary policies pursued by the monetary authorities. True this rate may be maintained by official intervention, or defended by exchange controls. But the underlying free rate of exchange will be largely a consequence of relative monetary policies. Typically these monetary authorities determine interest rates on the short term money markets by using the power of the government as the biggest trader. Alternatively monetary authorities fix the quantity of reserve money available to the banking system. But whatever the actual mechanism used, monetary policy determines the stock of money, and the rate of growth of money in the system.

If "too much" money is created then, like any other glut, the price of money will fall. People will try to reduce the amount of money they hold by spending it. On goods and services and, if allowed by the authorities, on other (foreign) moneys.

⁴. Of course aggregate supply also plays a crucial role here. I am ignoring supply side effects only for ease of exposition and certainly not because I believe them to be nonexistent or even unimportant.

Thus the domestic prices of goods and services will tend to rise. But this rise will be countered, in part, by foreign trade. Imports will increase and exports fall. The trade gap will open.

To buy the additional imports more foreign currency is required and there is a smaller supply from the reduced exports. The value of the foreign currency will increase; the domestic currency will depreciate. The overexpansion of money has reduced the value of the currency in terms of the size of the basket of goods it can buy on the home markets and, through the exchange rate depreciation, on international markets.

Of course, factors other than monetary policy can affect the prices of goods and of currency. Boosts in real output, catastrophies, dislocations and recessions can affect the flow of goods and services. These effects change the flow of goods facing the monetary demand - the larger the flow the lower the price and the higher the value of the domestic currency. It is the increase in the supply of money relative to the increase in the supply of goods that is an important determinant of both prices and the exchange rate.

Confidence and Credibility

There is another much more nebulous set of influences that much affect exchange rates, particularly in the short run. They are to be summed up in the words, on the one hand, "confidence" and "credibility" and on the other, "expectations" and "uncertainty". In the General Theory, Keynes argued that confidence was a main determinant of economic activity, but, realist that he was, he admitted that we knew did not know how to analyse it and its effects. Any market practitioner can feel in his bones whether confidence and credibility are high or low. Among the things he will take into account are perceived consistency of policies, using whatever historical or parallel evidence seems relevant. At this stage, however, the perceptive reader will accuse me of waffling merely to disguise my ignorance. True. I would claim, however, that we have made some progress in analysing expectations both of monetary policy, exchange rates and their consequences.⁵ But it is, I think, still true to say that our understanding of swings of confidence etc is very sketchy. As we shall see later, this is particularly unfortunate since much of the argument for joining the ERM/EMS and other fixed exchange rate systems hinge on the alledged acrual of credibility and confidence. This particularly applies,

⁵. In particular, the idea of consistent or rational expectations takes the position that people will formulate their expectations such that they are consistent with the basic laws of economics which they believe are best applicable to the phenomena they are analysing. In principle people are maximizers. Those who will survive and prosper will form expectations that are consistent with the "best" theory. For a first formulation of this idea in macroeconomics, see my "Consistent Expectations and the Quantity Theory", Economic Journal, 1971. The subject has since become a major preoccupation of many economists. See Minford and Peel, Robert Lucas, etc

not so much to the goods market, but to the international market for financial assets - to which we shall shortly turn.

Real Exchange Rates (Goods)

In much of economics we are used to talking about money as a "veil" over the important system of exchanges of real goods and services. Money serves as a medium of transaction, but it is the underlying exchange of one good or service for another that is the real stuff of economic life. The exchange rate records merely the price of money in terms of a foreign money. It does tell us the exchange rate between domestic and foreign goods and services.

If you are a casual reader or a pure economic theorist, the answer to this is obvious. Ignoring transport costs and trade barriers, it is ineluctable that the price of say a tonne of steel in Britain in pounds must be the same as the price of steel in Pittsburgh measured in dollars. If, per contra, the price in Britain were higher, then all steel buyers would rush to Pittsburgh, while the suppliers were deluging Britain with steel. The most delicate equilibrium requires the same real price. In the real world of transport and factoring costs, trade barriers, imperfect knowledge, sticky prices, etc, such an equilibrium is merely an abstraction. Prices, expressed in a common currency, do change over time. Indeed these price changes are the essence of the process of adjustment to changing trading conditions.

They are so important that economists have defined them as the real exchange rate as distinct from the nominal exchange rate. As the nominal exchange rate measures the price of one money in terms of another, so the real exchange rate measures the price of traded goods in one country in terms of the price of traded goods in another country where the prices are both expressed in the same currency using the current nominal exchange rate. It looks simpler in algebraic form:

$$\text{Real Exchange Rate} = (\text{Stg Price in UK}) / (\$ \text{Price in US}) \cdot (\text{Stg value of } \$)$$
$$\text{or RER} = (\$ \text{ value of stg}) \cdot (\text{Stg Price in UK}) / (\$ \text{ Price in US})$$

This expresses both numerator and denominator in sterling. As the ratio rises so does the prices of goods in Britain increase relative to the prices in the United States. The UK becomes less competitive.⁶ The real exchange rate ignores any change in price that is exactly counterbalanced by a change in the nominal exchange rate. Suppose, for example, prices in the UK doubled whereas American prices remained constant; but if the nominal exchange rate changed so that we got only half as many dollars for the pound, the competitive conditions would remain the same. (One can think of it as shifting from a 100p to a 50p unit of

⁶. It might be worth noting that, if we express the numerator and denominator in dollars, exactly the same result emerges. And the real exchange rate of the United States is the reciprocal.

account: the relabelling does not affect the underlying realities).

To illustrate the use of the real exchange rate (RER), let us imagine that for some exogenous reason the world's taste shifts from goods that Britain produces (scotch) to foreign products (champagne). The real exchange rate needs to fall to induce the world to buy the flows of scotch and champagne. Assume that Britain is a small part of the world market for champagne so that the dollar price of champagne does not change, one way this can be achieved is by reducing the sterling price of scotch, holding the nominal exchange rate constant. An alternative is for sterling to depreciate against the dollar while holding the two prices constant. And there are obviously many alternatives between (and indeed outside) these two solutions. A flexible exchange rate gives another degree of freedom in the adjustment of real exchange rates for goods.

In the theoretical world of champagne and scotch, the prices one uses are obvious. Alas this does not carry over to the real bread and butter world. There are many possible theoretical RERs, depending on the questions one is examining. And there are many limitations on the measurement of RERs due, primarily to the limited data available on price movements. Since the purpose of this book is to examine the process of monetary policy on exchange rates and inflation, it is natural to define the RER in terms of the price indices of traded goods or tradeable goods. Rough approximations to these can be found in the wholesale price indices or producer price indices. But there are many problems of interpretation.

Real Exchange Rates (Capital)

The relative prices of goods are only part, indeed to many the least important part, of the story. The main "commodity" that flows across national frontiers are financial instruments, such as deposits, bills, CDs, bonds etc. The flows of foreign exchange business connected with capital export and imports far exceed (perhaps by a factor of 50) those concerned with goods and services. The fundamental idea of the real, as distinct from the nominal, exchange rate also applies to these capital movements. But financial instruments are different from goods and services. With a tonne of steel the price paid is the only monetary transaction. Financial instruments, however, normally involve future money flows defined in a particular currency. These include not merely the interest or dividend payments but also the return of principal. Thus it is not only the current or "spot" rate of exchange that affects the relative price (the RER) but also expected future values of the exchange rate.

This problem of differing maturities of payments, however, is solved if there are suitable forward markets for foreign exchange. If a one year deposit in dollars yields 8 percent and a one year deposit in sterling yields 15 percent, then, in the absence of transactions costs, it will pay any investor to put

his money in sterling if he can get a guarantee to buy dollars (sell sterling) in one years time at less than a 7 percent premium (7 percent discount) on the current spot rate. This rush into sterling will stop when the total rate of return (that is to say the interest rate minus any loss on buying one year forward dollars) on sterling deposits is equal to that on dollar deposits. This implies that, in equilibrium, there must be covered interest rate parity, that is, for one year:

Interest on sterling = Interest on dollars plus forward dollar premium on stg

or Interest on dollars = Interest on stg minus forward dollar premium.

This knife-edge equilibrium ensures that there is no incentive for switching from one currency deposits to another.

Covered Interest Parity- Reality and Causation

The covered interest rate parity equation is a pure or theoretical case. It is analogous to the pure case of Pittsburgh steel with no transactions or transport costs, perfect knowledge and no trade restrictions. Then just as the price of steel must be the same in each country, so in this case the rate of return which one gets on the same sum of money must also be the same in each country.⁷ But there is much more reason to take the case of the equality of return on money as much closer to reality than the case of steel and most other goods. Interest rates move with far more alacrity than the prices of goods. No stickiness there. For money transactions costs are much smaller, and transport costs are virtually zero. In free markets, therefore, the covered interest parity will be a close approximation to reality.

It must be emphasised that the equation does not imply anything about causation. It merely states what must rule in equilibrium. It does not tell us how that equality is brought about, or how interest rates, spot exchange rates and forward premia or discounts interact with one another. For those causal relationships one must look at the underlying relationships of demand and supply. Whatever story we tell, however, must be consistent continuously with the covered parity principle. The covered parity rule does tell us that obvious, but often ignored, fact that, in a free market, a government cannot simultaneously truly fix the exchange rate and at the same time vary interest rates as required for an independent monetary policy. (Note that a truly fixed exchange rate would require that there would be no, or only a trivial, discount or premium on the currency).

One perhaps might expect that the forward markets would give an accurate guide on the realized path of exchange rates. The markets reflect a sort of consensus of views about the expected path of the rate, and it is often said that markets are efficient

⁷. These equalities are the results of goods arbitrage, in the case of steel, and capital arbitrage in the case of money.

in using all the relevant available information in making forecasts of the future. An interesting point, however, about the forward markets for foreign exchange is that they are poor predictors of performance. Indeed, knowledge of the forward market values is of no use in predicting the future actual path of spot exchange rates. In fact the current spot rate is a better predictor of future spot rates than is the forward rate. These results are not really surprising. If there really were information in the forward rates about the actual path, then that information would be the source of profit; everyone would realize it and so drive the spot and future rates to values where all the profitable information has been leached out, leaving only the dross in the forward values. Nevertheless these forward markets do provide an invaluable way of hedging currency risk or taking a speculation on the outcome. As we shall argue, such markets enable one to overcome many of the alledged disadvantages of a float.

The Effective Exchange Rate

Up to now, the discussion has been simplified by supposing that there is only one exchange rate between domestic residents and a homogeneous mass called foreigners - between us and them. In the real world there are about 170 countries, almost all of which have their own currency. Thus there are some 160 exchange rates between sterling and other currencies. Obviously some, such as the US dollar and the deutschemark, are much more important than others, such as the kwacha or cedi. In order to get a simple measure of the movements in the nominal exchange rate, vis a vis all other countries, one needs some weighting system in order to get an average exchange rate that reflects the importance of the countries. The best weighting system would be one that reflects the number of foreign exchange transactions in each currency. But, so far as I am aware, no such weighting system is used - probably because of the difficulty of getting reliable comprehensive data on foreign exchange transactions.

Instead the authorities have devised what is called an "effective exchange rate" which weights each constituent foreign exchange rate by the total amount of trade between Britain and that particular country. The effective exchange rate (EER) is in fact the trade-weighted exchange rate, and is reported as an index number. The real effective exchange rate (REER) is calculated in the same way.

For most of the discussion in the following chapters, I shall refer to the sterling exchange rate without going into the complexities of the effective rate. But it should be understood that I am referring to the EER or the REER.

The Many Jobs done by the Exchange Rate

From the discussion of goods and money and capital markets as well as from the complexities of many countries, it seems that the exchange rate performs a myriad of tasks. But it is possible to summarize them under two general headings:

First, the exchange rate moves to equilibriate the demand and supply of traded goods and services. Generally speaking there is some considerable stickiness in the prices of goods; they move sluggishly in response to market forces. The exchange rate in a free market moves with alacrity and speedily signals and eliminates the shortages and surpluses on the goods markets (but not on the labor market !).

At the same time the exchange rate must ensure that, along with interest rates, there is a sufficient attraction to capital flows to finance the deficit on the current account of the balance of payments. The net capital inflow, from dollars to pounds, must be just enough to balance the whole account.

Second, the exchange rate must be such that the existing quantities of non-interest bearing money in both the domestic and foreign countries be willingly held. If there is too much of the domestic currency relative to the foreign currency, then the domestic currency will decline in value in terms of the foreign currency (that is it will depreciate). One might go further and argue that it is also the critical factor that induces people willingly to hold the existing quantities of financial assets denominated in, respectively, the domestic and foreign currency. But in the case of financial assets generally, as distinct from non-interest bearing money, one must also take account of the yield in one currency on such assets. However it is clear that the exchange does a most important job in ensuring that people willingly hold the existing stocks of financial assets in the specific currency denominations of their choice.

Like other phenomena in economics, this simple price of one currency in terms of another does an enormously complex job of coordinating millions perhaps even trillions of decisions about producing and consuming goods, adjusting portfolios, investment etc. The free price system is a wondrous mechanism that can do all these things through the self-regarding behaviour of individuals. The millions of individuals rarely see one another, probably do not understand each other's language, and may even be highly antagonistic. Yet, through the price system, they achieve an immense harmony of cooperation and coordination. It is also clear that highly managed exchange rate and planning systems that eschew the use of free price adjustments have been dismal failures - as the experience of Eastern Europe and the Soviet Union attests.

Long Run PPP and Short Run Dynamics

Yet our understanding of the workings of the free market system is, to put it mildly, imperfect. In the field of monetary policy and exchange rates it is particularly important to be clear about what we do and do not know. Of course we step on much disputed territory. What follows is very much a personal interpretation. This is based on both my reading of theory, the evidence, and direct observation.

First and most important of all is that in the long run the purchasing power parities of currencies (PPP) must be roughly equal. Exchange rates must adjust to reflect the differences in

the price levels. Thus a one-shot increase of the money supply will give rise to an increase in the price level and a depreciation in the exchange rate - both in the long run. Similarly an expansion of monetary growth, relative to those of our trading partners, which is expected to persist will give rise to a long run continual depreciation of sterling.⁸ There are many pertinent examples of this long run rule. For example the long run depreciation of sterling against the deutschemark and the dollar attests to the fact that the monetary policies of Germany and the United States have been less expansionary and that the inflation rates have been, on the average, lower than those in the United Kingdom.

I believe that there is a broad agreement among economists that we can be fairly confident of the long run effects of monetary policy on the price level and on exchange rates. The former goes up and the latter down, more or less proportionately. But there is much less agreement on the short term dynamics of the adjustment process - again both in monetary economics and in exchange rate dynamics.

The basic problem is that, in the short run, there are many complexities and effects which are difficult to model and impossible to control. For example in the weekly or monthly adjustments, expectations and uncertainty must play a dominant role. Rumour and report of political events can play havoc with markets. Furthermore, short term movements in output, stickiness of prices, excess capacity will all have important, even dominant effects, in weekly or monthly movements.

Overshooting

One commonly accepted account of the transitional reaction of exchange rates to changes in monetary growth suggests that, far from rising monotonically to its new equilibrium value, the nominal exchange rate will far overshoot its long run target, but in the long run it will return to its PPP level.⁹ The rationalization is most easily seen if we first assume that total real output is fixed throughout. An expansion of the money supply will have the effect of depressing interest rates. Everyone will expect that prices will rise and there will have to be a corresponding devaluation in the long run. But the fall in interest rates will give rise, in the very short term, to a

⁸. Both statements must be qualified since differential real growth may have a significant effect. The monetary expansion is meant to be over and above that required to accommodate the increase in the demand for money accounted for by real growth of GNP. Also there may be systematic shifts in the long run demand for money. Again these should be accommodated in interpreting the effects of money on exchange rates and inflation.

⁹. The phenomenon of overshooting is characteristic of many models of the monetary process. I discovered this to be true of Milton Friedman's permanent income demand hypothesis. See my article, "Professor Friedman and the Demand for Money" (check title), Journal of Political Economy 1965.

capital flight which will in turn cause a sudden and sharp devaluation. The devaluation will cease when domestic resident can secure an overall rate of return, that is interest plus expected appreciation of the currency, equal to that which they can acquire abroad. In order to provide this expected appreciation, the sharp fall in the exchange rate must be sufficient to take it below the long run equilibrium value. Then all asset holders can look forward to an appreciation of the domestic currency up to the long run equilibrium. In short, the spot exchange rate must fall below its new long run equilibrium path, so that the future appreciation of the exchange rate will compensate for the initial fall in interest rates.¹⁰

A quite crucial feature of this story is that the prices in the goods and labor markets adjust much more slowly than prices in the markets for assets and in foreign exchange. But the increase in demand due to the monetary expansion will be generated not only through the lower domestic interest rates but also through the devaluation. Since prices are fixed in the short run, this implies that the nominal devaluation is also a real devaluation. But prices will then increase over the adjustment period, and both the nominal and the real exchange rate will rise. Indeed over this period one will observe increasing prices and an appreciating exchange rate - exactly the opposite of the long run adjustment !

This neat picture is somewhat obfuscated if one allows for potential movements in output. There is some evidence that a monetary expansion boosts real output during the shortish run - between some 6 months and perhaps up to 18 months before it dies away and becomes negative. This expansion will tend to reduce the fall in interest rates, maybe even increase them, and so dampen the overshoot after 6 months or so of the adjustment period. But the 6-18 months boost to output will then reverse.¹¹ This will produce yet another downward force on interest rates and an appreciation of the the spot exchange rate lagged

¹⁰. There is another non-monetary reason for the real exchange rate to overshoot in adjusting to a new level. Because the elasticities of supply and demand for goods are normally lower in the short run than in the long run, the real exchange rate will have to move much more in the short than in the long run. This form of overshooting is inherent whatever the exchange rate regime. See Milton Friedman, "The Case for Flexible Exchange Rates", Essays in Positive Economics, University of Chicago, 1953.

¹¹ Such a reverse must take place since it is illogical and quite inconsistent with the evidence to suppose that, by increased monetary injections, one can always raise output growth, albeit temporarily in the 6 to 18 month period, without growth dropping below its trend line afterwards. Any such scenario would enable a country to inflate and increase the long run level of its GNP. This reversal of the original output boost will, through the reduced demand for money, have a downward pressure again on interest rates which may in turn lead to a secondary exchange rate boost.

at least some 18 months behind the original monetary injection. Yet another late overshoot is possible, which is likely to occur just at the time that the sluggish prices are at last starting to move up.

Of course, any reader having got this far will conclude either that economists who produce models which capture this dynamic process must be fiendishly clever or that such economists don't know what they are talking about. Both are true. However plausible this account of the dynamics of adjustment, it is far from being a reliable tested proposition. Casual knowledge suggests that exchange rates have fluctuated more than monetary policy and the overshoot hypothesis may be one of the explanations. But there are many more influences on the dynamics of exchange rates as we know from the fact of their short run unpredictability. I would be inclined, however, to regard the overshooting phenomenon as something to look for but not something to rely upon.

An Alternative - Short Run Perversity

This skeptical view is supported by an alternative view of the short run adjustment mechanism, which seems to me to have just as much plausibility as the overshooting hypothesis. Suppose, per contra, that domestic prices - such as the prices of real estate and cafe services - do respond rather quickly to the increased demand. Let us then begin again with a monetary expansion at home (in Britain). Instead of looking at the path of equilibrium through the need to induce people to hold existing stocks of financial assets, let us examine instead the flow equilibrium through exports and imports. brought about by an excess domestic aggregate demand.

With a domestic supply response not elastic enough, in the short run at least, to assuage the domestic demand growth, the only way to satisfy the demand is through decreased net exports. In order to reduce exports the sterling price of those exportable goods, such as manufactures, relative to the prices of non-traded goods, such as houses and haircuts, must be decreased. This implies that the price of non-tradeables must rise. The deficit on the current balance of payments will increase. And in order to ensure such an increase in the overseas deficit, the real exchange rate must appreciate during the adjustment phase. The, albeit transitory, movement of the exchange rate is perverse

This is exactly the opposite of the sticky-price-overshooting theory. In the long run however, the stories converge. In the appreciation case, the deficit on the current balance is eventually eliminated, via a transitory surplus, and the economy settles down at higher prices but at a restored relative price of tradeables to non-tradeable goods. It all comes out the same in the end.

But this should be little comfort to those who seek to track the short term oscillations of the exchange rate - or indeed to those who seek to hang the economy on such shifting values. I suspect that most professional economists in the field would be prepared to defend the sticky-price-overshooting version of the

adjustment process. The slow reaction of the prices in goods markets compared with the speedy reaction in the markets for financial assets is a common theme of most accounts of the adjustment process. Yet there is no theoretical reasons why this should be the case. Nor has there been any extensive empirical investigation of the issue of price flexibility. Casual observation suggests that the prices of goods, particularly food, are highly flexible, often reflecting daily or weekly oscillations in supply. Similarly no-one can be in doubt about the boom and bust flexibility in the housing market. The reader may well reflect that this flexible price model tells a story which is rather similar to the experience of Britain in 1987-89; this is a theme I will take up again in chapter...

Exchange Rates as a Monetary Thermometer ?

As a result of this discussion, one might concede that, in the short run, the nominal exchange rate is of dubious utility as an indicator of the appropriate monetary policy. This conclusion should occasion little surprise. Just as we know little about the short run adjustments of the economy to a monetary expansion, so we know perhaps even less about the exchange rate changes. The exchange rate is one of the main channels through which the effects of a monetary expansion are transmitted to the rest of the economy and to foreign countries. And it is above all a monetary phenomenon. Our lack of knowledge of the dynamic adjustment paths of prices, real output, interest rate structures, etc. should be mirrored in exchange rates. And so it is.

This discussion of the principles of exchange rate adjustment has ignored, or taken as constant, many of the important determinants of exchange rates in practice. Changes in the weather, in political prospects, in technology, in the marginal profitability of domestic fixed capital formation, in thrift, and in expectations and confidence all impinge, often quite dramatically, on exchange rates. Even after the event, it is difficult or often impossible, neatly to attribute an exchange rate movement to its causes. It is quite impossible to do so for current movements in exchange rates.

For example, in 1987/8 the upward pressure on sterling vis a vis the deutschemark did not indicate that Britain was enduring a monetary squeeze compared with Germany; the contrary was the case, for reasons which we shall go into later.

Fixed Rates and Stability

It has been suggested that, by adopting whatever monetary policy is necessary in order to assure fixed exchange rates, compared with any alternative regime the economy will be much more stable and avoid sharp variations in output and inflationary or deflationary pressure. Protagonists of this view lean heavily on the assertion that confidence will be much greater under a fixed exchange rate regime than under any alternative

arrangement.¹² As argued above, there are a great many aspects to the concept of confidence and certainly there is no tested theory which tells us how to analyse it. Statements about it reflect largely the taste of the asserter. There are, of course, a myriad of subsidiary assumptions underlying any such assertion about, for example, the soaring confidence that would allegedly ensue if Britain joined the ERM, albeit a pseud regime. We shall defer discussion of these assumptions, but it is worthwhile reflecting at this stage on the efficacy of a fixed exchange rate regime.

What is required of a monetary and exchange rate regime is, I think, broadly agreed. We would like a stable and low (say 0 to 3 percent) rate of inflation, and we would like a high and stable growth rate with only sufficient unemployment to enable the market to work efficiently. From our discussion of exchange rates and monetary policy, it seems unlikely that, even if the reserve currency to which the currency was fixed behaved in the most immaculate manner, a fixed exchange rate regime would promote such conditions. For example, if the overshooting hypothesis is true, then any accidental monetary expansion would, under a fixed regime, require a very large short term increase in interest rates in order to offset the power of the overshoot. This would then lead to a great contraction in the rate of growth of the money supply, with an attendant recession to follow. If, however, the perverse model is true, then any accidental monetary expansion would be followed by pressure for an exchange rate appreciation, which must be eventually reversed. Such paths are hardly stable or secure.

The Fundamental Equilibrium Real Exchange Rate (FERER)

Clearly one of the main ideas of a fix is that once done, it is possible to simply let the system run on a sort of autopilot. However the system critically depends on getting the fix right. As Churchill discovered it was disastrous to get the wrong value to fix upon. In order to assist statesmen in this process, economists have tried not merely defining but actually specifying an underlying equilibrium rate. The value beloved of the fixers is the fundamental equilibrium real exchange rate (FERER).

The idea is that there is an underlying exchange rate which, ignoring transitory random variations brought about by swings in confidence and expectations etc, would give rise to a deficit just sufficient to balance the capital flow needed to exploit the greater profitability of capital in the receiving country. Somehow the FERER is the "right" rate.

I think that virtually all economists and many others carry around some idea of an appropriate rate. Yet it is impossible to define one that is useful for policy purposes. Of course all would begin with some idea about PPP in order to get an appropriate balance in the current balance, so that there is

¹². Because of the repetition of this view in his innumerable articles in the Financial Times, Mr. Samuel Brittan is certainly the best known advocate of this fixation.

suitable room for the desired capital flows. Such a concept would ignore however many realities of economic life - and to the peril of the policy maker. For example, suppose there is a penumbra of political uncertainty, say a left-wing takeover with capital and exchange controls in train, then this would have a dominant effect on the market exchange rate, allowing for capital flight on an unpredictable time table. It is clearly impossible to put such ideas in the FERER.

If it is difficult to define an operationally useful FERER it is quite impossible to make any meaningful measures of the concept. We have only sketchy ideas about the demand and supply conditions in international trade, as it obvious from the large errors which forecasters make in their predictions. Virtually nothing at all can be forecast about the profitability of capital in Britain and her trading partners, and the job of defining a neutral monetary policy and the associated interest rates is quite beyond any mortal's abilities. Ignorance rules.

It is therefore not surprising that the most eminent economists have ventured completely different views about the appropriate movement of nominal exchangerates. In 1988, for example, Martin Feldstein argued that the yen should appreciate against the dollar in order to eliminate a large US deficit, but, at the same time, Ronald McKinnon (with considerable support from the Wall Street Journal) was urging a devaluation of the yen in order to return to purchasing power parity. In the famous Louvre Agreement (February 1987) it was asserted that the dollar-yen and dollar Deutschemark are "consistent with the underlying fundamentals", although they required enormous intervention to keep them in place.

This suggests that, even if we knew how to define the FERER, we do not know how to measure it and use it operationally. And there is great danger in using simple calculations of PPP to decide on directions of exchange rate movement towards equilibrium. Substantial variations in PPP can take place, and indeed have taken place over the years after World War II. (Graph of p.175 of Cato Conference) Such deviations can persist for a long time. (Indeed today, all frequent transatlantic travellers are convinced that \$160 in Washington buys much more than 100 sterling in London - and has done for some time.) One should beware of using any simple PPP calculations as guide to determining what is the " fundamentals".

Intervention - Unsterlized and Sterilized

The discussion of official intervention, one of the four ways of securing a reconciliation of demand and supply on foreign exchange markets, was deferred while we considered the various other equilibrating mechanisms. Now we consider the direct involvement of government or central bank in the market.

The simplest form of intervention, unsterlized, is when the government sells or buys foreign exchange in order to affect the rate, with no concomitant open market operations in the bond

market.¹³ Thus if the Bank of England sells pounds and increases its reserves of dollars, this would be intervention against sterling and in support of the dollar. The important point is that the private sector would acquire more pounds. This foreign exchange transaction would increase the sterling money supply of the United Kingdom. This will eventually increase the price level. Thus the selling of sterling for dollars is simply a way of increasing the money supply. Instead of buying long dated bonds, as in normal open market operations, the Bank buys dollar balances.

For the most part, however, governments want to intervene only to influence the exchange rate. They may be quite content with their monetary stance and wish to confine effects to the foreign exchange market. Thus they wish to sterilize the intervention and offset any effects on monetary policy. If the target of monetary policy is the growth rate of some monetary aggregate, then in the sale of sterling example, sterilization would take the form of open market sales of a sufficiently large number of long dated gilts in order to mop up the sterling created by the intervention. The money created by intervention is taken back in the gilt sales. The market ends up with the same amount of money, increased holdings of gilts and reduced holdings of foreign exchange.

Sterilization - forms and effects

This definition of sterilization, although much used in theoretical work, is not the usual one used by central bankers in their actual operations. For the most part central banks control short term interest rates as their main instrument of monetary policy. Thus it is natural to define sterilization in terms of maintaining the short term interest rates unchanged. In the Bank of England operations, for example, the Bank supplies or subtracts from the market daily just sufficient funds to maintain the short term interest rates thought to be appropriate for monetary policy. When a substantial intervention, such as selling of sterling, takes place, the Bank mops up any excess that appears in the daily money markets to threaten the maintenance of the interest rate. In that sense, therefore, the Bank always sterilizes - up to the point at which it is decided to vary the short term interest rate.¹⁴ When interest rate

¹³. Governments have many occasions to enter the market in conducting ordinary government business, such as buying imports or providing or receiving aid. Such transactions would not be intervention in the sense that their purpose is not to influence the exchange rate.

¹⁴. The two definitions of sterilization cover a multitude of other subdefinitions. Obviously with the quantity-of-money-constant definition, there are as many definitions of sterilization as there are concepts of "money". It is important also to note that because interest rates and money have no exact or unique one-to-one relationship, there is in practice bound to be some monetary effects of sterilized intervention. And the larger the intervention, the more likely that these effects will

changes are associated with intervention, then it is unsterilized.

But the important question is: does sterilized intervention work? Does it really affect exchange rates substantially while maintaining unchanged the monetary stance? From experience, there is no doubt that sterilized intervention does have some effect in the short run. The immediate effect of foreign currency sales appears on the markets and probably has some effect on the market's expectations. However it is very likely that this effects lasts only for a short time - days rather than weeks. As Michael Mussa says, however: "There is good reason to doubt, however, that pure (i.e. sterilized) official intervention can have a significant effect on the long-run behaviour of exchange rates...when the market becomes persuaded that the authorities are attempting to maintain a disequilibrium exchange rate, the magnitude of intervention required to sustain the rate rapidly grows to enormous proportions"¹⁵. In view of what happened in Britain in early 1988, it is easy to appreciate Mussa's point.

In short, sterilized intervention is an instrument useful only for playing short run games with the market. (In my view this is unseemly behaviour for a central bank, but many regard it as a useful weapon in the bank's feasible armoury.) It cannot have any long-run effect on exchange rates. The very failure of sterilized intervention, however, has its effects on monetary policy. When sterilized intervention fails to shore up, or keep down, an exchange rate, then the authorities are tempted, and often do, change monetary policy. As we shall see, this is what Mr. Lawson did in May of 1988.

be large. It will also be clear that intervention with sterilization is likely to affect the term structure of interest rates, which will again have monetary effects. In other words complete sterilization is elusive and ultimately impossible.

¹⁵. "The Role of Official Intervention", in The Merits of Flexible Exchange Rates; an Anthology", ed Leo Melamed, George Mason University Press, Fairfax, Virginia, 1988, p.331-360

Chapter 3

Money and Exchange Rates in Practice

The High Keynesian Consensus 1945-1969

Some thirty years ago, when I began to work on monetary economics, it was generally thought that money and monetary policy had little or no effect on the price level or the rate of inflation. In those days of high Keynesianism (or the "New Economics" as it was called in Kennedy's United States), it was thought that inflation was largely determined by the extent of unemployment and the fiscal deficit. Low unemployment would ensure that any fiscal stimulus from an expansion in the fiscal deficit would generate increases in prices rather than increases in output, inflation rather than growth. If however there was a lot of unemployment, then any fiscal stimulus would increase employment and output with little or no effect on prices and inflation. Most inflations were caused by "cost-push" factors such as trades unions demanding too big a wage increase or greedy business misusing their market power to push up prices or unconcerned foreigners increasing import prices.

In the list of dramatis personae, money was merely a bit player. The authoritative Radcliffe Report (1959) had said unequivocally that the quantity of money did not matter very much because the velocity of circulation could be "infinite". Lord Kaldor opined that the role of money was simply to maintain 'orderly (financial) markets'. He likened it to his trousers which, he said, as he got fatter he let out the seams, rather than go on a diet. With such compelling imagery, the main point was that monetary policy should be accommodating so that the really important levers of fiscal policy, and the various direct controls over investment etc, were appropriately effective.

The policy objective of high Keynesianism was to pursue near full employment by ensuring just enough fiscal stimulus that would at the same time guarantee that there would be no inflation. The margin of the small army of unemployed would ensure that wage push would never get out of hand, and although business may exert its latent monopoly power or foreigners may demand more for their wares, such effects could not go on year after year. Competition, both domestic and international, would exert a discipline on such inflationary forces.

Foreign trade served as a temporary safety valve. Any overstimulus of fiscal policy would be partially dissipated in an expansion of net imports to meet the excess demand. The resulting deficit on the current balance of payments would absorb

at least part of the incipient inflationary pressure. Obviously this was only a temporary respite since one could only run a persistent deficit if foreigners were willing to lend enough money to finance it.

Foreign Exchange Rate Regimes

Now we need to look, at least superficially, at the foreign exchange regime. In order to sort out the various strands in the argument, it is convenient first to discuss what would happen if there were no restrictions at all in foreign exchange transactions. In these years Britain was on a pseudo-fixed exchange rate and not a really fixed one. There had been two devaluations in 1947 and 1967. But if Britain had been on a really fixed exchange rate, then, provided that no doubts arose about the credit worthiness of the government, Britain would have been able to finance these deficits by borrowing at interest rates little different from the lenders (say the United States). For if a pound always buys, and is always expected with complete confidence to buy 2.40 dollars, then the interest rates in Britain must be the same as those in the United States.¹⁶

Under such conditions, namely no exchange or capital controls and absolute confidence in the maintenance of the dollar value of sterling, interest rates and monetary policy were out of the hands of the British government. Thus any inflationary pressure, whether generated by cost-push unions or natural calamities, cannot be countered by a tighter monetary policy. Only the instruments of fiscal policy were available.

The effectiveness of fiscal instruments, such as changes in taxation and public expenditure, appeared to be becoming weaker and even perverse during the 60s and into the 1970s.¹⁷ The

¹⁶. Experience suggests that readers may have some difficulty in accepting this somewhat startling conclusion, namely that with absolutely fixed exchange rates, their interest rates in all maturities must be the same. If the rate of return was greater in the UK than in the USA, then it would pay anyone with dollars to transfer at the ever-fixed exchange rate into pounds and thus earn the higher interest confident in the fact that he can get back into dollars at any time. Such a massive capital inflow into sterling financial assets would ensure that their rates fell, and US rates rose, until they were again equal. Thus does capital arbitrage ensure the equality.

¹⁷. I reviewed the arguments and evidence of the decreasing efficacy, even perversity, of fiscal policy, and the increasing impact of monetary policy, in Britains's Economic Renaissance; Margaret Thatcher's Reforms 1979-1984, Oxford University Press, 1986. The last five years (1984-1989) have been consistent with, indeed have reinforced, these findings. The swing from fiscal deficit to large fiscal surplus over these years, particularly in 1987-89, certainly had no visible effect in depressing the economy. On the contrary the economy boomed along with the substantial increase in the rate of monetary growth. This argument is pursued in chapter....

powerful instruments of monetary policy however had not been entirely emasculated by the Bretton Woods system of fixed exchange rates. First, the authorities rationed, with various degrees of tightness, foreign exchange (dollars) to the residents. The authorities simply did not allow one to switch out of sterling into dollars, except for limited amounts and with good reason. (Good reason did not include expectation of a higher yield !). Second, and most important, was that sterling was never inflexibly fixed. Sterling was a pseud in Bretton Woods. The likelihood of a devaluation, particularly high at various periods (e.g. 1956 in the Suez crisis, and from 1963 to the eventual devaluation in 1967) was always an ambient risk. The size of the foreign exchange balances and other realizable foreign assets was an imperfect but useful indicator of the risk of devaluation

Capital Flows and the Demise of Bretton Woods

Thus in practice there was room for Britain to pursue its own monetary policy, primarily through fixing interest rates and controlling monetary expansion through various forms of credit rationing. It is ironic that it was the probability of devaluation, that is violating the fixed exchange rate rule of Bretton Woods, that enabled a member to pursue monetary policies that made it possible to stay in the system. In the 50s and through the early years of the 1960s, private capital flows were rather small; governments were the main money movers. But by the end of the 1960s there was a substantial free-booting Eurodollar market in London which dwarfed the official flows. Thus while, up to say 1965 it had been possible for governments to help one another stay at the fixed parities by lending one another sums of foreign currency (as in the case of the United States loan to Britain in 1956) which dominated the market, after 1965 government funds were eclipsed by private flows. And of course the incentive for the private sector meant that private funds flowed against the official tide, eventually swamping it.

The most telling demonstration of the power of private capital flows to upset the desire of governments to hold exchange rate parities was in sterling's devaluation of 1967. The Labour government of 1964 inherited the pre-election monetary fling of Maudling (the Tory chancellor). The inflationary genie was out of the bottle, and although Mr. Wilson tried every trick, including high interest rates, draconian credit controls, a budgetary squeeze, stringent restrictions on foreign exchange, and even an import surcharge, the flight of private capital (led by the "gnomes of Zurich according to Mr. Wilson) could not be offset by intergovernmental borrowings. Sterling had to go in November 1967, from \$2.80 to \$2.40. Even so doubts persisted whether it had gone far enough and the hallowed Bretton Woods system was essentially a casualty of free capital movements.

Myths and Reality in Bretton Woods

Much nostalgia has been lavished on the Bretton Woods system.¹⁸ It is said that it provided a great stability and low inflation during the twenty four years or so (1947-1971) it was in operation. This misses important realities. First the Bretton Woods system did not really become effective until the end of the 1950s. Before then all the major currencies were inconvertible, so the private capital movements were precluded and, for example, many of Britain's old colonies were saddled with sterling balances which they could only use at the discretion of the British government. And clearly by even before 1967 everyone knew that the second most important currency was in turmoil. After 1967 one saw essentially the end of gold convertibility in the two tier gold window, where the United States would honour, albeit reluctantly, convertibility only for central banks. The system was moribund and then died in 1971. So the Bretton Woods system really lasted at most some ten years. It is indeed ironic that the great inflation of 1972-5 was generated under the Bretton Woods system, whereas the great disinflation of the 1980s was achieved when all the major currencies were floating.

The story of Bretton Woods is one of the major reserve currency, the dollar, and the minor reserve currency, sterling, beginning by being undervalued.¹⁹ Gradually, however, expansionary monetary policies took their toll. The United States increased its rate of monetary growth from the early 1960s and the great inflation got under way. The dollar shortage, which had prevented convertibility throughout much of the 50s, became a dollar glut. At its fixed parities, with respect to European currencies, the dollar had become overvalued. At its gold parity, there was a big excess demand for the contents of Fort Knox. So in the last act of the Bretton Woods saga, the two reserve currencies ended the 1960s as overvalued and unwanted. The United States which had been accused of dragging the world

¹⁸. For example Mr. Ballardur urged a return to a Bretton Woods type of system using some sort of commodity standard, rather than the dollar, in Wall Street Journal. February 23 1988. The article reviews also the alledged defects of the floating rate system but, alas his criticisms collapse when one considers alternatives to the floating rate system. Paraphrasing Churchill, floating rates are an awful system, but the alternatives are far worse.

¹⁹. It is obvious why the dollar was undervalued in the decade or so after World War II. Low inflation due to responsible monetary and fiscal policies together with a domination of free-world production all helped. Sterling was a more dubious case. However the very large devaluation in 1947 did probably under value sterling until the British inflation, relative to those of our trading partners, eroded it by the latter half of the 1950s.

into recession in the 1950s, was then accused, quite rightly, of exporting its inflation through the Bretton Woods system.

Alternatives Foregone?

There were alternatives to floating, none of them very palatable however. One possible (Churchillian) solution would have been for the United States to pursue a persistent deflationary policy by reducing monetary growth to, say, zero. It is doubtful if this could have been done from 1971 onwards without substantial dislocation and unemployment. The United States would certainly have been accused of exporting its recession to the rest of the world. Another solution would have been for Germany, for example, to pursue inflationary policies to reduce the differential between the dollar and the mark. But Germany and many other countries were adamant about the need to avoid domestic inflation and resented importing inflation from the United States. Why should Germany pay for the mismanagement of the United States ?

It is interesting to reflect on whether Bretton Woods would have survived if the United States had not inflated in the 1960s. With responsible behaviour on the part of the major reserve currency country, could not the Bretton Woods system have survived to this day? I very much doubt whether it could. The United States inflation merely hastened a death which was inevitable. The first reason is the burgeoning private capital flows which increasingly won the battle against official intervention. The second reason is that fixed exchange rates could never have taken the enormous strain caused by the oil price and other shocks of the 1970s. Lastly, fixed exchange rates generate such tensions between the participating governments. When the reserve currency is too strong, then its partners accuse it of inducing a recession, whereas when it is too weak, it will be condemned as an inflationist. And no currency is ever just right.

Floating and Monetarism 1971-1990

Just as there is no pure fixity of exchange rates, so there is no pure floating. In a pure float the government would undertake no transactions in foreign exchange that were outside the normal processes of government taxation and spending and designed to affect the value of the currency. Even the most "hands-off" policy will often consider the timing of taxation dates and payment schedules in order to smooth the market process. It is convenient to consider, however, the pure float as a theoretical category since one can analyse it much easier.. Most countries, however, pursued what was dubbed a "dirty float". Government intervened in foreign exchange markets, sometimes buying their own currency in order to prevent a reduction (or secure a rise) in its value or selling it in order to prevent a rise (or secure a fall). (Nor did they restrict intervention merely to their own currency. Indeed, if one has enough money, anyone can intervene in any traded currency to influence its value. But clearly the game is really restricted to

governments who can dip liberally into the pockets of taxpayers to spend on their wizard wheezes.)

The unpegging of exchange rates meant that countries had much more latitude to pursue independent monetary policies. Under complete freedom from exchange controls, sterling interest rates could exceed United States interest rates if the pound were expected to decrease its value in terms of dollars. For example if the pound were expected to depreciate by 5 percent against the dollar over the year, then 12 month interest rates of, say, 14 percent in London and 9 percent in New York could happily coexist. The average expectation of return on a sterling or dollar asset would be the same.

Consequences of Floating

This is the first, and perhaps the most important, consequence of free exchange rates. It enables Britain to pursue a monetary policy which does not have to slavishly follow that of the major monetary power, whether the United States or Germany. British monetary growth can be determined by domestic conditions, and the appropriate interest rates will emerge, together with the expected change in the value of sterling, on the market. Or, alternatively, British short term interest rates can be fixed by government operations in the money markets to produce the monetary conditions which it believes is appropriate. One should beware, however, of claiming too much for floating rates. In the short run, there has been substantial interdependence - in for example the transitory reactions to the OPEC oil price increases of 1973 and 1979. Floating does not insulate us completely from short run shocks. It helps but it is no panacea. For the long run however there is considerable evidence that floating rates have given the independence of monetary policies, movements in prices and interest rates which one would expect. And in the control of inflation this is the critical test.²⁰

Another important consequence of floating, however dirty, has been that it enabled countries to reduce or eliminate controls on both the flows of goods and of money and capital. With no desperate need to defend an exchange rate parity, there was no need for the desperate measures which Mr. Wilson had been induced to deploy in 1964-68. In Britain the floating rate eventually enabled Mrs. Thatcher to abolish all exchange controls, both overt and covert, in 1979-1980. Similarly the United States found it no longer desirable to employ the battery of capital controls which it had introduced in the 1960s. One may contrast this with the persistence of exchange controls and the growth of trade restrictions in the EMS from 1979 to 1987. Of course this does not mean that floating countries are bound to adopt more liberal regimes than fixed countries. Floating removes merely many of the incentives for dirigisme.

²⁰ See Darby, Michael R. and James R. Lothian "The International Transmission of Inflation Afloat" in Money, History and International Finance: Essays in honor of Anna J. Schwartz pp 203-36, edited by Michael Bordo, University of Chicago Press, 1989.

Alternatives to Floating

It is instructive for us in Britain to examine dispassionately what would have happened in the last decade if the world had been on some alternative regime. All the alternatives that have been suggested are variants of the Bretton Woods type of "fixed but flexible" or "stable but adjustable" pegs. From November 1982, the economy of the United States embarked on a sustained non-inflationary expansion. Both a very large trade deficit and a massive nominal and real appreciation of the dollar ensued. The deficit provided the stimulus to the rest of OECD countries and pulled them out of the slump. It also allowed a considerable capital inflow into the United States in response to the high profitability of investment engendered, in part, by tax reductions.

If the United States had been constrained by a Bretton Woods type of system to keep the dollar down at its 1979 level (in effective terms), this would have required a massive injection of dollars into the world monetary system. It would have produced a monster of an inflation which would have destroyed confidence in an even more devastating manner than the inflation of the 1960s and early 1970s. It is likely that the system would have broken down with resort to controls and protectionism. Back to the dirigisme of the 1930s.

I suspect that it is widely accepted that there was no really feasible alternative but to float in the turbulence of the 1970s and 1980s. The inflation disparities were too large, the real economies required too much adjustment, the deficits too difficult to contain in a Bretton Woods straightjacket, however accommodating its binding. But in the 1990s many of the great disparities have been reduced considerably. Surely, it is said, there is now no excuse for the oscillations of exchange rates; best to eliminate or mute them in some new Bretton Woods arrangement.²¹ One may presume that the discipline of Bretton Woods will prevent any large disparities and "disequilibria" developing. It is hard to accept this argument in the light of the fact that the old Bretton Woods had no such effect.

Variability of Real Exchange Rates

One of the enduring complaints against floating exchange rates is that there is much more variation in exchange rates than under a fixed or Bretton Woods type of system. This is of course entirely understandable with respect to nominal exchange rates. In a "fixed but adjustable" system nominal exchange rates will move on "realignment", as it is called in the EMS. But such movements should be infrequent. Generally the nominal exchange rate will be contained between the bands (2 per cent in the case of Bretton Woods and 4.5 to 12 percent in the EMS).

²¹. This argument about the appropriate ambient conditions for fixed exchange rates was put by Mr. Lawson in his television interview with Mr. Brian Waldron in November 1989. Quote from transcript..

The more interesting question is the variability of real exchange rates. What is the effect of floating on the variability of competitiveness as reflected in the relative price ratios? There are no experimental data. Evidence can be adduced only from the historical record of before and after 1972. A first reading is clear. The amount of real exchange rate variability, measured in virtually any pair of currencies, increased substantially after 1972.²² (The ratio of the United States to the German price levels, adjusted for the nominal exchange rate, is shown in figure..) Thus it does not seem that flexible movements in nominal exchange rates adjust to offset differential movements in domestic price levels.

This increased variability is puzzling. There is no theoretical reason why this should be so. Several ad hoc answers can be unearthed and used to rationalize the result. First, it may be claimed that before 1972 the system had stored up, and papered over massive inconsistencies which had to be resolved over the next few years. This might have some plausibility for the mid 1970s, but the variability continued through to the end of the 1980s. Secondly there were the oil shocks of 1973 and 1979 and the great inflations that were associated with, though not caused by, these events. Massive adjustments were needed. This may be true. But one suspects that it is not the whole story. I am inclined to believe that one powerful explanation is the emergence and phenomenal growth of private international capital markets. From 1969 these markets burgeoned. And the development of technology together with the gradual reduction of regulations has made speculation and cover less expensive.

I do not think that these explanations are at all adequate. This variability remains a puzzle and a challenge to the profession. To avoid misunderstanding it is necessary to stress that variability as such is not a bad or a good thing. It has to be judged along with all the alternatives available.

Chapter 4

Monetary Policy and International Coordination

Basic Ideas on Coordination

One of God's greatest gifts to mankind was the free price system. It enables the cooperation and coordination in production of the most complex products such as my word processor. Countless people have cooperated to produce and market this machine. Those who have so conjoined will never see

²². See Michael Mussa, "Nominal Exchange Rate Regimes and the Behaviour of Real Exchange Rates: Evidence and Implications", Carnegie Rochester Conference Series on Public Policy, 24, (1986) 117-224.

one another and probably do not ever know of the others' existence. They may speak different languages, have different religions and mores. Yet they coordinate their efforts, not through the directives of some super manager, but through their free choice among the teeming options offered by the free market system.

The efficacy of the price system in achieving coordination and productive cooperating is well documented. Compared with a Gosplan, it is a marvel of freedom and efficiency. It is now widely accepted, even envied and emulated in Eastern bloc countries, as the only effective way of organizing economies. It is natural to enquire whether the free price mechanism, which has been so successful in organizing individuals and businesses, could not be equally applied to nation states.

From the chapters above, it is easy to see that there is a similar form of coordination through the price system. First there needs to be freedom to make trades across national borders. Any severe restraint on this freedom will inhibit international cooperation. Secondly one has to ensure that the price system can work by maintaining a fairly stable price level. But that is nothing new since it is needed for internal purposes. No system can work efficiently if the unit of account is constantly and substantially changing its value. But different countries will have different views about what is the appropriate or tolerable rate of inflation. For example Germany would regard a steady underlying inflation rate of 4 percent as quite beyond the pale; whereas I suspect that most Americans would be content with such an inflation. Nevertheless the citizens of Germany and the United States can happily coordinate with a zero inflation in German and 4 percent in the United States, provided that no-one succeeds in fixing the dollar-mark exchange rate. Like any other price, the price of a mark in terms of dollars will adjust to the differential inflation rates.

Spillovers and Incentives

In this free price system there is no need for any explicit coordination of government monetary and fiscal policies. True there will be spillovers from one country to another. The flexible exchange rate is no cordon sanitaire. Any undue expansion of the money supply in the United States will have some effect on Germany. The additional demand in the United States will suck in imports from Germany. To pay for them dollars will flow into the accounts of German exporters. This will increase demand and prices in Germany. Some of the inflationary pressure in the United States will be exported²³.

But the pressure in Germany will be modest compared with that in the United States. If the inflation is made in the United States, then its main effects will be felt there, not in

²³. It will be recalled that, in the short run, one cannot predict which way the exchange rate will move. Ultimately however there will be an increase in the dollar value of the mark.

Germany. Thus, if the United States with its 4 percent inflation target, does expand the money supply by an amount which will give it, say, 6 percent inflation, then the United States government and Fed will have by far the greatest incentive to bring money under control once more so that it is in line with its 4 percent norm. Similarly by far the main effect of any undue expansion by the Bundesbank will be on the German, rather than the American, rate of inflation. Spillovers will be the second order effects. Thus coordination is achieved by each government pursuing its own interest of stabilizing its own price level. If each of the monetary authorities of the world designed policies to keep its domestic inflation down to its (presumed low) target, policies would be coordinated automatically through the medium of exchange rate and price and wage movements, and capital flows.

Granted the veracity of this argument, however, many observers will complain of the slow speed of adjustment, of possible overshoots, of speculative bubbles that bedevil markets, and of course of all the externalities. Surely it is possible to speed up the adjustment process, to avoid excess speculation and many of the other mistakes of the market. This is the normal version of the case for coordination, central monitoring, and even some central international direction.²⁴

Reality vs the Ideal in Coordination

The first point to note about this argument is that, on its own assumption, it is logically impeccable. Obviously if Germany and the United States knew all the effects, both domestic and international, of their policies, they could get together and fashion a joint arrangement which was, in aggregate, superior to the sum of their individual efforts. This is a subspecies of a more general argument used by utopians, socialists, and many schools of economists: with perfect knowledge and foresight and unlimited powers of control, one can always improve on the free market. Externalities, social costs and all those aspects which the market ignores or distorts can be taken into account by a benign bureaucracy in regulating markets.

Most of us, however, are rather skeptical about the efficacy of benign bureaucrats in regulating markets. The rise of the Public Choice school has made us aware that civil servants and politicians are moved by their own aims and ambitions. But political temptations are only part, and I think the smaller part, of the story. The main reason is the limitation of

²⁴. Coordination has been given a great variety of meanings. At its most innocuous level it involves merely the exchange of information between governments. Such information must be confidential or otherwise there would be no point. (For my part I cannot see why governments withhold such information from the private sector if it is at all valuable for judging the future of economies). At the highest level, coordination has been used to describe an international or multinational plan with specific roles allocated to the participating states. Most people use some concept between these two extremes.

knowledge. Economists know very little about the myriad of interacting processes that comprise markets. (Perhaps I should add that although economists know virtually nothing, they know more than politicians and journalists). Chapter 2 told the story. But everyone will know how often economists predictions are confounded.²⁵ We are abysmally ignorant about the macroeconomic processes and the dynamics of forces that determine the fate of national economies. Any joint coordination of national policies would be based on pretensions which are completely unwarranted. Likely they would do more harm than good.

Persuasion and Sanctions

But even if one believes that economists are very clever and much more knowledgeable than I suppose, it is still difficult to see how coordination will be achieved in practice. How will all the ships of state be kept in line? What sanctions can be imposed? Although one may think of various shots across the bow, such as refusal to support a currency, the imposition of trade restrictions, etc, even the mere threat of such shots would surely scatter if not scuttle the convoy of cooperators. Coordination must depend on multilateral undertakings, goodwill, a community of interests, good faith and the salutary effects of the good example - rather weak reeds on which to lean in order to counter the self-interest of a national state. If a

²⁵. One interesting example is the behaviour of the yen in 1989. Virtually everyone was predicting that, because of the large surplus, the yen would have to appreciate relative to the dollar. Indeed, at a conference in February 1988, Rudiger Dornbusch argued that "the superior performance of Japan in manufacturing and trade requires real appreciation as the classical response...a move away from PPP is required as an adjustment to these favourable developments for the Japanese economy." Many distinguished economists also thought that the yen must appreciate. (Incidentally I also thought it likely that the yen would go up in value.) In 1979, however, the yen's effective exchange rate fell by 10 per cent, and against the dollar the fall was even larger.

government believes that it is in its interest to pursue noncooperative policies, it will.²⁶

There is an argument that coordination does help all participants to pursue non-inflationary financial policies. Suppose that the governments really do want to maintain responsible monetary and fiscal policies. But they have difficulty in convincing important groups of the electorate. In a round-up of the usual suspects the trades unions would be first in the bag. These governments with the best of motives can then confront the trades unions with the fact of the coordination agreement. The government would say that it finds it impossible to agree to some outrageous wage increases because this would be inconsistent with its treaty obligations. As a general proposition, there seems to be something in it. We are all used to embracing rules which bind us in difficult cases. This argument has been adduced as one of the reasons for membership × of the ERM by both Mr. Lawson and Mr. Brittan. It may well be true, but I remain doubtful. From my own inquiries, I have not yet found any wage negotiations that even considered, however remotely, the transitory variability of the exchange rate as one of the factors to be taken into account. Even corporations that have profits that much depend on the exchange rate appear to cover their commitments. for the year or so covering the wage contract. I believe it is up to the protagonists of the Lawson/Brittan view to offer some evidence for scrutiny if we are to credit their point of view with any substance.

On the international, as distinct from the European, coordination of economic policies generally, governments have paid considerable heed to the interest groups that command critical votes. Governments have not used the international agreement to confront such groups with the spectre of a government bound by 'foreign entanglements'. As the Americans say, it would not play in Peoria. A short review of international coordination in the 1980s will help put British policies in their international context.

International Coordination in the 1980s

Perhaps the first substantial coordination of economic policies took place in the Bonn summit of 1978. From 1976 the Carter administration had embarked on a massive expansion, and by 1978 the inflation had risen to 9 percent with obvious signs

²⁶. For example, in the 1960s the United States followed an inflationary policy in response to short term political interests (to finance the Vietnam and poverty wars). It is doubtful if any solemn multilateral undertaking not to use inflationary finance would have had any noticeable effect on the behaviour of the administration. (There is of course another explanation: economic ignorance. The economists who advised on policy believed that there would be no substantial inflation because of the presence of unemployment, at least until the 1968 tax increase.)

of much more to come.²⁷ Over the year the dollar had depreciated about 15 percent against the mark. At the summit the United States undertook to adopt more responsible policies (indeed it argued that they were already largely in place) and in return Helmut Schmidt agreed that Germany would adopt more expansive measures, particularly in fiscal policy. For the German economy, this proved disastrous. There was already the beginnings of a massive German boom; the summit measures added fuel to the flames. Germany embarked on her own inflation from which she only slowly, and painfully, recovered in the early 1980s. Not the most auspicious beginning of post Bretton Woods cooperation.

With the advent of Mrs Thatcher, Mr. Reagan and Herr Kohl, international coordination was a secondary concern to the need to reduce inflation. Monetary control was the centrepiece of policy. Exchange rates were largely left to market forces, although it was occasionally used to corroborate whether monetary policy was suitably tight or too loose. Most of the summit countries reduced their fiscal deficits. The glaring exception was the United States. For reasons which are still the subject of much controversy, the federal government deficit rose in 1983 to about 6 percent of the GNP,

Virtually all summits of the mid 1980s, even the late 1980s, were variations on the original sin of the United States federal deficit. European and Japanese governments and central bankers have claimed that the federal deficit was responsible for high real interest rates, the high deficits on the current account of the US balance of payments (and their own unwanted surpluses) and for the 40 percent real appreciation of the dollar to 1985. The high dollar in turn fueled the protectionist movement in the United States, and undoubtedly frightened her trading partners.

There is little doubt that the soaring dollar, and the effects on both agriculture and the rust belt industries, wrought a profound change in the United States policy on exchange rates. It threatened the vote - or perhaps the vote threatened. In any case, Mr. Baker, the new treasury secretary, thought that exchange rates should be managed to bring the dollar back to levels which he regarded as economically and politically acceptable.

Plaza and Louvre

The means by which the dollar was to be brought down, one would have thought, should have included the bete noir of the Europeans and Japanese - the federal deficit. However apart from the usual noises, Mr. Baker entered no undertaking to increase taxes or reduce spending. In September 1985, the meeting at the Plaza (hotel in New York) agreed that the main instrument would be coordinated intervention by the five central banks, but mainly the Fed and the central banks of Germany and Japan. All three would sell their stocks of dollars for marks, yen, even for sterling and francs.

²⁷. In fact the December to December consumer price index rose to 13.3 per cent in 1979.

The fall of the dollar was sharp and sustained. The participants of the Plaza agreement have proclaimed the success of concerted intervention. Examination of the evidence, however, reveals that the fall of the dollar began in February 1985, some seven months before the start of implimentation of the Plaza agreement. Inspection of the graph reveals that the dollar fell at roughly the same rate in the six months before the Plaza agreement as in the six months after. It appears that Plaza had no discernable effect.²⁸ But this in no way inhibited the participants from admiring their own perspicacity.

The fall of the dollar continued apace. By the end of 1986, fears of an undervalued dollar were rife. Overshooting and the inflationary consequences for the United States were the main impetus behind the Louvre agreement among the G7 countries in February 1987. By concerted intervention, Louvre aimed at supporting the dollar where it was, on the presumption that the rates were just right. The market however demurred. It anticipated a further decline. So the world's investors held off buying dollar bonds. Accepting their Louvre obligations the central banks of Germany and Japan bought the excess offerings of dollar paper to an amount of more than \$140bn in 1987.

The Louvre failed. In spite of sharp increases in US interest rates in mid 1987, contributing to the Wall Street crash of October 19th. In the next ten weeks the dollar fell 7 per cent against the G7 currencies (except the Canadian dollar). There had been a considerable expansion of marks, yen and, yes, even pounds in order to prop up the sinking dollar. The effects of these monetary expansions have produced many fears of inflation igniting again - and indeed we have seen that insidious upward pressure on prices in 1989 with perhaps some more to come in 1990.

In many respects the mid 1980s have been reminiscent of the other periods, 1969-72 and 1976-1978, when there was massive intervention, more or less coordinated, by the central banks to manage exchange rates. Both ushered in a monetary expansion which culminated in the two deepest recessions of the post war years. In the 1985-7 period, however, the world was saved from any substantial excess mainly by the most responsible behaviour of the Federal Reserve Board. (In particular the courageous behaviour of the Fed's chairman, Alan Greenspan, must be given great credit for squelching the inflationary policy of his predecessor.) The speedy dethroning of exchange rate targets and the low monetary growth from mid 1987 onwards are good grounds for believing (in January 1990) the United States will have a

²⁸. It is necessary to add the usual caveat; we do not know what the path would have been in the absence of Plaza. It is conceivable that the dollar was due to reverse and rise dramatically from October on, and the Plaza agreement saved us from such a continued overvaluation. In view of the expansionary monetary policy from 1985 on, this seems very unlikely, though, I concede, no impossible.

stable and low rate of inflation over the early years of the decade.

Alternative Policies of Coordination (I) McKinnon

In the Plaza and Louvre initiatives, there was, so far as one can tell, no systematic theory on which the policy was based. Policy was guided largely by domestic political considerations. The United States treasury secretary, James Baker, was reacting to the howls of rage from the rust and farm belts. Economists, however, have developed theories which support specific policy rules for international coordination. Perhaps the most persuasive model is that of Ronald McKinnon.²⁹ His basic argument is that in the modern world there are so many low-cost opportunities for people to switch between the major currencies (the dollar, Deutschmark and yen) that policies which pay sole concern to domestic money supplies are likely to produce serious disturbances and misalignments.

McKinnon suggests that we fix the exchange rates of the major currencies at roughly speaking PPP. Then the three countries should agree to a constant expansion rate for the joint money supply of all countries combined. The base case is when the three money supplies expand at the same rate (say 4 percent). But supposing that portfolio holders lose their taste for dollars and wish to acquire Deutschmarks? Then, according to McKinnon, the authorities should simply accommodate that currency substitution at the prevailing exchange rates. The Bundesbank would expand faster and the Fed would correspondingly reduce the monetary growth rate.

There is much to be said for this suggestion. But there is a fatal flaw. It offsets any transitory pressure on exchange rates brought about by changes in the demand for one currency in terms of another. This is not, however, the only cause of exchange rate strain. Many other real factors also affect market exchange rates. How can one identify simple portfolio shifts from these other real factors? I confess I do not know, even after the event let alone contemporaneously, what was the true cause of the exchange rate pressure. And we know that in response to real factors exchange rate adjustments are often the best way to adjust. Nevertheless if the authorities do want a system of fixed exchange rates, some policy similar to McKinnon's must be the basis. I suspect that the most likely result would not be fixed exchange rates but again a system of pseudo-fixity, and perhaps a decided inflationary bias similar to that which saw the end of Bretton Woods.

Alternative Policies of Coordination (II) - Williamson's Target Zones

John Williamson has attempted to avoid many of the problems of rigidity in exchange rates in the Bretton Woods and McKinnon

²⁹ See Ronald I. McKinnon, "Monetary and Exchange Rate Policies for International Financial Stability: A Proposal" Journal of Economic Perspectives, 2 (Winter 1988: p 83-103.

schemes.³⁰ First, instead of the 2 percent band of Bretton Woods, he proposes a much broader band - perhaps as much as 20 percent - within which the exchange rate could move without raising the issue of mandatory intervention. Secondly the target zone should be given "soft buffers" so that, if some unexpected shock threatened to push the rate out of the target zone "the authorities would cease defending the zone". Third the zone would be used as a "crawling" peg; this means that if the exchange rate were bumping against the lower bound for some (specified?) time, the whole target zone would be moved downwards by a predetermined amount. Fourthly there would be regular "reviews" of the real exchange rate target. Lastly, monetary and fiscal policy would be adjusted to avoid major interventions.

It is difficult to claim that the Williamson system lacks flexibility. Indeed suitably interpreted it seems little different from a free float. But it is different. It invokes intervention and "reviews" when any large exchange rate movement takes place. For example it would have induced intervention and reviews of the Deutschmark in 1977-8, of sterling in 1979-81, and of the dollar in 1981-5. What such intervention and reviews would have accomplished is, of course, another matter. Would they, for example, have undermined the anti-inflationary squeeze of the early 1980s in the United States and in Britain? We do not know the answer, but it can be said with certainty that the Williamson framework would have had some effect in modifying the disinflationary policy.

There is so much room for interpretation and dissent in the target zone proposals that it is difficult to see it as an appropriate basis for any agreed system of coordination. Financial commentators, such as Hobart Rowan and Samuel Brittan, have lavished their approval on the target zone proposals.³¹ It was reported that the proposals, in some form or other, were widely accepted as the way forward. After the collapse of the Louvre agreement, however, the proposals seem to have lost some

³⁰. John Williamson and Marcus Miller, "Targets and Indicators: A Blueprint for the International Coordination of Economic Policy", Policy Analyses in International Economics, No. 22, Institute for International Economics, Washington DC, September 1987. See also Jacob Frenkel and Morris Goldstein, "A Guide to Target Zones", IMF Staff Papers, 33, Washington DC, 1986, and Gottfried Harberler, "The International Monetary System and Proposals for International Policy Coordination", Deficits, Taxes and Economic Adjustments: Contemporary Economic Problems, p 62-98, Ed by Phillip Cagan, American Enterprise Institute, Washington DC 1987.

³¹. See Samuel Brittan "Reference ranges rule, O.K.?", Financial Times, June 2 1988. Brittan appears to think that "reference ranges" differ from "target zones" in having what are called soft edges - namely there is no commitment to intervene, only an obligation to consult.

of their glitter. I suspect that this is in part due to the recognition that we do not know much at all about the so-called fundamental equilibrium real exchange rate. Experts disagree on the concept and the measures.

In my view, if the target zone is effective, then it will give rise to massive speculative capital movements which are such a bane to any pseudo-fixed rate system. Perhaps the signals of impending devaluation are more blurred than under Bretton Woods. But a complete obfuscation of signals would be similar to flexible rates. Thus if it is effective it is bad, if it is ineffective it is otiose.

Appropriate Coordination

Is there any role for coordination ? Looking at the performance of coordination during the last decade or so would give one pause. Herb Stein has characterised most of the coordination recently as each country telling other countries how they should conduct their economic policy. Nevertheless I think there is a case for coordination. But it should have modest goals and a minimum of mandatory measures and sanctions. Clearly it is a good idea for ministers of finance to keep each other informed of their views about domestic policies, and, indeed, their views about each other's economic policy. There is a role for friendly discussion and persuasion. But there is also a great need for tolerance. Each country will have different ideas about the best way forward. None is the custodian of the "correct" model. Humble pie should be the daily diet of ministers and their advisers.

There is room for deals to be made, provided they are in the mutual interests of the parties and do not involve any binding commitments on future governments, or discrimination against any excluded party. Meeting of the G7 or summits are not the appropriate place for ministers to play political games in pursuit of maximizing strategies. Similarly they are not the occasion, as have occurred frequently in the last eight years, for grandstanding accusations of one government by the others. Quiet informed exchange of facts and opinions is the best way forward.

32

(TO BE COMPLETED - POSSIBLY PUT IN APPENDIX ?)

³². For a detailed blow-by-blow account of the Plaza to Louvre, see Yoishi Funabashi, Managing the Dollar: From the Plaza to the Louvre, Institute for International Economics, Washington DC (1988).

Chapter 5 (?)

Monetary Systems for Europe

Antecedents- The EPU and Sterling Area

Since World War II various forms of monetary cooperation have appeared in Europe. The first effective one was the European Payments Union. This was fashioned in response to the dollar shortage in the 1940s and 1950s. In the framework of Bretton Woods, it enabled the members of the EPU to have limited convertibility with one another while discriminating against the dollar (using the scarce currency clause of the Bretton Woods agreement) in their exchange controls. The EPU undoubtedly introduced a degree of multilateral clearing and trade. It was a great improvement on the bilateral deals of the interwar years. By the end of the 1950s, however, the dollar shortage was largely over - at least for the major European countries. Full external convertibility became the norm for Germany, France and the UK as well as for the many other smaller European countries. There was thus no need for the EPU.

There were other attempts to have convertible currencies within blocs. In the aftermath of World War II, Britain ran such a system in the sterling area. Some countries, generally members of the commonwealth or empire, based their currency on sterling. The currency board system was the model for such arrangements. Such boards held sterling to exchange at the fixed rate for the colonial or commonwealth currency. In practice much of the reserve was held on deposit in London. The sterling area worked quite well for some years. It fell apart however in the mid 1960s. Sterling was obviously precarious and no basis to build a currency. The devaluation of sterling in 1967 put the finishing touches to its corpse.

The Snake

The breakdown of Bretton Woods saw attempts to resuscitate it, in the Smithsonian agreement of January 1972. It soon failed. Concurrently the idea of monetary union in the EEC, mainly the brainchild of Raymond Barre, had been incorporated in the Werner Report of 1970. The basic proposal was to reduce currency fluctuations in Europe and to establish a machinery to "coordinate" economic policies. In the early months of 1972 the European countries entered into an agreement to keep their currencies in line with one another, floating as a group against the dollar. The four major currencies - Deutschemark, sterling, franc and lira - were joined by a number of minor currencies in forming the "snake". Each country had the responsibility of keeping its currency in line with the others and there were understandings, but no undertakings, that there would be assistance forthcoming in time of need. There was no arrangement to coordinate financial policies, as Barre had urged in the Werner Report. In the view of many observers, this was a fatal flaw.

Unfortunately the snake soon slid into the crises that beset all countries from 1973. The snake could not digest the rapid and variable rates of inflation together with the large capital movements. Three of the major currencies - sterling, franc and lira - defected, leaving only the Deutschemark and its satellite currencies. The snake became very bloated and permissive with few pretensions to be a fixed rate system.

The EMS and the ERM
footnote

It is surprising to find that the issue of monetary union and exchange rate coordination is not mentioned in the Treaty of Rome as amended by the Single European Act. In the Bretton Woods ambience of the mid 1950s, with inconvertible currencies paying court to a scarce dollar, perhaps one would not envisage any such goal. end of footnote.

The creators of the European Monetary System in 1978 were Chancellor Helmut Schmidt and President Giscard d'Estang. The motives for joining have been much discussed. It has been argued, for example by Samuel Brittan, that Helmut Schmidt was simply searching for a way of dealing with the flight from the Carter dollar into the mark and wanted a convenient way of diffusing the inflow to his European partners. I suspect that President Giscard d'Estang saw it as an opportunity to link France more closely to the mighty German economy, and at the same time he believed that it would give some French control over the tide of German monetary policy. And it was a step on the way to a world of managed exchange rates - a consistent theme of much French policy. Possibly it was seen as a way of reviving the ideal of a united Europe - a much tarnished ideal in the Europe of the late 1970s. It is also interesting to note that, at inception, the independent Bundesbank was against it, probably because of the unhappy experience with defending parities in the 1970s. Gradually the Bundesbank became "cautiously positive".³³ Many of the smaller countries, such as Eire, went along with the EMS idea because they conceived it as a form of help from the mighty German economy. And to the Netherlands, it was little change from their existing fix.

Whatever the motives, the leaders and their expert advisers, had noted the problems with the snake, and believed that these could be solved by creating mandatory help with intervention. This arrangement - exchange rates contained in a band and mandatory assistance - comprises the Exchange Rate Mechanism (ERM).

All the countries of the ECE are members of the EMS and are entitled to join the ERM. However they are not required to join the ERM. Thus Britain, Greece and Portugal are members of the

³³. For this assessment, see Gottfried Harberler, "The International Monetary System, The European Monetary System (EMS) and a Single European Currency in a 'Single European Market'" in "Geldwertsicherung und Wirtschaftsstabilität", Festschrift für Helmut Schlesinger zum 65. Geburtstag, ed Norburt Bub, Dieter Duwendag, Rudolf Richter, Fritz Knapp Verlag, Frankfurt, 1990

EMS but do not participate in the ERM. In common parlance it is said that these countries have not joined the EMS. Although not strictly correct, this usage is so widespread that I will occasionally use it in this book. Thus a member under exchange rate pressure could rely on short term support from other members.

In principle a weak currency country can have access to automatic and, in principle, unlimited credit through the Very Short Term Financing Facility.³⁴ This mutual support system has varied over the life of the ERM. And different countries have given it different interpretations at different times. There have been numerous complaints however about the mechanism of central bank intervention in the foreign exchange markets. In particular Germany has felt the weight of the burden of support.³⁵

The Band and Realignment

The normal requirement of the ERM is to maintain the exchange rate around the central value plus or minus 2.25 percent. Italy (until January 1990) and Spain, however, have elected to maintain their exchange rates within a plus or minus six percent band. Within these constraints, however, countries have pursued more restrictive policies. Thus the Netherlands, so closely tied in to the West German economy, has virtually locked itself to the Deutschemark. Other countries outside the EMS and ERM, but closely integrated with the German economy, have also pegged their currencies with some rigidity to the German mark: the most notable example is Austria. And it is generally true that members try to avoid straying near the limits of toleration. Rarely does a member allow its currency to bump along at the lower level of the band.

The EMS allows for the "realignment" of currencies at new central parities. In the ten years from 1979 to 1989, there have been 11 parity changes.

(Table of Exchange Rate Realignments Dollars Deficits and Trade p 217 to be inserted here)

These realignments were much more frequent in the early days when there was a need to adjust to very different rates of inflation.

³⁴. See Rainer Masera L'unificazione monetaria europea, Bologna; il Mulino 1987, for a detailed account of the institutional changes of the September 12-13 1987 EC Council of Finance Ministers. The Very Short Term Financing facility was also lengthened, and there was an agreement to monitor exchange rates and monetary conditions in each of the EMS countries (including, one presumes, the UK).

³⁵. See Helmut Schlesinger, "Zur weiteren Entwicklung der währungsspolitischen Kooperation auf internationaler und europäischer Ebene", Deutsche Bundesbank, Auszüge aus Pressartikeln, no 84, Frankfurt, November 17, 1988

From January 1987 there has been only one adjustment of the central values, the devaluation of the lira in January 1990 as it entered the 2.25 per cent band. But it is widely thought that the disparities have become so large that a substantial realignment cannot be long delayed.

The process of realignment was meant to proceed from a deliberation on the fundamentals, in particular relative growth and inflation rates. In practice the currencies have often been pushed, often precipitously, into a realignment in order to counter speculative capital movements. The market has a number of signals it can read to see when a realignment is imminent. Ministers and central bankers become agitated and leaks soon spring forth. This provides a rich nectar for the busy bees of private speculators.

Aims of the EMS/ERM

The EMS was created to achieve "a zone of monetary stability in Europe" that would eventually develop into a European Monetary Fund. What is meant by monetary stability? Certainly the basic idea was exchange rate stability. But that can be interpreted in various ways. The first is that the EMS would reduce the day to day, or weekly and monthly variations in exchange rates. Much of the casual criticism of the floating system by traders and vacationers was in terms of the difficulty of planning short term operations. The second is that there will be more long term stability in exchange rates. That is to say the exchange rates will not sink or rise consistently year in year out. The corollary is that there will be little divergence in rates of inflation - this is the so-called "convergence" objective.

There is little doubt about which is the most important goal. It is useful to reduce the variability of exchange rates, provided that one does not thereby introduce even more damaging distortions elsewhere. But, for the majority of transactions, it is always possible to buy cover in the thick forward market for short periods ahead. On the other hand it is impossible to buy any cover for inflation losses (with the rather limited exception of indexed gilts.) The long term stability of exchange rates, provided that it is not behind a barrier of controls, is clearly the most important objective. But it needs to be interpreted in a subtle way. The underlying objective is, of course, stability of prices or, at least, stability of low (circa 2 percent) inflation. Then to achieve, say, zero inflation in the long run may require a long term appreciation against the dollar or even against the European Currency Unit (a basket of European currencies) or against the SDR (a basket of the five most important currencies). In short if the world or Europe or even Germany goes on an inflationary, or deflationary, binge long term stability of the exchange rate is a recipe for importing such price movements.

EMS and German Hegemony

This discussion highlights a central issue: who actually runs the EMS/ERM? Like most multinational institutions, the EMS

was set up formally as an institution with equal participation by all members.³⁶ National prides demand no less. In a democratic institution all nations were to be equal. The reality, however, was quite different. Some were more equal than others. In the event Germany became the price leader and in effect dominated policy. This German hegemony has been much resented by France and Italy, among others. Because of their reluctance to realign, French financial policy is largely determined by the Bundesbank, over which the government of France has virtually no control and little influence. Indeed, because of the statutory independence of the Bundesbank, the German government has only influence not power to affect monetary policy - so even if France brought pressure to bear on the German government, such pressure would be much dissipated by the time it found its way from Bonn to Frankfurt. Bundesbank ruled.³⁷

This should have surprised no-one. Germany was the biggest and richest economy with the most liberal markets. The German reserves were unmatched, and, corresponding to its role as a major exporter of goods, Germany had become an important exporter of capital. Above all the Deutschemark was rightly seen as the most inflation-free of all the major currencies (including the dollar).

The Bundesbank enjoyed credibility as the guardian of monetary propriety. The other countries believed that by joining the ERM they would also acquire creditbility for their currencies and credibility for their policies. But this would be possible only if the Bundesbank were seen to be in a position to maintain its responsible policies. And it was widely accepted that the Bundesbank's independence, as well as the abiding fear of inflation in Germany, was a critical element of that credibility.

Here was a central dilemma. In order to have more "democratic" control of the EMS policy, what the French call symetry, it is necessary to allow French, Italian etc due

³⁶. The institutions of Bretton Woods, however, did not accept the system of equal voting. The votes in the IMF and World Bank were according to the share holdings of the participating governments.

³⁷. The dominance of the Bundesbank is a common theme of most contemporary accounts of the EMS, see for example Jaques Melitz, "Moetary Discipline and Cooperation in the European Monetary System: A Synthesis", in Francesco Giavazzi, Stephano Miscossi and Marcus Miller (eds) The European Monetary System, Cambridge University Press, London 1988. This view has been disputed by Michele Fratianni and Jurgen von Hagen in "German Dominance in the EMS: the empirical evidence", Open Economies Review, Vol.1 No.1, p67-88, Kluwer Academic Publishers, Dordrecht, 1990. Primarily from analysing interest rate policies, they argue that the Bundesbank policy is largely independent of the policies of its fellow ERM countries. But that does not mean that the Bundesbank dominates the others. France and Italy, through realignments and financial controls, can diverge from the Bundesbank line if they so wish.

influence in formulating German monetary policy. But such influence would clearly erode and eventually destroy the independence of the Bundesbank on which the whole edifice of credibility is built.³⁸ Thus if the EMS is to achieve its major function, it must be dominated by the elite and unelected Bundesbank, and democracy be damned ! Obviously such a concentration of power has caused much tension. For example in January 1987, because France differed so much with the Bundesbank's restrictive policy, France refused to intervene when the franc fell to the floor. In the event the Bundesbank, fearful of wrecking the ERM, bought francs to put in back in the fold.

The resentment of German power and influence is a worrying resuscitation of an old theme of European politics.

As we shall see, this fundamental dilemma is inherent in any system similar to the EMS. And it gives rise to similar types of political tensions. There is little to be done that would resolve the inconsistencies of objectives. One ideal way would be for France, Italy etc to acquire, in their own right, a credibility as convincing as that of the Bundesbank. Not only is this idle speculation, but of course there would be no need for an EMS for achieving the convergence of inflation rates. Then there would be a possibility for more non-German participation in policy. But still the union would be dominated by Germany. This has led some commentators, among whom one must number several Presidents of France, to suggest that the only way to solve the problem of German monetary hegemony is a return to a gold standard. But later I shall suggest other solutions.

It may appear that, as the leader of the EMS, Germany has substantial freedom to pursue its own monetary and fiscal policy. It looks like Deutschland uber alles - or at least alles participants in the ERM. But, paradoxically, Germany is also a prisoner of the ERM. Because of the reluctance to realign, Germany is prevented from pursuing a monetary policy that the Bundesbank believes is consistent with its obligation to avoid inflation. Just as in the late 1960s and to August 1971, the United States complained that, as the anchor of the Bretton Woods system, it alone could not devalue the dollar against the mark, so, as the linchpin of the EMS, Germany cannot unilaterally revalue the mark against its main trading partners in the ERM. The Bundesbank has some apparent freedom to raise interest rates, but pressure to prevent such a rise from France and Italy is as likely to be as intense as the resistance to realignment. Germany is hardly the dog that wags the ERM tail. As Karl Otto Pohl must know, it is the tail that dogs the wag.

³⁸. The central banks of France and Italy, like the Bank of England, are simply creatures of the government. In Europe only the central bank of Switzerland has an independence approximating that of the Bundesbank.

It is extraordinarily difficult to make assessments of the performance of the EMS that command everyone's confidence. The normal method of judging the EMS is to pursue two sorts of comparisons. First one may compare what happened to participants before 1979 and after - a time series approach. Secondly from 1979 a comparison may be made between those countries involved in the ERM and those which stayed aloof - a cross section approach. The time series has the advantage that one can compare the same country, with all its many constant individual characteristics, before and after. But of course countries would have changed their performance in the absence of the EMS, and consequently we do not know how much of the change to attribute to the ERM membership. The cross section comparisons suffer from the fact that countries will vary in performance considerably, and participation in the ERM will be one factor among many others. Nevertheless these two approaches do give some basis for judging performance. A third - the modelling approach - has been tried by Patrick Minford. In order to produce a standard for comparison, he models what would have happened in the absence of ERM membership, thus giving a "counterfactual" account against which to compare the real record.

One quite remarkable result of these empirical enquiries is that they all tell broadly the same story. First, let us look at exchange rate variability. The most obvious point is that bilateral exchange rate variability between ERM participants is less than in the years before 1979. This was one of the aims of the EMS and it has been achieved. This does not mean, however, that there has been any gain in stability of effective exchange rates or that exchange rate variability with other OECD has not increased. Indeed the second result confirms that, whatever stability had been achieved in bilateral rates was more than offset by increases in variability with respect to non-ERM currencies.

The summary on variability of nominal rates is really quite simple: the ERM provided some intra ERM stability which was more than offset by increased external variability. And this result carries over to real exchange rates. Thus the increased external variability in nominal rates was not fully offset by differential rates of inflation. All these conclusions held whether one

³⁹. There is an enormous and rapidly growing literature on this subject. My selected reading would include Michele Fratianni, "The European Monetary System: How well has it worked?", in Dollars, Deficits and Trade, ed James A Dorn and William A Niskanen, Cato Institute, Washington DC 1989, Roland Vaubel, Comments on Manfred Wegner, "The European Monetary System: A Regional Bretton Woods or an Institutional Innovation" in J. Vosgerau (ed) New Institutional Arrangements for the World Economy, Springer-Verlag, Berlin 1989, and Patrick Minford, European Monetary Union and 1992, Selsdon Group Special Paper, London 1989.

compared experience before 1979 with that after, or whether on analysed the ERM countries compared with those outside.⁴⁰

The Performance of the EMS - Inflation, Trade and Growth⁴¹

But one of the abiding claims for the EMS is as a discipline on inflation - the participants acquire the credibility of the Bundesbank. Perhaps so, but it is not evident from the statistics.

In the ERM countries the (weighted) average inflation rate decreased more slowly than in the rest of OECD countries. Even confining the discussion to Europe, the decline in the ERM countries was less than that in other OECD European countries.

Furthermore the inflation rate in the ERM was, in 1986, rather higher than that in the other OECD countries. From 1987 on, these relationships become blurred by the sterling shadowing of the mark and, overall, the various interventions and monetary policies induced by the Louvre and other "agreements".

What about the variability of inflation. Contrary to assertions frequently made by the pro-EMS lobby, convergence on inflation took longer in the EMS than in the rest of the OECD. Furthermore over the life of the ERM (to 1986) the dispersion of inflation rates has been much larger in the ERM countries than among the major OECD countries. Indeed, comparing the 7 years before with the 7 years after 1979, among ERM countries the dispersion of inflation rates increased, whereas in the other OECD countries the dispersion fell.

The argument that stability of nominal bilateral exchange rates should, according the EMS apologists, promote trade by reducing the exchange risk. The growth of trade within the ERM compares, however, most unfavorably with the growth of trade with non-EMS countries.⁴² The (unweighted) average of the five old

feeble | ⁴⁰. The bases for these statements is contained in Horst Ungerer, Owen Evans, Thomas Mayer and Philip Young, The European Monetary System; Recent Developments, International Monetary Fund, Occasional Papers 48, Washington DC 1986. Note that Ungerer's analysis ceases with 1985, so it covers the period when the major countries were not conducting massive intervention, and in particular Britain was not shadowing the deutschmark. From 1986 onwards the results have been confounded by many attempts to influence the dollar, yen and deutschmark.

⁴¹ The best summary of all the experience on inflation and growth rates is to be found in Roland Vaubel, Comment on "The European Monetary System: a Regional Bretton Woods or an Institutional Innovation" in J.J Vosgarau (ed) New Institutional Arrangements for the World Economy, Springer-Verlag, Berlin 1988

⁴². See Paul de Grauwe, Memorandum in : Memoranda on the European Monetary System, of the Treasury and Civil Service Committee, Consequences of UK Membership of the European Communities, House of Commons, London 1985.

EMS members growth of trade with one another from 1979 to 1984 was 0.6 percent compared with 4.1 percent with non ERM countries

Finally growth. The growth of real investment and GDP was much slower in the ERM countries than in the other OECD countries. And after 1979 growth and investment declined more than in the other OECD countries: and in European non-EMS countries investment growth actually increased.

(Put Table No. 1 from de Grauwe (1987) in here)

The EMS - Modelled Results

All these conclusions are from the actual historical record. And they are properly subject to the argument that we do not know what would have happened in the absence of the EMS in the years following 1979. It might be suggested that, if the EMS had not been created the performance of the ERM countries would have been much worse. Although there is no irrefutable way of dealing with such allegation, Patrick Minford has performed a great service by modelling the EMS in its world context.⁴³ The results are complex but clear. As Minford puts it: "...the EMS system gives somewhat poorer overall stability than floating to the 'dependent-currency' participating countries - that is France, Italy and the UK...the reason...is that the EMS, with its deflationary bias for the dependent-currency countries, causes them to over-react in a deflationary direction to the shock (of 4 percent increase in monetary growth for two years)."

The (shock) increase in monetary growth would be associated, in the absence of the EMS, with a fall in the nominal and real exchange rate. There is an increase in the inflation rate, but demand increases and output and net exports increase. In the EMS the constraint on the movement of the exchange rate means that prices and wages increases cause an appreciation of the real exchange rate. Thus the dependent countries suffer from the reduction in net export demand due to the real appreciation and from an increase in inflation. These are, of course, the transitory effects. Ultimately the dependant country must either devalue (realign) or deflate, in order to counter the effects of the original monetary expansion.

Minford's model does seem not to conflict with the descriptions by Vaubel, Fratianni etc. The EMS induces a perverse appreciation of the real exchange rate and induces unnecessary output losses in adjusting to the monetary shock. On the other hand countries that are not Bundesbank dependent gain somewhat from the overvaluation of the French franc and Italian lira etc. The obvious example is Germany, but also the United

⁴³. The results are to be found in A. Hughes-Hallet and Patrick Minford, "The European Monetary System - does it achieve its aims", Konstanz Seminar on Monetary Theory and Policy, 1989, Liverpool University, Liverpool. The Liverpool model of the world economy has been used extensively to explore many issues of fiscal and monetary policy.

States and Japan are able to secure some of the markets of France, Italy etc.

EMS adherents will, of course, argue that these model runs are not really relevant, since the EMS will be more likely to prevent a monetary shock than if one is outside the ERM. Such an allegation requires more than assertion to give it credibility, especially in view of the behaviour of the United Kingdom during the shadowing of the Deutschmark in 1987-88. Indeed, on that occasion "joining" the ERM club actually caused the monetary explosion.

The EMS and Persistence of Overvaluation

Granted that there is more inertial inflationary pressure in France and Italy, it is possible that this Minford mechanism explains some part of the chronic overvaluation of the franc and the lira. And this overvaluation has occurred in spite of the use of exchange controls, on occasion most restrictive controls, during the life of the EMS. It is never easy, however, to demonstrate that an exchange rate is above the value that would emerge on a free market, but the persistence of the large German current balance of payments surpluses with respect to its EMS participants does suggest that the overvaluation has been chronic and substantial.

I suspect that the reason must be sought in the lore of politics. There is no doubt that, politically, realignment, however justified, is viewed as a policy failure. The long reluctance of politicians to concede to a devaluation contributes to chronic overvaluation of the dependent currencies. But there is the additional question: when they do devalue, why is it that the devaluation is such that the currency is just about brought into line with its deteriorated purchasing power? Why do not they devalue sufficiently so that, on the average up to the time of the next realignment, the currency is not persistently overvalued? If, for example, one examines sterling's devaluation in 1949, most authorities were clear that in PPP terms it was overdone (from \$4.20 to 2.80). Sterling was then undervalued for some years. At the time it was thought that this was an appropriate policy, since one had to ensure that the markets would certainly not expect another devaluation to follow for many years. So it turned out. One suspects that the reluctance of ERM members to sharply devalue is that the central banks believe, rightly or wrongly, that such devaluations would signal a country's choice of a lax policy on inflation. The country would be thought to be not merely making up for past laxity but also preparing for new monetary expansions. If so the persistent overvaluation of the currency is a high price to pay for such a reputation and credibility.

Germany and Credibility

One of the oft-repeated arguments for ERM membership is the "credibility" argument - members latch on to the stability of the Bundesbank. The view that by hanging on to the tails of the Bundesbank members reduced the costs of disinflation has been discredited by the data. Countries outside the ERM did rather

better. But we must ask the additional question: what does Germany gain from being in the ERM ?

Initially the Bundesbank strongly opposed the EMS. In one of the rare capitulations of the Bundesbank to political pressure, Helmut Schmidt foisted it on them. There is no doubt that Schmidt saw considerable political gains to be garnered from polishing up a very tarnished image of the Common Market. The relaunch of European integration was one of the achievements of both Schmidt and Giscard d'Estang. Of course the creation of a free-trade area and the removal of controls on capital and labor flows could have gone ahead, I believe rather more easily, without the apparatus of the EMS. But it was an important political symbol. As the Bundesbank surmised however, the economic benefits to Germany were, and remain, much less clear.

The Bundesbank's responsibility was defined in its constitution as the defence of the domestic value of the mark. It had never relished the role of the mark as a reserve currency. The demands on the mark as a reserve currency may often be inconsistent with the policy of domestic stability. But the emergence of the mark as a one of the three great currencies meant that it could not avoid some of the problems of being, for example, one of the main custodians of speculative flows out of the dollar. In such circumstances, the EMS might be seen as a way of diffusing those flows to other members. However, the other members of the EMS (excepting the Netherlands) maintained not merely exchange controls but also a formidable battery of other credit and capital regulations which were designed, inter alia, to ward off such speculative flows. Ironically the non-ERM member, the United Kingdom with its wide open capital markets in the 1980s, that was, after Germany, the next most important recipient of speculative flows. If the price of the ERM was continued capital controls, then German was, on this score, a net loser.

The Bundesbank behaviour with the EMS is almost certainly different from the policy it would have pursued in the absence of the EMS. The pseudo-fixed system ensures that, if Germany pursued an expansionary monetary policy, the inflationary costs would be more spread over the other members than if there was a floating rate regime. Thus there would be less incentive for the Bundesbank to keep money tight, and more incentive to inflate.⁴⁴

This raises expectations of a higher average rate of inflation throughout the EMS. Not only does Germany not gain from her membership, but also the credibility gain is more disputable.

⁴⁴. See Francesco Giovazzi and Alberto Giovannini, Limiting Exchange Rate Flexibility: The European Monetary System, Cambridge, MIT Press 1989.

In general, one may conclude that the fears expressed by the Bundesbank, and over-ridden by Helmut Schmidt, were well founded.⁴⁵

A Fundamental even Fatal Flaw in the EMS

In the old gold standard system, there were automatic mechanisms which, in response to some external event such as a physical calamity or to some internal "error", would restore the equilibrium of the system. For example the loss of an a country's main grain crop would give rise to increased prices and net imports which would be financed in part by exports of gold. This would reduce the reserves and the money stock to bring the price level back into line with the rest of the world (where both gold reserves, money stock and prices would rise). It was a self-correcting system.

There is no inherent self-correction in the EMS. On the contrary, in its pure form the system will provide perverse signals. In order to demonstrate such perversity, I fear that we must specify more precisely how an ideal EMS works. Of course such an ideal will not include either exchange controls or, more important, those barriers and restrictions which are imposed on domestic institutions which prevent or inhibit the residents choosing freely the denomination of their assets and debts. I shall therefore assume that, in this broad sense, there are no exchange controls. Since the objective of the EMS was to provide an "area of stability", let us assume that the exchange rates between participants are actually fixed for a specified period, then realigned. The actual period during which they can be presumed fixed will vary according to the divergencies in inflation rates - the smaller the diversion the longer the time between realignments. Let us suppose that the period is one year.⁴⁶ If everyone knows that exchange rates are fixed for that year, then nominal interest rates on financial instruments which originate and mature in that year will be approximately the same for all participants in the ERM. Arbitrage will ensure this near equality. For if the rate of interest in Italy substantially exceeds that in Germany, then it will pay all asset holders to switch to lira, to borrow in Deutschemarks and invest in lira for that period of fixity of the lira-mark exchange rate. This is no more than the application of the "law of one price" to financial instruments. (In this case, because of the fixed rate of exchange, the cost of forward cover for the transaction is zero)

Thus the EMS forces countries to have the same nominal interest rates. If, however, Italy is inflating at a rate of 7

⁴⁵ On the effects of the EMS on Bundesbank behaviour during the Plaza and Louvre accords, see Yoishi Funabashi, Managing the Dollar: From the Plaza to the Louvre, Institute of International Economics, Wahsington DC (1988).

⁴⁶ The reductions in the dispersion of inflation rates over the period 1985-9 have resulted in a period of three years, up to January 1990, when there were no realignments.

percent and Germany at a rate of 2 percent (both over the relevant period of fixity), then there is a problem of perversity. With the same interest rate at, say, 5 percent, the real rates of interest for Italy is minus 2 percent and for Germany plus three percent. Thus Italy will have an expansionary monetary policy, while Germany will pursue one of restraint. But this will exacerbate inflation in Italy and yet restrain further the already low inflation in Germany. This is the opposite of "convergence", namely it induces divergence.

Realignment Dynamics

Such perverse forces cannot continue for long. As the date, assumed known and fixed, for realignment approaches, so the interest rates, for shorter and shorter maturities, will reflect the expected depreciation of the lira. It will pay speculators to borrow lira and buy mark financial asset to cash in on their appreciation at the realignment. This will cause lira interest rates on maturities that cover the realignment date to rise well above corresponding German rates; the difference will reflect the expected change in the exchange rate. When the maturity is overnight corresponding to the realignment, lira rates of interest may rise to hundreds of percent. Of course the interest rate differential is at last in the right direction; the high inflation country with the high rates and the low inflation country with the low ones.

It is unlikely, however, that these interest rates would be the pattern which would be chosen by a Minister of Finance who, unconstrained by membership of the ERM, was pursuing a domestic disinflationary policy. But, more important, after realignment and with Italy still inflating at 7 percent and Germany at 2 percent, the system reverts again to the status quo ante. With the exchange rates fixed for the next year, Italy and Germany will have the same interest rates and the same perverse effects on monetary growth.

This sort of effect can be observed in the Lawson decision to peg sterling to the mark at 3.00 in early 1987. With British interest rates at about 5 percent above those in Germany, a fixed exchange rate gave rise to a great influx of capital. This put considerable pressure on British interest rates and, in spite of the manifest inflationary pressure, they were brought down to 7.5 percent. Although, as we shall see, the authorities allowed the mark-sterling rate to rise from March 1988, this was an overshoot before the inevitable high interest rates and devaluation (or "realignment").⁴⁷ The details of that story will be told in chapter 7.

⁴⁷ I discussed this process in Britain's Economic Renaissance (Oxford 1976), and, in application to the current situation in Britain, in articles in the Financial Times April 6th 1988, The Times, June 3rd 1988, and finally in the Independent, "Money on a Roller-Coaster", July 14th 1988. By the end of July, I was asked to keep quiet and cease publishing. I did.

Uncertain Realignments and Moving in the Band

This model of the ERM is a caricature. It delineates, even exaggerates, the strengths and the weaknesses of the pure EMS. But as a working institution the EMS is anything but pure. For example the exchange rates can move within the band, so that in principle there can be a 4.5 percent devaluation (or 12 percent in the case of Spain). Participant countries however usually try to keep their rates somewhere in the immediate vicinity of the central rate, presumably because any bumping against the limits would signal the likelihood of a realignment. This brings us to the assumptions we made in the model, namely that the time of the realignment is known with certainty. This is not the case. Although they are not complete surprises, the realignments of various dimensions can be predicted only with large uncertainties attached. It is however usually quite easy to predict the direction of the realignment - the French franc and the lira will go down against the Deutschmark. Thus the shadow of devaluation is cast forward in time and increases interest rates in Italy relative to these in Germany. But again whether that devaluation-shadow effect is consistent with what a prudential Finance Minister would require to cope with domestic conditions in Italy is another matter.

One may reflect that it is odd that it is the uncertainty of exchange rates in the ERM that makes it possible for Italy to pursue disinflationary monetary policies and for Germany to avoid deflationary policies. The EMS was to be an island of stability and certainty in a sea of floating flotsam. But it is only the uncertainty that keeps it above water.

Exchange Controls and the Consequences of Freedom

Participants in the ERS can pursue deviant interest rate policies if they are protected by suitably high controls. Behind the controls the authorities can increase interest rates, knowing that they can regulate the import of capital. Such exchange controls have been characteristic of France and Italy during the life of the EMS. They are required to be eliminated by mid 1990. Indeed overt exchange controls have been substantially reduced over the years 1987-89. As one would expect the Eurofranc and Eurolira market rates have more closely approached the rates of interest on domestic markets in France and Italy. And in January 1990 Italy embraced the 2.25 percent band. All this suggests that the equality of nominal interest rates will become more of a reality of the ERM.

In 1990, it has been suggested by Messrs Francesco Giavazzi and Luigi Spaventa that now overt exchange controls have been eliminated among the main participants of the ERM, governments cannot risk a realignment.⁴⁸ Any hint of a realignment will cause such speculative capital flows, untrammelled by controls, that governments will not be able to maintain domestic stability.

⁴⁸. See Francesco Giavazzi and Luiga Spaventa, "The 'New' EMS", CEPR Paper No. 369, Centre for Economic Policy Research, London, 1990

It is conceded that there will be downward pressure on real interest rates in the inflating countries and this will push up inflation in the short run. But it is argued that the appreciation of the real exchange rate, together with rigid nominal exchange rates, will so influence expectations that business men will become convinced that they cannot raise prices and that they must resist trades union pressure. Thus will inflation be conquered, convergence will be complete and the old central rates maintained.

This argument may well be correct. It leans very heavily on expectations all accommodating to the fixed exchange rate. We know very little about expectations and they may behave in the manner the authors claim. One must have grave doubts that any such adjustments occur. We have a long historical record - Britain in 1926-1931 and in 1987-90, Chile in 1979-83, and many other examples - to show that too high a real exchange rate distorts the economy, raises the relative prices of domestic goods and depresses the prices of traded goods, rather than defeats expectations of inflation. Furthermore, for their system of fixed parities to be validated, it must mean that over some period the inflationary countries must inflate at a value less than that of Germany. For example, if Germany's inflation rate is 2 percent and Italy has been inflating for, say 3 years at 6 percent, then to recover lost ground in the next three years, Italy must have a deflation of 2 percent for those years. Possible, perhaps, but hardly plausible.

Similarly it appears that the Italian authorities, while conceding that the lira interest rate is constrained by the ERM to be negative in real terms and a powerful stimulus to demand and inflation, would be simultaneously intoning their absolute opposition to "long run" inflation as manifest in their determination to hold the nominal exchange rate. It is analogous to the drug addict who swears off drugs, but only after the next fix. I find it difficult to believe in such an inconsistent package of policies. It will be accepted only by the most credulous.

Messrs Giavazzi and Spaveta are really describing a knife-edge type of equilibrium. Suppose for example that Italy and Germany have converged so that they have the same rate of inflation. Then they may comfortably have the same nominal and real interest rates. There is de facto union, and exchange rates can remain fixed. Everyone may well be convinced that they will remain so and expectations will be validated. The ERM will be required to cope with incidental increases in the demand for money by one country and the reduction in demand by another country, by maintaining the same interest rates. But this state of perfection is hardly of interest. We know that we cannot identify all the trials and tribulations and offset them to produce such a model of stability. What we need is a system that will deal with perturbations and shocks, such as monetary mistakes and natural disasters. Suppose, for example, someone makes a mistake and there was an accidental increase in the Italian inflation rate. Then, alas, we have all the inconsistencies and perversities discussed above.

Covert Exchange Controls

Although overt exchange controls have been largely eliminated in the EMS, this does not mean that there is complete or even substantial freedom to move capital and currencies over borders. Continental Europe has substantial control over national banking systems and over financial institutions. These are most apparent in the cartel structures that are characteristic of banking and finance in France and Italy. French bankers conceded, albeit privately, that their their high margins and high costs are due to a cartelized market which the government continues to sanction because it makes it easier for government to maintain covert control.⁴⁹ Similarly it is well known that Italian banks have extensive cartel arrangements, and that government controls percolate throughout all large banks.

Perhaps more surprising, however, is the extent of covert exchange controls in Germany - apart from Britain and perhaps the Netherlands, the most liberal member of the Community. German insurance companies, which control probably more than 70 percent of long-term savings, are not permitted to buy non-Deutschemark denominated assets. By regulation they must have a complete currency match for their obligations. They can only hold 5 percent of their portfolio in equities (and necessarily mark equities). In a corporatist society, the purpose of these regulations, although ostensibly prudential, is to ensure a recycling of capital, usually via the intermediation of the banks, as loans to the large firms of German industry. Similarly there are restrictions imposed on foreigners (that is non citizens of the Federal Republic) holdings of Bundesbankobligationen.⁵⁰

Whatever the reason for these restrictions, the effect is to prevent the free flow of capital within the Community. They act as exchange controls, and perhaps even more effectively than the conventional exchange controls, in preventing any mass flight of capital or in stemming the tide of an inflow. Even more important it their role in maintaining a corporatist system in

⁴⁹ See Guy de Jonquieres, "The break with French tradition", Financial Times January 17th 1990. He quotes a foreign banker as saying "The authorities have'nt bitten the bullet by signalling to the local market that it has to compete internationally". France's high tax on capital income may well encourage a larger outflow over the longer term.

⁵⁰ It may appear surprising that these covert exchange controls have not played a more important role in Treasury and other discussions about the EMS. In Britain's Economic Renaissance, Renaissance, I talked about the "restraints on the free flow of capital" but I was not aware of the true state of affairs until 1988. Most commentators ignore them and just remark on the remarkable reduction of exchange controls - with no great effects on the EMS. It is noteworthy that, at the summit meeting in Madrid in June 1989, Mrs Thatcher and Sir Geoffrey Howe, when agreeing to join the ERM, explicitly required that these regulations and controls be eliminated.

the continental members of the Community. But that is another story.

Conclusions

The various forms of exchange rate regimes which have been practised in Europe since World War II have all depended on exchange controls, both overt and covert. So far the EMS is no exception. Unlike the other regimes, the EMS has persisted for more than a decade and has not yet collapsed. On the contrary it is planned as the basis of a Monetary Union of the Community. The evidence suggests that the EMS has not been helpful in reducing inflation rates, in promoting overall exchange rate stability, in securing high growth and investment, and in stabilizing interest rates. In part this may be due to the perverse incentives generated by the ERM. The essence of the ERM prevents automatic adjustment mechanisms in response to shocks, and induces perverse oscillations in monetary policy. Ironically the ERM mechanism works well when there are the same inflation and interest rates in all countries - but then why bother ?

Chapter 6

Chapter 6

The Lawson Years

The Medium Term Financial Strategy

As the EMS started on March 13th 1979, Britain had to have an election within the next three months. The economy was in a parlous state. Neither party had any intention of joining what most thought to be an offspring of a snake. Experience since the breakdown of Bretton Woods showed that it was extraordinarily difficult to maintain nominal exchange rates at levels which differed substantially from the market. The massive outflows and inflows of money in 1975-77 had made their point.

The first Thatcher government saw its first main task as that of securing financial stability. In particular the high inflation, at an underlying 15 percent, had to be brought under control. The main instruments for bringing inflation under control were evident from the beginning; the rate of growth of the money supply, which in the first half of 1979 had been running at some 16 per cent, had to be brought down. Mr Lawson was one of the main architects of the document that set out Britain's Medium Term Financial Strategy. This envisaged a steady downward trend in the rate of monetary growth (of M3) and a decline in the fiscal deficit that was consistent with the

monetary targets. If anyone suggested that Britain should tie itself through a fixed exchange rate in order to reduce inflation, I can attest that the suggestion did not get very far.

To the modern reader this may seem odd. In the many attempts that have been made to control inflation (albeit near hyperinflations) in Latin America, in Israel and now in Eastern Europe, the conventional wisdom is that the exchange rate must be controlled and usually that it should be fixed. But even in France and Italy in 1979-81 where inflation was in the teens, a fixed (or strictly pseudo fixed) exchange rate was thought to be a central plank of a disinflationary policy. It was a way of converging on the low inflation rate of Germany. Why not in Britain? And indeed why not in the United States?

The first answer is that while an exchange rate fix may be useful for bringing really high inflations down, it is clearly not a necessary or even useful condition for controlling inflation rates of circa 10 to 20 percent. The disinflationary policy with a flexible exchange rate will have lower costs than the policy of fixing the rate. (The evidence on the higher growth rates and lower inflation rates of the non-ERM countries reviewed in chapter 5 is relevant here.) The argument, however, may be that one needs an anchor for the currency in order to ensure that the appropriate monetary squeeze is properly applied; one can, so to speak, trust the monetary authorities to stick to an exchange rate target whereas, because of political pressure it is very difficult for them to pursue the appropriate policy of monetary restraint. That view is clearly not merely discredited but shown to be perverse by experience both in the UK and the USA. As we saw, both sterling and the dollar soared to new heights as the monetary squeeze took effect. If an exchange rate fix had been employed in the UK, then the monetary squeeze would have been quickly reversed in order to stop sterling rising above its upper bound. The fix would have had the opposite effect on monetary policy to that which was intended.⁵¹ The inflations would have been refueled rather than doused.

Secondly, and this is peculiar to the UK not to the USA, Mrs Thatcher first major act in international economic policy was to abolish exchange controls in 1979. No such liberalization would

⁵¹. I confess to being most dubious about the advantages claimed for an exchange rate fix as a necessary element of a monetary reform program. It has failed in Argentina, Brazil and Chile in the 1980s. The seemingly effective case in Israel turns out, on examination, to be quite different from appearances. Israel fixed to the dollar in 1985, but this was just at the peak of the dollar value. From 1985 the dollar fell precipitously, and this ensured that the effective exchange rate of the shekel also fell. The nominal fix was not an effective fix. By 1989, however, the inflation rate of Israel had risen again to 20 percent. Bolivia is also a case where the exchange rate fix appeared to work well - but again it was over the same lucky time period. The essential element in both, albeit partial, successes was the reduction in the monetary growth rate.

have been possible if Britain had been on a fixed exchange rate regime. And since the effects of the abolition of exchange controls were unknown (and incidentally turned out to be quite different from forecasts), it would have been folly on a grand scale to give any commitment to any fixed regime. In addition, it was widely argued, Britain was a large oil producer, and one could not anticipate, nor be expected to counter, the effects of variations in the oil price on the exchange rate. For my part, I doubt whether the oil-price argument was entirely valid, or if so was at all powerful.⁵² Most observers, however, believed that oil was most important, and there is no unequivocal evidence to discredit that view. So it was prudent to eschew the ERM and all its uncertainties.

The Role of the Exchange Rate 1980-1982

The exact role of the exchange rate in economic policy is subject to many subtle interpretations. During this period, however, there was a general attitude, albeit with different degrees of emphasis, to the exchange rate which was broadly shared by the civil servants and ministers. First the exchange rate was not a target for policy. This applied to the whole range of instruments: interest rates, funding operations, and fiscal measures. All instruments were concentrated primarily on domestic targets and indicators. The exchange rate was left very largely to market forces. This did not mean that there was no intervention at all, or even that it was restricted merely to smoothing operations. The Bank of England did, on occasion, intervene in markets quite heavily, but virtually always sterilized through the money markets. The prime purpose was to prevent what was usually called a "free-fall" in the exchange rate having an effect on the market for gilts. But there was no target rate. Indeed from the Budget on March 11th over the next nine months (to Dec 11th) the effective exchange rate fell about 10 percent.

Although the exchange rate was not a target, it would have been foolish simply to ignore it. The exchange rate may tell us something about the severity or laxity of monetary policy. This may be a useful indicator when, as sometimes happens, the usual indicators of monetary growth are badly distorted or, for some reason, unavailable. Such conditions occurred in 1981. The deregulation of financial markets caused a great growth of M3 and other broad money aggregates - the targets of the MTFs. And there was industrial action by the civil service which caused long delays in the production of the monetary statistics; but of course the exchange rate was readily available.

So the exchange rate loomed large in the discussions of policy. The decline in sterling's dollar exchange rate (about 18 percent from March 10 to Sept 29) was the primary reason for

⁵². For arguments on this point see my Britain's Economic Renaissance: Margaret Thatcher's Reforms 1979-1984, Oxford University Press and American Enterprise Institute, London 1986, particularly p.142, and 160 et seq.

raising interest rates from 12 to 16 percent. In retrospect the squeeze was overdone. The steep decline in narrow money (both M1 and non-interest bearing M1) in the third quarter of 1981 undoubtedly caused a marked slowdown in the recovery in 1982. The exchange rate had misled us into the belief that the monetary laxity was far greater than it was in reality. As for the reasons for such a misleading indicator, it was like "rounding up the usual suspects". First the United States had embarked on a severe monetary squeeze which made the normal dollar comparison particularly wayward, secondly there were rumours about the price of oil, and lastly, as reflected in the opinion polls, the government appeared to be distinctly shaky. All had a depressing effect on the exchange rate, which had nothing to do with domestic monetary policy.

From September 1981 through to October 1982 it appeared that the authorities were on an exchange rate target of sorts. The effective rate remained in the relatively small range 90 to 92 over this whole period (1975=100). But from the overt statistics it could have been just as readily asserted that Britain was on a Friedmanian path of stable monetary expansion. Monetary growth (Mo) remained in the 2 to 5 percent range. Indeed all the monetary aggregates were in the target range for the financial year 1982/83.

Election 1983

Not only was Britain not on an exchange rate target, I believe that everyone, except the most absurd ideologists, knew that such a target, or even the market perception of such a target, might well be disastrous in the environment of a closely fought election. The scenario was stark. The Labour party platform was clearly to resocialise Britain. Inflationary expansion was one of its main planks. Increased taxation, renationalization, and a substantial spread of controls were among the main instruments for change. And various promises had been made to reintroduce exchange controls and bring back much of the capital that had fled the country so that it could finance job creation at home.

Such a program is a warning to any asset holder to get out while the going is good. The warning is the more to be heeded, the higher the Labour party scores in the opinion polls and the more it appears that the policy is expropriatory. This is a great temptation to Labour. It appears that the more socialist the policy, the greater the capital flight. If the government were on an exchange rate target, it would have to raise interest rates - probably very sharply. But this would squeeze business, lower output and probably throw more on the dole. Not the sort of scenarios in which governments are reelected. The alternative of avoiding the monetary squeeze and letting the exchange rate find its own depreciated level does avoid the election-induced recession.

The government followed this strategy by letting the exchange rate fall 15 percent both in nominal and real terms from

November 1982 to March 1983.⁵³ Interest rates rose 2 percentage points, Mo's growth rate was reduced, and this was enough to ensure the gentle but persistent disinflationary pressure. In the event, the run up to the election was smooth. Although it has been claimed (for example by Sir Terence Burns) that devaluations do even more political damage than monetary squeezes, the 1983 election discredits that view.⁵⁴

It appears that a socialist opposition has an enormous advantage in inducing capital flight, interest rate increases, and wrong footing governments economic policy. But, like most things, it can be carried too far. True the more rabid the socialist program, the greater the capital flight. But, of course, the more extensive the expropriation, the less the electoral support. If its purpose is to maximize the probability of gaining power, then the Labour party will pitch its program to balance this reduction in the vote against the gain in support derived from the perversion of the government's policy. In the events of 1983, I believe that the Labour party, largely because of internal tensions, badly miscalculated the trade-off. Their program of old fashioned unreconstructed socialism put off the voters so that the party never really looked as though it had a chance of gaining power.⁵⁵ The Tories won.

The EMS and the 1982 Decision

The EMS, and exchange rate targetting, had hardly figured in the election at all. Labour were far more vitriolic than any Tory about the iniquities of any community constraint on their sovereignty. Nevertheless in 1981 the issue of Britain's membership had been raised, largely at the behest of the existing members of the ERM. The Governor of the Bank (then Mr. Gordon Richardson) had favoured Britain joining the ERM as soon as possible. There was much more skepticism lower down in the Bank's hierarchy, but since the Bank was not a collegiate institution, little dissent percolated through to ministerial discussion. The Chancellor, Sir Geoffrey Howe, was favourably disposed to the idea, but no-one could claim that he was enthusiastic. The officials in the Treasury and particularly the Second Permanent Secretary responsible for international finance were highly skeptical. As one would expect, the Foreign and Commonwealth officials were enthusiastic - believing that joining

⁵³. This fall in the nominal exchange rate was even more sharp than the fall in 1981.

⁵⁴ To do Sir Terence justice, I believe that he was arguing this in the context of an avowed fixed-exchange-rate policy, and not in terms of a floating regime.

⁵⁵. It is worth noting that the government had taken many precautions against capital flight. First there had been an extensive issue of indexed gilts which would protect the holders against a Labour (or Conservative) inflation. Secondly, the government developed "Maggie Mae's" a conventional gilt with the option of switching, after the election into an indexed instrument. In the event, the capital flight was minimal.

the ERM would help in securing advantages from the EEC on such matters as the budget, trade etc. Oddly enough, Lord Carrington the foreign secretary, took a much more jaundiced view of these advantages. The Prime Minister was unequivocally opposed to joining the ERM, particularly in recognising that we would be the only country with really free financial markets and no overt or covert exchange controls. In her view the speculative capital movements would be so destabilizing, that it would be virtually impossible to hold any rate without inducing quite perverse policies domestically.

As was widely reported in the media, in January 1982 at No. 10, a meeting, chaired by the Prime Minister, was held of the Chancellor and the Governor with their advisers; later Lord Carrington joined the discussion. In addition to general issues of strategy with respect to monetary policy, the meeting considered the ERM issue. After all arguments had been aired and everyone had their say, it was clear that the Prime Minister's views had won the day. There was clearly no case for joining the ERM either then or for next year. Of course this did not mean that there would never be good reason to join. Circumstances may change or the ERM may change. The issue was left open; one should join only when and if it was appropriate.

That decision was fortunate. Had Britain joined the ERM at the average mark rate of 4.331 (for first quarter of 1981), it would have required very large increases in interest rates to hold this parity. Even with the 2 percent increase in interest rates that actually occurred, the Deutschmark rate had slipped to 3.684 by the first quarter of 1983 - the eve of the election. But in the ERM for such a short period there would have been much reluctance to realign substantially enough to put to rest the speculative capital raiders. In my judgement, had we have joined the ERM in early 1982, the pressures would have been so great that there was a real danger of reintroducing exchange controls.

The New Chancellor

Mr. Lawson must be considered among the best prepared chancellors of the century. He had been financial secretary in 1979-82 and secretary of state for energy in 1982-3. In the treasury he had been instrumental in pressing through the MTFS, the indexed gilts, and the funding policy. I believe he was a strong supporter of the whole program. In my first brush with him at the time of the 1981 budget, he ask me whether it was true that I had suggested an even tighter budget than the one actually adopted. I said yes - but marginally so. His reaction was a "phew!", but in approbation rather than reproach.⁵⁶

⁵⁶. I believe I first met Mr. Lawson shortly after my attack on Heath's policies. in 1972. Then I had always thought he was a kindred spirit. After the fall of the Heath government, Mr. Lawson was an important discussant in developing a new economic policy.

On the issue of exchange rate targetting and the ERM, Mr. Lawson was firmly in the Thatcher camp. The basic policy was to continue with Sir Geoffrey Howe's gentle but persistent downward pressure on the monetary instruments to bring inflation down. The exchange rate was one of the factors to be taken into account in judging the tightness of monetary policy. But there was no targetting of the exchange rate and no shadowing of the EMS. Both these trends can be easily seen in charts... and ... (Pepper's charts III and V Note that chart III will have a notional trend value added continuing the trend fall over 1983-1986 to 1989 where it will approximately intersect at a growth rate of zero). The growth of Mo was on a gently declining trend from the middle of 1983, when it was about 7 percent per annum, to the last quarter of 1986, when it was about 3 per cent. If this downward trend had been continued then the growth of the monetary base would, by the end of 1988, have been approximately zero.

In my view the policy over the period 1983-1986 was about as close as one could get to ideal. The underlying inflation rate fell, with a bump or "blip" in 1985, from about five percent to some 3 percent in 1986. Had the policy been continued, so that zero Mo growth rate was achieved by the end of 1988 and thereafter the monetary base had remained unchanged, it is likely that the inflation rate would also have been approximately zero. Mr. Lawson had on various occasions said that the ultimate aim was to eliminate inflation completely and over the years ensure a stable price level. Here he was within two years of achieving that once elusive goal.⁵⁷

The Curious Case of Hong Kong 1983

The remarkable story of how this opportunity was not merely missed but actually thrown away can only be related from my partial point of view. The conversion of Mr. Lawson to an enthusiast for Britain's entry into the ERM took place between February and November 1985. I suspect that the change in his ideas probably took place much earlier in 1984, fairly soon after his appointment as Chancellor. It may well be that the experience of fixing the Hong Kong dollar in October 1983 had a influence on his views.

Until the breakdown of Bretton Woods, Hong Kong had been on a currency board with a fixed sterling exchange rates. The sterling parity was maintained by the Hong Kong Currency Board always being ready to exchange Hong Kong dollar notes against sterling notes at a fixed exchange rate. During the next decade, the Hong Kong dollar could be characterised as floating amid the

⁵⁷. In a memorandum dated Dec 6th 1985 I said "If monetary growth (Mo) is held at its present level (i.e. virtually zero) for a period of two or three years, then it is likely that inflation will fall to about zero before the end of the 1980s and perhaps even by 1988.. At last we shall have price stability". I had left my government employment in 1984, but, as an interested citizen, I still offered my views.

jetsam of the 1970s. But there was no discipline of monetary control to replace the currency board. The escalation of the US dollar, the recession, inflation, justifiable doubts about government monetary policy and the political uncertainties generated by the end of the lease (1997) caused a number of runs out of the Hong Kong dollar. These finally culminated in a massive flight in September 1983. The Thatcher government reacted with exemplary speed and decisiveness. The Currency Board was reinstated. The Hong Kong dollar was fixed at a parity of 7.8 Hong Kong dollars for a US dollar. Immediately the run ceased and capital flooded back into Hong Kong. The policy was a great success. (See appendix...for a more extensive discussion).

It was clearly best to engineer a rapid return of a currency board system. Although there were many questions about the adequacy of Hong Kong's reserves, whether it should be fixed to the dollar or the SDR (I do not think that sterling was a serious possibility), and exactly how the Currency Board would operate, the need for a speedy decision was clear. The policy was duly agreed. Mr Lawson did wonder, and with good cause, why I, an avowed British floater, could be so enthusiastic in proposing a fix for Hong Kong. I explained my penchant for clarity in policy and the perils of pseudo systems. I doubt whether my explanation had any effect whatsoever, but I suspect the subsequent euphoric experience of Hong Kong did dispose Mr. Lawson, and perhaps many others, to be more favourably inclined towards a pseudo-fix for sterling.

Preparing a Putsch for ERM 1985

The year 1985 began with the Chancellor saying that in monetary policy most attention should be paid to the exchange rate. However, in February he was still opposed to Britain then joining the ERM; but by September the campaign to join was in full swing. Corresponding to the elevation of the exchange rate into proposed ERM entry, was the downgrading of monetary indicators. Sterling M3 had been downgraded somewhat in 1981 with some attention being given to the exchange rate. In 1982 narrow money in the form of M1 had entered the target list, and the exchange rate gained even more prominence. After M0 replaced M1 in 1984, the exchange rate was accorded primacy among monetary indicators.

This became quite clear in early 1985. Base rates were increased from 9.5 percent in December 1984 to 14 percent in February. The reasons could not be seen in any sustained acceleration of M0. True there was a spike in December, but this was soon corrected by a trough in January.

(INSERT here Pepper's Chart IV)
Nor could one point to any clear explosive behaviour in sterling M3, PSL2 or any of the broad aggregates.⁵⁸ On the other hand,

⁵⁸. The annual rate of growth of sterling M3 had increased from 8.2 percent in September 1984 to 10.0 percent by February 1985. By the end of the year, however, the growth rate was near 14

the dramatic fall in the dollar exchange rate to near to one-for-one in February (a near 20 percent fall over the year), and the reduction of 15 percent in the effective rate were powerful reasons for the Chancellor imposing his monetary squeeze.⁵⁹ Yet there was no question, at that time, of joining the ERM. Exchange rates were too turbulent and monetary conditions appeared to need tightening (at least according to the exchange rate interpretation).

But there is no doubt that joining the ERM at a propitious time had become a central plank of the Chancellor's policy. This became clear to me after a visit to London in early June 1985. Several city commentators had been arguing that "monetarism was dead".⁶⁰ Were there parallels between 1972-4 and 1985-? Retail price inflation had reached 7 per cent in May and June 1985 compared with 5.1 per cent in mid 1984. The growth rate of M3 had begun to accelerate. In their attempts to contain the growth rate of M3, the authorities had accumulated a massive "bill mountain", which many thought, erroneously, represented a great monetary laxity. In my view the fact that the monetary base had been well contained (see the Pepper chart IV), was good evidence that there was no inflationary Armagedon coming in 1986-87. The absence of any take-off of inflation in asset prices, particularly land and houses, was additional evidence to support the argument that monetary policy had not been loose. In the performance of both Mo and asset prices, the situation in 1985 was quite unlike that in 1972. From my meetings with the Chancellor, I believe there was substantial agreement between us on these issues, and that

percent. The Chancellor was, in my view rightly, convinced that sterling M3 was a misleading indicator of monetary stringency. One should not ignore it, but in view of the rapid changes in credit markets, it was very difficult to interpret.

⁵⁹ Note that the reduction in the exchange rate of the Deutschemark was only from 3.889 to 3.608 - about 8 percent - during the year ending February 1985. By July 1985 the mark was at 4.014.

⁶⁰ For example, Phillips & Drew, "The Death of Monetarism", Market Review May 1985, and de Zoete & Bevan, Weekly Economic Survey, Issue 85/19, May 16th 1985. Of course the "death" of monetarism had been pronounced many times. In my recollection the earliest declaration was by John Kenneth Galbraith in 1980. The City commentators, however, presented serious argument to support their case. The most sophisticated analysis of the situation was given by Gordon Pepper in Greenwell's Monetary Bulletin, No. 172, May 1985. He argued that the growth of M3 was primarily due to the increase in the real interest rates, and was not a harbinger of inflation. But he did strongly, and in my view rightly, condemn the inefficiency of the demand-side control of monetary aggregates.

the Prime Minister was assured that the economy was on the right track.

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But whether and when to join the ERM was another matter on which there was no agreement. I had made my views clear in the manuscript of my Britain's Economic Renaissance, a copy of which had been mulled over in the treasury and Number 10. I do not know whether the Chancellor read my manuscript - perhaps not, because he asked me to his study in Number 11 to talk about my views on the EMS. I explained as best I could what my objections were. My notes after the meeting indicate that the Chancellor did not attempt to discredit my arguments about capital movements, exchange controls, and perverse policies; what he was concerned to stress was the discipline on any government (the possibility of a Labour government in 1987-8 was not all that remote at that time), and on wage demands by powerful unions. I conceded that such a discipline argument had some plausibility, but I did not see that membership of the ERM had in fact given rise to any more stiffening of government sinews, compared with countries outside the ERM. The abiding impression, however, was the complete conviction that Britain should join the ERM as soon as possible. I interpreted his motives for initiating the discussion, and I now think perhaps wrongly, as an attempt to enlist my support in persuading the Prime Minister to embrace the ERM.

The October-November Attempt to Enter the ERM

During the next few months, the treasury and the Bank prepared their case for entry into the ERM. By November the inflation rate had subsided to 5.5 per cent and was expected (and did) fall to about 2.5 per cent by June 1986. One of the conditions for ease of entry had been satisfied. The mark-sterling exchange rate had been fairly stable over 1984. 1985, however, was a year of great instability. The rate of 3.5 in February was clearly reckoned to be too low and a threat to antiinflationary policy. By July 1985 it had exceeded 4, and this was thought to be too high and put too much pressure on industry. In early November the rate had slipped to half way between these two values, at 3.75; this mean was thought about right.

The case for entry was put in speeches by the Chancellor and the Governor, with substantial support from Sir Geoffrey Howe. It was argued that joining the ERM (and I believe everyone had in mind the narrow band of plus or minus 2.25 percent) would reinforce the counter inflationary strategy. It would be not only an anchor but an observable and credible anchor. Businessmen would know that they could not look to a slide in the exchange rate to bail them out of their own mismanagement. This, of course, was a repeat of the 1982 brief. But in addition there was the waywardness of the monetary targets, particularly sterling M3.⁶¹ (In fact the misleading nature of M3 had been argued by me from the end of 1980 and thereafter) It was said

⁶¹. In his Mansion House speech in October 1985, the Chancellor had announced that the sterling M3 target had been suspended, and that "The inflation rate is judge and jury"

that it was very difficult to present monetary policy in a credible form. An exchange rate target would solve all such psychological and presentational difficulties. Thus solved, there would be such an effusion of confidence in the conduct of the authorities that the uncertainty premium which was attached to interest rates would fall.⁶² Much weight was placed on the additional stability in the (Deutschemark) exchange rate through expectations generated by the ERM, and there would be less room for speculation.

I have reviewed the case against entry, and with varying degrees of emphasis I imagine that this was put by the Prime Minister. Many other senior members of cabinet undoubtedly supported the Prime Minister's view that the time was not ripe. Nicholas Ridley and Norman Tebbit, for example, have been highly skeptical of the virtues of entry. But some, such as Michael Heseltine and Peter Walker, were undoubtedly sympathetic to the Chancellor's proposal. Although so far as I am aware there was no full scale debate at E committee of cabinet.

What if Britain had entered the ERM in 1985 ?

It is at least interesting, if not particularly informative, to reflect on what would have happened if Mrs Thatcher had been won over by the Chancellor's case and Britain had entered the ERM in early or mid November. The parity or central rate at which one enters a fixed exchange rate system is always a critical decision - as Churchill found in 1925, the Chileans discovered in 1979, and Hong Kong observed in 1983. We can get some idea of what would have happened if Britain had entered the ERM at 3.75 by observing what actually happened to the mark-sterling rate from November 1985. By the end of December the rate had sagged to 3.53, by mid 1986 to 3.00, and by the end of 1986 it was hovering around 2.80. In 13 months sterling had fallen about 27 percent.

In order to give some idea of the effect of the ERM on Britain's policy I shall assume that there was no realignment in the first year or so of entry. The 2.75 rate is held. The question is then, how far would interest rates have to rise in order to hold the central rate at that level ? Some estimates can be made by applying the so-called "4 to 1" rule, namely that a 4 percent depreciation in the exchange rate is counterbalanced by a 1 percent increase in base rate.⁶³ This

⁶². For a number of repetitions of these arguments see Samuel Brittan's articles which began with his conversion in the Financial Times, November 14th 1985 with "Now, alas, it is time to join the EMS" (he meant the ERM).

⁶³ See Charles Goodhardt, "British Monetary Policy" (check title), Economic Journal 1989. The rule refers not to the Deutschemark but to the effective exchange rate index. The fall in the effective exchange rate over this period was of the order of 20 percent. But the defence of the central parity in the ERM is effectively with respect to the mark, so in these very rough calculations I have assumed the same rule applies to the mark-

would imply that, holding the ERM central value at 3.75 would have required increases of $(27/4)$ 6.75 percentage points in interest rates over and above the 10 to 12.5 percent that were in effect throughout. This would have meant interest rates of some 17 to 20 percent.

Many EMS protagonists would claim that this estimate does not take account of the beneficial effects on expectations, including the greater certainty and credibility of being in the ERM.⁶⁴ It seems dangerous to rely so much on a subject we know so little about, namely expectations. But, in any case, exchange rate pressure which induced such high interest rates would clearly generate expectations of realignment or perhaps even withdrawal, or, worse still, of incipient exchange controls.

In retrospect the widely reported intransigence of the Prime Minister to entering the ERM was a godsend. If we had entered, then raising interest rates to new highs in late 1985 and throughout 1986 would have jeopardized, even ruined, the conservatives in the elections of 1987. After such a very tight monetary squeeze through 1986, there would have been a recession - and most likely a deep one - in 1987-88. This would have been exacerbated by the closing of the gap between the parties and the effect on capital flight and interest rates discussed above. No doubt that, in the event, the government would have taken some evasive action, such as realignment, as the dire consequences of the decision to join the ERM became apparent. But, willy nilly, any such actions would be acknowledgment of a gross error of policy, and hardly a basis for asking for another term in government.

It is easy to conclude that Mrs Thatcher was lucky in just happening to be right. The market exchange rate might have remained more or less constant and so there would have been no trouble in maintaining the ERM central rate up to the election. Under such happy circumstances the Chancellor and Governor would have been vindicated. Before mellowing with such comforting thoughts, one should review the history of exchange rates since 1972 (as in the Pepper chart V). There are few periods where one could describe the exchange rate as being stable without a pronounced drift. (We must acknowledge, however, that 1984 was relatively stable with a small drift from near 4.0 to 3.5 - a near 10 percent devaluation). Alternatively the underlying market exchange rate might just have gone the other way and massively appreciated. But, as we shall see in 1987-88, this is exactly what did happen and with the shadowing of the Deutschemerk, this delivered a substantial inflation in 1989. In my view, Mrs Thatcher understood the basic problems with the ERM and was unwilling to put the British economy, not to mention the election, through such a risky wringer.

sterling rate as to the effective rate.

⁶⁴. This is a moot point since the "4 to 1" calculation was over the period of which included the period of shadowing the Deutschemerk.

The "End of Monetarism 1986

Without restrictions imposed by the ERM, 1986 was a good year. Growth was about 3.5 percent and inflation was way down, partly because of the collapse of the oil price and partly because of the reductions in mortgage interest rates. (It is odd that few commentators observed the collapse of the Deutschemark exchange rate and the fall, rather than the rise, of inflation.) But even as early as 1986 the writing was, albeit faintly, on the wall.

At various stages since 1983 the Chancellor had announced that the ultimate objective was stability of the price level - that is to say zero inflation. Indeed the joining the ERM policy was thought to be consistent with this aim, since the objective of the Bundesbank was a stable price level. A stable price level required a reduction in the rate of growth of Mo from its ambient 3 to 5 percent in 1985 to zero. This monetary growth path consistent with the objective of zero inflation by 1990 is shown in (chart V of Pepper); by 1988 the quantity of Mo is stable, and its growth rate zero. From 1983 to mid 1986 the trend rate of growth of Mo is gently declining, and had it continued to decline at that rate, the goal of zero inflation would have been reached in 1990. The actual record, however, shows a marked increase of some 2 percentage points above the trend line in the last half of 1986.

At least as far as Mo is concerned, this marked a turning point in the policy of persistent pursuit of lower inflation which had been manifest since the 1983 election. It was not a dramatic reversal. The change was initially small, almost imperceptible. Yet, as can be seen in (Pepper chart III), the divergence between my target path of zero inflation by 1990 and the actual growth rate of Mo grew inexorably throughout 1987 and 1988. Finally in September 1988, the growth rate of Mo was over 8 percent and the difference from my preferred path was as much as 7 percentage points.

If ever one is to date the "end of monetarism" in the Lawson record, then I think that the middle of 1986 has a good claim. Of course it may be argued that this was nothing more than the usual pre-election expansion to give the voters an aura of prosperity in which, it is hoped, they will reelect the incumbents. But it was more than that. The boost persisted for three years, long after the election.

There are many explanations of this change in policy. The temperament of Mr. Lawson was different from his predecessor. Lawson was said to "...have the temperament of a financial operator, even a gambler..."⁶⁵. The temptation to indulge in

⁶⁵. See Peter Riddell, The Thatcher Decade, Blackwell, Oxford 1989, p. 20. In the television interview with Brian Waldren on "Weekend World" in November 1989, Mr Waldren referred to Lawson as a gambler. It was widely reported that Mr. Lawson was not a rich man; apparently he inherited a substantial sum but lost it in investments in the early 1970s.

"wizard wheezes", to "have a go" and to deliver spectacular growth may well have overcome his initial prudence. He had come a long way from the Mais lecture of June 1984 when he said: "It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macro-economic policy". There was also the fact that, although treasury officials had demonstrated that Mo was an efficient guide for monetary policy, various commentators, such as the ubiquitous Mr. Brittan, had repeated that the City could not conceivably regard such small change as an appropriate target. If the City could ignore Mo, why not the Chancellor? Similarly he could brush off much of the criticism of the burgeoning broader aggregates and particularly sterling M3. In a financial system that was changing its very structure so dramatically, M3 was a dog that had barked too often to be taken seriously. But I suspect that the most seductive influence was the general attitude among the G5 finance ministers that exchange rates were too important to be left to the whims of markets. All right-thinking finance ministers agreed on the need to topple the dollar in 1985 - hence the Plaza agreement. (Note that this was before the fiasco of the Louvre in 1987). Among the G5, Mr. Lawson was clearly the most clever and most experienced. It must have been quite heady stuff to redraw the financial map of the world. To deliver what all people who really matter knew what was right. Power is the goal of all politicians. Here it was - but in half rather than full measure.

The Untarnished Attraction of the EMS

It must have appeared the logical next step to take Britain into the ERM and, most important, to play a full role as the second most important financial power in Europe, first in influencing policy of the Bundesbank and secondly as the honest broker between Germany and France in developing a full integrated financial system for Europe. Indeed it would be entirely logical to see Mr. Lawson as clearly the best candidate for the role of monetary czar, or president of the central bank, of Europe in say 2000. Thus may private ambition and intellectual persuasion happily mesh.⁶⁶

All these considerations might explain the persistence of the drive, by hook or by crook, to get Britain into the ERM. And there is also the obvious personal reason. With the conviction that he was right, it was galling to have the Prime Minister exercise her prerogative in 1985. And it was tempting for him

⁶⁶. This depends on Mr. Lawson having come to terms with the fact that he is unlikely to be leader of the conservative party. I am sure he has sufficient self-knowledge to have arrived at that conclusion long ago. A "financial leader", who insists on anonymity, told me that, because of his arrogance, Mr. Lawson could not conceivably be appointed to, for example, the job of Managing Director of the International Monetary Fund, let alone Governor of the Central Bank of Europe. Although Mr. Lawson is somewhat assertive, I should have thought that his considerable ability would have been the most decisive factor, and thus I still conjecture that his prospects are quite rosy.

to show how right he was after all.⁶⁷ I believe these factors largely explain the decision to "shadow" the mark from early 1987 onwards. The idea was to demonstrate his wisdom and to show that the Prime Minister's fears were quite groundless.

In this endeavour, Mr. Lawson had powerful allies outside the cabinet. The Governor was quite firmly in his camp. One detected, however, much less enthusiasm among the Bank staff and among junior ministers and officials in the treasury - perhaps because they had been through similar hoops before. But their loyalty was unquestioned.⁶⁸ The City was said to be enthusiastic for a fixed mark parity and entry into the ERM. The CBI had stated clearly its full and complete support for entry. This at least offset the much more skeptical view coming from the management of industry - the Institute of Directors. And above all, as a highly successful reforming Chancellor, Mr. Lawson had fullsome support on the conservative benches in the House of Commons. From all this he could well conclude that he had a mandate from from all quarters except Number 10.

In view of the behaviour of the sterling-mark exchange rate in 1985-86, and the obvious difficulties Britain would have encountered had she joined at the November rate of 3.75, one would have thought that this would have given the Chancellor pause before saddling up for another ride on the tiger. Clearly it did not. Nor can I find any satisfactory explanation for his ignoring the lessons of 1985-86. It is inconceivable that the treasury official did not carry out "what if..." exercises on this period.⁶⁹ I suppose he may have surveyed the evidence and drawn quite different conclusions from those which I adduced above. For example accepting the facts as I outlined, he may have believed that the magic ingredient of expectations and

⁶⁷. It has been suggested that there was also a 'macho' element in Mr. Lawson's behaviour, namely that he was furious because a 'mere woman' was thwarting his policy and ambition. I am very doubtful if such a macho factor played any role at all. I suspect he would have been just as annoyed if the Prime Minister had been a male.

⁶⁸. It is noteworthy that, while the resignation of Peter Thorneycroft from the the Macmillan government was accompanied by the resignation of his junior ministers, Enoch Powell and Nigel Birch, there was no hint of any of Mr. Lawson's junior ministers accompanying him to the back benches.

⁶⁹. It has been reported (Keegan) that senior officials in the treasury were entirely surprised by the Chancellor's announcement at the IMF in January (?) 1987 that exchange rates were the main guide for monetary (interest rate) policy. The decision to shadow had not been a considered in depth or detail by officials. It was represented as the consequence of a number of discussion between Mr. Lawson and Sir Terence Burns, with offstage assistance from that most distinguished financial journalist, Mr. Samuel Brittan. This report is consistent with the picture of Mr. Lawson as a gambler who likes to keep his cards close to his chest.

confidence would clearly bail sterling out of any difficulties, as had apparently happened in Italy, notwithstanding Britain's open financial markets. More likely he ignored the reasoned economic arguments on the grounds, alas not unjustified, that the economists had usually been useless on predicting exchange rate movements. Like many a gambler, he felt more at home with his hunches.

Shadowing the Mark

And his hunches, tactically, were good. When sterling began shadowing the mark in early 1987, the Deutschemark rate had fallen below 2.8, even though base rates were relatively high at 11 percent. Sterling had then hit its nadir. At this value the mood of the market was that sterling had reached its bottom. A policy to maintain the rate around 3.0 was both attractive and easy. Indeed it was combined with a fall in base rates from 11 at the turn of the year to 9 per cent for the election in May. Sterling soon appreciated in February to 2.9 and thereafter it rarely deviated more than 1.5 per cent (0.05 Deutschemark) from 3.0.

The economic ambience of this policy seemed like a new golden age. One can easily forgive the Chancellor any hubris. Growth proceeded at between 4 and 6 percent, according to the measure used. Investment boomed with a 7 percent growth. Inflation remained low, a little over 4 percent, but the tax price index was only about 2.5 per cent. A great tax reform was introduced in the March budget. Marginal personal tax rates were reduced to a maximum of 40 percent, and many loopholes and anomalies were swept away. Yet, such was the ebullience of the economy that revenue increased dramatically and the deficit in the public sector turned into a surplus. Debt retirement began. Interest rates fell. The election was won.

The pre-tax real rate of return on assets in the corporate sector had been rising since 1981 (when it was 2 percent) and finally by the end of 1987 it had reached 12 percent. It was expected to rise even further, and so it did - to over 13 percent in 1989. Such high rates of return had not been seen since 1964. More important they clearly exceeded the rates of return in other OECD countries.⁷⁰ Much of this improvement was due to supply side changes, which were expected to continue.⁷¹ This meant that there was a great attraction for investors, both domestic and foreign, to invest in Britain, either through foreign direct investment or through portfolios. The demand for sterling was boosted by this investment effect. There was perhaps an even larger demand created by the interest differential between the United Kingdom and overseas. United States treasury bills in

⁷⁰. See "Company Profitability and Finance" in Bank of England Quarterly Bulletin, Vol 29, no.1, August 1989, page 377.

⁷¹ These have been analysed in detail by Patrick Minford in von Fuerstenberg (ed) (CHECK ref)

January 1987 were yielding only 5.85 percent compared with about 11 percent on sterling bills. The risks of a three month devaluation of sterling were clearly low, so sterling attracted many buyers.

The increase in the demand for sterling buoyed up the exchange rate at 3.00; there was initially no difficulty in holding it there. The authorities did intervene largely to prevent the rate rising above the 3.0 limit. This took the form of selling sterling and buying convertible currencies. Intervention statistics remain a secret. It is interesting to note however that the convertible currency reserves increased over 1987 from \$13.78 billion to \$35.73. Much of the increase was due to a deliberate policy by the Chancellor to prepare for defence of a fixed exchange rate whether in or out of the ERM. I would guess that some \$10 billion of the increase was associated with the intervention.⁷² The intervention was formally sterilized in the sense that it was not allowed to have any persistent direct impact on the money market rates of interest. Bills were sold to take sterling off the market. Thus the bill mountain, such a source of concern in 1985, duly melted away.

Many studies have shown that sterilized intervention has little lasting effects on exchange rates. Since most of it was sterilized in 1987, the persistent pressure for an appreciation of sterling continued. The only way to prevent it was a reduction in interest rates relative to those in other OECD countries. This was Mr. Lawson's policy. First however there was a little diversion due to the Louvre agreement. In May the United States authorities were driven to raise interest rates sharply to stop the decline of the dollar (again after a failure of massive internationally coordinated sterilized intervention to do the trick). US rates continued to rise throughout the year until the stock market crash of October 19th. In July British interest rates were increased by one percent, but thereafter they did not follow the dollar up further. And following the October crash, base rates resumed their downward path to 8.5 at the end of the year, and 7.5 percent by May 1988.

It is ironic that during 1987 the attempt to put a floor under the dollar and the attempt to put a cap on sterling both failed. Yet both were fought with the biggest intervention funds ever deployed. Both substantially sterilized their intervention, and discovered it was ineffective. Both were driven back to monetary policy, to higher interest rates in the United States and low ones in Britain.

The massive interventions in Britain came to an end in the first months of 1988. It was rumoured that more than \$2bn was

⁷² Gordon Pepper shows that the net effect on M4 of foreign exchange reserves in 1979 was 7.2 billion sterling. He concludes, however, that although the authorities failed to "sterilize" (in the sense of having no direct effects on M4) all the intervention in 1987, they did manage to catch up in the first quarter of 1988.

spent on intervention in one day. Intervention was scaled back to the normal smoothing operations. There was a well publicized disagreement between the Chancellor and the Prime Minister. Just before the March budget, the Prime Minister made it clear that you "cannot buck the market". The fact that it was manifestly true did nothing to abate, indeed probably exacerbated the fury of the Chancellor. In any case the 3 Deutschemark fix was finished on March 4th. By the end of March the mark rate was at 3.125.

Lawson's Crowning Error and the October Excuse

But this did not mark the end of the folly. In what can only be seen as a vain attempt to put a somewhat higher cap on the exchange rate, interest rates were reduced again and again to their low of 7.5 percent in May. The only conceivable rationalization for such folly was that the exchange rate appreciation, both overt and incipient, showed that monetary policy was still "too tight". Yet every other indicator suggested that monetary policy was too loose rather than too tight. The labour market was showing distinct signs of strain and unemployment was falling by about 50,000 a month. The prices of assets - and particularly real estate - were rising strongly. The current balance of payments had turned markedly into the red, and there was a clear import boom. Investment boomed ahead at record rates. The monetary indicators were all pointing to an inflationary surge. The Mo figures suggested that there would be a two percent increase in underlying inflation coming in 1988-89, and the broader money aggregates were suggesting even more alarming forecasts of price inflation.

What possible excuses could there be for ignoring this weight of evidence? One such excuse, according to the Economist, Mr. Brittan and other supporters of the Lawson line, is that a monetary expansion was the appropriate response to the October 19th 1987 crash. This would then avoid the mistakes made following the crash of 1929 and 1931. But the appropriate response to a crash is not inflationary excess.⁷³ The problem in October might well have been a run on the banking system or some other form of liquidity run. This calls for the Central Bank to stand ready to discount paper to stem the run, not to flood the market with money. In the event, the Federal Reserve Board of the United States handled the October crash in an exemplary manner which should have been a model for the United Kingdom. In the Economic Report of the President, February 1988, (page 39), it was shown that, in spite of October's troubles, the Fed actually tightened monetary policy in 1987 - because it feared

⁷³. Nor is it to hold fixed the exchange rate. As is well known, Britain entered the recession by Churchill's fix in 1925, and it began to emerge from the slump after floating the exchange rate in 1931. The United States hung on to its fixed exchange rate (with respect to gold) for two more bitter years until 1933; then having floated the dollar, the United States started its recovery. In 1987-8 the fixing of the mark-sterling rate at too low a level led to inflation.

that the expansionary policies of 1986 would promote inflation. This is exactly what was needed in the United Kingdom.⁷⁴ There was nothing that prevented such a prudent policy being pursued - except Mr Lawson's fatal obsession with the exchange rate.

The Monetary Squeeze from June 1988 on

From June 1988 monetary policy was successively tightened by raising interest rates frequently but by only half a percentage point. This was new. Normally in a squeeze the interest rate is put up substantially - usually by 2 percentage points. Then the market is much less certain about the next move of interest rates, whereas using the innovation of Mr. Lawson, the market was certain of the direction of the next interest rate movement. Mr. Lawson, it was said, thought that his penny-numbers adjustment process was much better because it showed that he was in control and in no panic, but merely adjusting with prudence to the new situation. By August base rates were up to 12 percent.

The question remained, however: was Mr. Lawson still operating with an exchange rate band as the target? Albeit the band had moved to 3.1 to 3.3 or so, but the rate was kept in that band until a month or so before he left office in October 1989.⁷⁵

We do not know what would have happened if there had been no resignation. But the evidence of incipient inflation became more evident with every passing day. House prices boomed, labour shortages were spreading, unemployment was falling as fast as ever, and all the signs of overheating were there to see. The need for a substantial increase in interest rates, whatever the exchange rate consequences, was manifest. Fortunately the exchange rate pressure was downwards and so provided a convenient argument for increasing interest rates in one percent steps from 12 percent in October 1988 to 15 percent one year later; thus, at last, there was the coincidence of the exchange rate giving an appropriate direction to monetary policy.⁷⁶ The market was quite convinced that it was virtually only concern about the Deutschmark and German interest rates that was driving interest rate policy in the UK. Indeed the Chancellor and the Governor

⁷⁴. Most of the other major OECD countries appear to have acted with a prudence similar to that of the United States. Britain was the odd man out.

⁷⁵. Additional evidence on this point is derived from the ruminations of Mr. Samuel Brittan. In the Financial Times....(date etc to be checked), he opined that the main mistake made by Mr. Lawson was to fix at 3.0 instead of 3.3. The reader may himself conjecture the economic costs of a belief in Brittan.

⁷⁶. There is still room for debate about whether the monetary squeeze from 1988 onwards was too tight or still too loose. There was no doubt at all that interest rates of at least 12 percent were needed in order to get the growth of the monetary base under some sort of control.

had given the market good reason for believing that exchange rates were the main determinant of interest rates.⁷⁷ And once the belief is ingrained in market lore, it is very costly to try and change that belief.

Britain was on the back of the tiger of idee fixe. As the exchange rate fell, or threatened to fall, in the autumn of 1989, so the interest rate was driven up by market expectations. The authorities had the choice of validating expectations or changing them. However desirable it might be to avoid riding the tiger, the alternative was to fall into its jaws. The government would certainly be chewed up if they had announced a substantial change in their macroeconomic targets. Even though 15 percent interest rates may seem like riding the tiger into a recession, the alternative was even worse.⁷⁸

→ (TO BE COMPLETED)

The Foreign Exchange Reserves

(THIS MAY NOT BE SUITABLE AT THIS JUNCTURE - POSSIBLY NOTE OR APPENDIX?)

So far we have ignored the consequences, particularly the costs, of fixing the exchange rate on the foreign exchange reserves. One of the little known consequences of the first Thatcher government's financial program was the privatization of a substantial fraction of the official foreign exchange reserves. In 1979-1980 the authorities held more than \$18 billion in convertible currencies.⁷⁹ By 1984 this had been run down to about \$7.5 billion. This reduction was possible because the authorities did not need any substantial reserves if sterling were floating. If it were a free or pure float, then, apart from the needs for normal operations, there is no need for any official reserves. But Britain was on a dirty float and the Bank always liked to smooth the path of sterling, so some balances were needed for these operations. We can conjecture that if Britain joined the ERM, then considerably more reserves would be required. One notes that France and Italy maintained reserves of 18. and 23 percent of their exports in 1984, whereas Britain's reserves were only 6.5 percent. It is reasonable to suppose that, were Britain to join the ERM, reserves of about three to four times the \$7.5 billion, that is \$22.5 to \$30

⁷⁷ In his speech at the Party Conference in October, only days after the increase of base rates from 14 to 15 percent, the Chancellor made it clear that the Conservative Party would not be "the party of devaluation".

⁷⁸ Reports appeared in the media that I was opposed to the increase in interest rates to 15 percent in October 1989. Other reports said I supported the increase. My position was that we were in no position to change the market expectations, and that moving up to 15 percent was the least bad alternative.

⁷⁹. See Bank of England Quarterly Bulletin, table 17.1. Note that I am including only convertible currencies and excluding gold, and the IMF reserve and special drawing rights.

billion (for 1984 export volumes and in 1984 prices) would be required. Bringing them up to 1989 values, one would get a required reserves of \$30 to \$40 billion. (Just to confirm this figure, the official reserves in 1988 rose to \$40 billion at the end of July and to over \$42 billion by the end of the year). The ERM, therefore, would require us to have additional reserves of some \$20 to \$30 billion - let us assume hereafter that the extra reserves amount to \$25 billion.⁸⁰

What are the costs of keeping these reserves? The real rate of return on the reserves is roughly the real short term interest rates in the money markets of New York and, to a lesser extent, Frankfurt and Tokyo; a figure of around 2 percent seems appropriate as the average value of the return to be expected. If these funds had not been required for padding the reserves, they would have been employed by the private sector, as in 1980-1984, as capital assets. We know that the average real rate of return on capital employed in private industrial and commercial companies in the UK in 1988 was about 12 percent.⁸¹ If these were the rates of return of alternative investments forgone, then the costs of the reserves were about 10 percent of the \$25 billion, or \$2.5 billion a year. Of course the alternatives forgone may be overseas investment, either in portfolio form or in the acquisition of real assets or direct capital formation. We do not know the full rate of return on these investments, mainly because of the lack of information on capital gains.⁸²

⁸⁰. In 1884 I ignored the \$2.5 billion floating rate note issue which the treasury issued for the specific purpose of increasing the reserves. Obviously this issue had potential ERM entry in mind.

⁸¹. Bank of England Quarterly Bulletin, Vol 29 No 3, August 1989, p.377. A more conservative calculation may take the point that a 12 percent rate of return cannot be sustained and that a 10 percent, or even an 8 percent, rate would be more appropriate in the long run.

⁸² See "External Balance Sheet of the United Kingdom", in Bank of England Quarterly Bulletin, vol 28 no 4, p 520-527. The net asset position grew from 12.1 stg at the end of 1979 to 113.2 and 89.5 billion stg at the end of 1986 and 1987 respectively. Such assets are obviously in part acquired by the cumulation of current balance surpluses, but this can only account for some 17 billion stg in the published statistics. (The reader may well believe that the current account balance is much underestimated in the official statistics. But even if we double it to 34 billion stg, it still cannot account for the bulk of the additional net foreign assets.) The balance is largely accounted for by the yield, and in particular the capital gain including currency revaluation, on such foreign assets. On certain assets the Bank has calculated the full rate of return on assets (not net assets) - see chart 6 p.525. This suggests that the full rate of return has been about 20 percent over the period end 1979 to end 1986. This appears to be the nominal rate of return, so the real rate of return would be somewhat below this, but almost certainly in excess of 15 percent.

But from the information available, it appears that over the Thatcher years the rate of return has been very very high at some 15 to 20 percent, and substantially larger than that on domestic investment. Thus the cost of the reserves for the ERM is between \$2.5 and \$5 billion (or 1.5 and 3.0 billion stg)

Thus, in maintaining these additional reserves, the ERM will cost us some half to one percent of GNP each year. Whether this is considered large or small depends on the alternatives. One possible alternative is to go the whole hog and switch to a Deutschemark currency or to a currency board system. (This is the logical consequence of Delors stage 2.) Instead of pound notes, Deutschemark notes would circulate and we would be on a full Deutschemark standard. The Bundesbank would hold reserves; we would simply hold some of their currency. At present currency and coin in the UK amount to about 17 billion stg, or some \$26 billion. This capital value of the seignorage is about the same as the additional reserves for joining the ERM. If a currency board substitutes sterling currency at a fixed rate for Deutschemark notes, then the \$26 million equivalent can be at least partly invested in short term mark financial assets. So the cost of the ERM is about the same as the cost of a full currency board system.

Conclusion on the Lawson Years

There is no doubt that the great Lawson error was to launch a country that had suffered much in quelling, if not conquering, inflation in 1979-82 into a renewed inflation in 1988-90. Opinions differ on when this inflationary policy started; some trace it back to 1985 with the surge in the growth of sterling M3, some only to 1987 or even 1988. I believe, however, that there is substantial agreement that the inflationary pressure could have been held if Mr. Lawson had pursued more monetary stringency in 1987-88.

The role of the exchange rate in the general conduct of monetary policy and in particular the shadowing of the mark was quite critical in exacerbating the inflationary pressure. The ambient influences arising from the Plaza, the Louvre and the crash of October 1987 no doubt much affected the Lawson decisions, yet they cannot serve as an explanation let alone an excuse. Although it might be thought that the primary motive for the expansionary policy, at least up to early 1987, was to win the mid year 1987 election, this cannot be the explanation for not merely continuing but refueling the inflationary policy of the latter half of 1987 through to the summer of 1988.

Whatever his motives, Lawson's intention to take Britain into the ERM dominated his policy from 1985 onwards. To this task he applied himself with remarkable resolution. Even when the indications of disastrous inflationary pressure were all around him, he continued with this policy. Clearly he must be accorded the main blame for the inflation of 1989-91.

(TO BE CONCLUDED)

Chapter 8

A Monetary Constitution for Europe ?

Introduction

In this final chapter, I try my hand at sketching a monetary system which will ensure stability of the general price level. This, albeit in a wobbly sort of way, Western Europe enjoyed under the gold standard for centuries. The norm for a civilized society was a stable currency and not inflation. After these many decades of depreciating currencies, it seems that the world yearns again for that ancient stability. Anchors are needed. Institutions such as the Federal Reserve Board, the (old) Bank of England, and the Bundesbank have provided such anchors in various periods of the historical record. But all have, at times and to varying degrees, failed to give that that rigidity when under pressure.

Rather than relying on authorities and institutions, one would like to rely on rules. It is rather easier to agree on rules and procedures than to agree on policies and outcomes. Furthermore those rules should be transparent and unavoidable, rather than, as under the gold standard, obscure and escapable. In this chapter I discuss the problems and prospects of basing a European currency on a commodity basket. Thus one unit of money will always be able to purchase certain quantities of commodities which represent the budgets of consumers. I also consider some paths from the present situation to the commodity currency, and how commodity money may exist side by side with present national moneys and ECUs

Of course this is not a complete monetary plan for Europe. It is merely a mixture of some ingredients of a monetary constitution. It is really half-baked. But it is proposed simply to test the ideas, not to inflict on suffering humanity. The underlying spirit of these ideas is that the people of Europe should be free to chose whatever currency they wish in order to carry out their business. Governments should impose neither restrictions nor penalties. Competition between currencies is the best way of preserving both our freedoms and reliable units of account. But also, in cooperation with the private sector, the governments of the Community should promote a monetary unit which, by virtue of its own operating rules, is free of inflation.

The Need for a Stable Currency

Money performs three basic functions: it serves as (1) a store of value, (2) a unit of account, and (3) the medium of exchange. Inflation erodes all three functions, but to very different degrees. As we know from many historical inflations, money still serves as an intermediator in exchange even though inflation is very high. For example, in the many Latin American inflations that have occurred in the 1980s, although the increase

in the price index may be as much as 30 per cent per month, the currency is still used for the host of small household transactions. But no-one keeps notes as a store of value and virtually all contracts are not in terms of the currency as a unit, but are calculated in US dollars or perhaps in some agreed indexed form of money.⁸³ The separation of the unit of account from the rapidly depreciating medium of exchange involves considerable costs - as anyone who has lived in Argentina, Brazil, etc can readily testify. One main business is to minimise any currency holdings so that one is not substantially expropriated by the State. And it seems that everyone gives up many a useful employment to become a currency dealer. The main business is getting rid of currency as quickly as possible.

Maintaining a constant unit of account is as important as maintaining constant standards of physical measurement - where a kilogram and a metre are always the same. With money it is more difficult since, unlike distance of weight at sea level, there is no natural and immutable definition of the value of a monetary unit. Money exchanges against a host of goods and services. In the past the definition of money has been in the form of goods, such as ounces of silver or gold of specified purity. Thus there is usually just one particular good, defined and widely used as money.

This is ideal only when the price of gold (say) in terms of representative baskets of other goods and services in the economy does not much change. Then gold is good surrogate for all goods. But, over the years, gold has not behaved so well. Gold discoveries and new technologies have reduced the price of gold relative to other goods, and so induced inflation. At other times, the stocks of monetary gold have stagnated and so, as production of other goods increased, given many years of deflation. (See Table 7.1 Wholesale Price Changes under the Gold Standard) The legendary stability of the gold standard is indeed legend. Allan Meltzer has shown that predictability of the price level and GNP was far, far less under the gold standard than under the floating rate system of the 1970s.⁸⁴ Little wonder that Keynes described gold as a "barbarous relic".

A Broad Commodity Money

The natural question is whether it would be wise to include more goods in the definition of the monetary unit. Other precious metals are obvious candidates. Bimetallism, for example, became an active issue in Britain in the 1850s as people became concerned about the gold discoveries inducing inflation.

⁸³. Deflation, it will be noted, increases the attraction of money as a store of value and increases, if anything, its use as an intermedator. As a standard of account, it may suffer somewhat, but not if the deflation is gentle (as in the United States after the Civil War)

⁸⁴. "Some Evidence on the Comparative Uncertainty Experienced under Different Monetary Regimes", in Alternative Monetary Regimes, ed Colin D. Campbell and William R Dougan. Baltimore, Johns Hopkins University Press, 1986

Bimetallism involves fixing the ratio of the prices of gold and silver at the mint - and both are given the status of legal tender. Under propitious circumstances - in particular where the mint

ratio is approximately the same as the free metal price ratio - the bimetal standard can function as such. But if, for example, many new easily accessible silver deposits are discovered, then the price of silver will fall relative to that of gold, and so silver currency will drive out gold; at the fixed mint ratio, Gresham's Law works - bad money drives out good. This is the normal fate of bimetallism.⁸⁵ Nevertheless, throughout history the periods of bimetallism have exhibited much more stability than those of gold monometallism.⁸⁶

An obvious way out of the Gresham's Law effect is to avoid fixing the mint ratio. The unit can be defined simply as a basket of the two metals - say one ounce of silver and 0.02 ounces of fine gold. The price ratio could then fluctuate. The coins would be composed of an alloy of gold and silver in the fixed ratio. No doubt there are many technical difficulties in minting and maintaining such coins. But for our modern economies this does not matter since we circulate bits of paper rather than coin. Under this metallic commodity standard, the currency note would be a claim to the 1/0.02 ounce mix of the metals. The monetary authorities would stand ready to convert notes into the metal mix, and vice versa. This requires the authorities to hold stocks of silver and gold sufficient to meet any convertibility demands. Any shortfall of such stocks will be reflected in people's suspicion that the authorities will not honour their obligations and the currency will become inconvertible. There have been too many cases in history where convertibility has been suddenly revoked to allow any monetary authority to get away with small stocks of the precious metals.

A Commodity Money without Commodities

The idea of a commodity money that is not based on the narrow basis of silver or gold stocks, but is founded on a broad range of representative commodities or services has surfaced periodically in discussions about anchors. The attraction of convertibility into a basket of commodities, or even services, is that one avoids the idiosyncracies of gold or silver supplies and all the political problems associated with the gold producers or owners. Furthermore it seems quite absurd for scarce resources to be devoted to digging a hole in the ground to extract gold, only to return that gold again to the deep vaults of the world's central banks. Convertibility into the ordinary

⁸⁵. The United States went on a bimetallic standard in 1792, but as the price of gold rose relative to that of silver, so silver drove out gold and the United States was on a de facto silver standard for some 40 years.

⁸⁶ See Michael Bordo, "Bimetallism" in The New Palgrave Dictionary of Economics, ed John Eatwell, Murray Milgate and Peter Newman, Macmillan, London 1987.

useful commodities of trade appears much more attractive as an anchor in the real economy.

Obviously the commodity basket must be very large to accommodate normal lot sizes of wholesale trade. Similarly the commodities must be readily storable and of identified uniform quality, just as under the gold standard the gold content was of a given purity. And the monetary authority would clearly enter the lists as a major commodity dealer.

The prospects of a monetary authority sitting on large stocks of commodities, and the likelihood that one would add to the present grain mountains, cheese hills and oil lakes has been sufficient to chill the enthusiasm of most economists. (Although some economists have also been entranced by the prospects of introducing a world Commodity Reserve Currency to replace the old role of gold and which, in addition, would enable the world authorities to intervene massively in "smoothing" the oscillations in commodity prices and in reducing the variations in the incomes of producers of primary commodities.⁸⁷).

However it has also occurred to many economists, although I believe the Irving Fisher was the first to enunciate the idea, that one does not really require commodities as the reserve asset.⁸⁸ Instead one could simply supply a financial asset which gave the holder sufficient resources to buy the commodities if he so wished.⁸⁹ The point is that the value of the currency is preserved in terms of the commodity basket. If, for example, one defined the currency in terms of a fixed fraction of the basket of goods and services that enter into the retail price index, then one unit of the currency would be of a sufficient value to purchase that fraction of a basket.

As indexed money, it appears to be closely analogous to an indexed gilt-edged security. But there is a crucial difference. An indexed gilt has a fixed maturity, usually many years, at which time the principal is paid duly enlarged in proportion with the change in the retail price index. The authorities, however, do not guarantee to redeem the gilt at par, duly uprated for the retail price index, at any time. With an indexed gilt, one takes one's chance on whatever price one can get on the

⁸⁷. See Albert Gailord Hart. "Commodity Reserve Currency" The New Palgrave Dictionary of Economics, ed John Eatwell, Murray Milgate, and Peter Newman, Macmillan, London 1987. Lord Kaldor was the primary force behind these suggestions.

⁸⁸. See Irving Fisher, The Purchasing Power of Money, 2nd edition, New York, Macmillan 1913. Warren L. Coats has developed these ideas in: "In Search of a Monetary Anchor: A New Monetary Standard", IMF Working Paper, October 11, 1989, Washington, DC.

⁸⁹. The seminal paper is Robert L. Grefield and Leland B. Yeager. "A Laissez-Faire Approach to Monetary Stability", Journal of Money Credit and Banking, Vol 15 August 1983, p 302-15. See also Irving Fisher, Stabilizing the Dollar, Macmillan, New York, 1920.

market for such bonds. For this commodity money, the authorities always redeem at slightly below the par value of the retail price index. The "slightly below" condition is to ensure that there is some disincentive against too ready redemption, and that the issuing authority earns sufficient profits to pay for the costs of operating the system.

A Stable Commodity Money for Europe

How would one provide this alternative of a stable European money? I believe that it should be introduced as a parallel currency to the existing national moneys in Europe. In accordance with the liberal principles nominally embraced by the Community, all citizens should be allowed freely to use what every currency they would wish with no restraints of legal tender or overt and covert exchange controls. Thus they should be able to hold and transact in the commodity money. Thus people could choose to conduct business in any of the national moneys or in the Euro commodity money, the ECOM.

The next issue is to specify the paper assets in which the ECOM is redeemed. The natural candidate is any of the national currencies. Thus if the commodity basket is bought by 100 stg at the beginning of the year and by 108 stg at the end of the year, and if one ECOM buys the basket, both at the beginning and the end, then the redemption value of the ECOM will rise in sterling terms by 8 percent over the year (ignoring the profit margin of convertibility). Thus the European Bank of Issue (EBI) would have to maintain a reserve of sterling, or easily realizable sterling assets, and other Euro-currencies in order to redeem its pledge. Then the EBI would be acting like a currency board, except that the redeemable values would be defined as the equivalent money to buy the fixed commodity basket.

An alternative redemption arrangement might be more efficient. First one would restrict redemption operations to wholesale quantities of money. Thus instead of exchanging ECOM against sterling, one would specify that the ECOM would be exchanged only for large treasury bills (say of 100,000 stg equivalent). On one ECOM note it would promise that "this note is redeemable for a fraction (or number) of treasury bill(s) sufficient to purchase the basket of goods defined as one ECOM".

To see how the system would work, imagine that we begin in a nice equilibrium, but then there is some accidental overissue of ECOMs. Prices in ECOMs would then rise as people got rid of their ECOMs by spending them on goods and services. But the ECOMs can be exchanged for an amount of treasury bills equivalent to the base value of the ECOM, and these treasury bills are worth more than the ECOM notes by the amount of the price rise. So people will be induced to redeem their ECOM notes; they will take their ECOMs to the EIB and receive treasury bills in exchange. This will reduce the quantity of ECOMs and so depress the ECOM prices of goods, until equilibrium is again restored with the

ECOM value in the market at its original goods value.⁹⁰ Private arbitrage will thus keep the standard ECOM constant in value.

Problems with the ECOM

There are obviously a host of problems in setting up an ECOM. Many of them are basic policy issues. For example, I have discussed linking the ECOM to the consumer basket - and obviously I would mean the weighted average consumer basket in the Community. The ECOM would be kept in line with the weighted average of retail price indices. This would have the advantage that no single country would have any incentive, in addition to those they have already, to distort the index. But there would be also the problem of "harmonizing" the indices and, preferably, calculating them more frequently than the present monthly figures. A more substantive issue is whether the retail basket is an appropriate anchor. It is probably better to index to the prices of things produced, rather than consumed, by the Community; then holders of ECOMs (as do indexed gilts) will not be shielded against changes in the terms of trade. But the retail price indices are much used throughout the Community and represent a more accepted unit of standardization of value.

In order to set up the EBI, the various central banks would contribute reserve assets, defined as outlined above, in exchange for shares on a pro-rata GDP basis. Analogous to the introduction of indexed gilts in the UK, it would be best to begin with a relatively modest issue of ECOMs - though there needs to be sufficient to give a sufficient momentum to the market. In its constitution the EBI would have the sole role of issuing and redeeming ECOMs.

It might be efficacious if there were developed first an external eurocurrency as suggested by Jaques Riboud.⁹¹ This, in M. Riboud's proposal, would be a market in constant-value dollars. The Community could encourage this market and guide it by suggesting that the standard of value should be related to the weighted retail (or producer) price index for the Community. The ECOM could then take over the external unit of account, accepted and even hallowed by use, and then internalise it.

There is no doubt that creating an ECOM would not ease the task of the constituent monetary authorities in dealing with the liberation of financial markets to which all constituent countries are committed. But it is doubtful if it would make the task much more difficult. If, for example, Greeks can transact in Deutschemarks rather than drachmas, the possibility of substituting ECOMs will not be any great change. As people in Greece switch out of depreciating drachmas into either Deutschemarks or ECOMs, the Greek monetary authorities will have to reduce their drachma monetary expansion to keep inflation at its existing rate.

⁹⁰. For a clear account of the process of arbitrage, see Warren Coats 1989 op cit.

⁹¹. Op. cit

A ECOM Monopoly for the Community ?

If there is to be a monetary union which develops as Delors envisaged through the EMS becoming more stringent, that is to say with narrower bands and virtually no realignments, then it must be based on the dominant role of Germany (FRG and GDR). There are obvious political objections to this arrangement which Delors tried to solve by building up a central bank of Europe (a European System of Central Banks) which would control Europe's monetary policy. But the Bundesbank, along with Britain, has strongly resisted any encroachment on its powers and prerogatives. In fact the Bundesbank must be the main agent controlling Europe.

The reluctance of countries in surrendering their monetary sovereignty to another sovereign state is entirely understandable. And this must be an especial concern if that state is a Greater Germany - so much the dominant power in the Community. It is, however, a different matter if monetary sovereignty is surrendered not to any state but to the standard of an inflation-free currency. The government of Britain, for example, would not be giving up its sovereignty to any other legislature or to any foreign central bank. It would be surrendering its power to expropriate its citizens by inflation. Monetary policy would be depoliticized. Neither domestic nor foreign politicians and functionaries would have any control over the money of Europe.

This suggests that once the ECOM has been introduced and used for some time, it might well be that an ECOM currency union could be formed for Europe. If the ECOM displaced national currencies to any considerable extent, it would be a natural development to adopt the ECOMN as the currency for the Community. Indeed, just as the gold standard was widely adopted throughout the world in the 1870s, so might the ECOM, in one or other its many mutations, be embraced by countries outside Europe - even the United States and Japan. But these are, of course, pipe dreams of an inflation free world.

Pros and Cons of the ECOM

When discussing the likely consequences of an ECOM system, one must always specify, as best one can, the best feasible alternative. A point by point discussion would try any reader's patience. It might be useful instead to lay out what I believe are the major issues and indicate my judgement about where the balance of advantage lies.

Consider first for Britain the alternative of the free float and a monetary policy that maintains a constant quantity of Mo, preferably through the operation of a monetary base control system. This, I believe, would be superior to the ECOM arrangement. The constancy of the monetary base would ensure that there was no runaway inflation or crushing deflation. True, one would not enjoy the great price stability of the ECOM, but it is often more efficient to adjust to technological progress, changes in the terms of trade (increases in the price of oil, for

example) etc., by allowing exchange rates freedom to move to their market value. The central point is that if markets are not allowed to adjust exchange rates, then the burden of adjustment will fall on other markets: commodity, labor, money, bond and stock markets. A change in exchange rates is likely to be the best way of making such adjustments.

The objections to this system of monetary-base-control with floating exchange rates, compared with the ECOM, are easy to list. The change in the velocity of circulation may be different from the 3 percent upward drift that we have conveniently assumed. (Although I believe it is consistent with the history of the last two or three decades, there is no guarantee that trends can be extrapolated). The great advantage of the ECOM system is that the velocity adjusts endogenously, whatever happens to the demand for (base) money, to keep the price level constant. There is no opportunity for making mistakes in forecasting money demand; if there are changes in technology or monetary markets that increase the demand for money, then the ECOM system will ensure a response at the fixed price level. There will be no monetary excess or starvation of the economy.

An interesting question is whether it is indeed plausible so to divorce monetary and exchange rate policy from political control. In the case of monetary base control, I very much doubt it. In practice, in order to deal with liquidity crises and dramatic changes in the public's choice of a cash-deposits ratio, we must allow some over-ride discretion on the part of the monetary authorities. This has been demonstrated in many liquidity crises throughout history, and most recently in October 1987. In the ECOM system, however, there is no need for any such over-ride. Provided there is a wide enough spread of reserve assets (and substantial quantities of reserve assets can be sold by making their price attractive), the EIB will provide ample liquidity to prevent any deflationary slump. But would not governments be tempted to "improve" on the performance of the EIB? Since we lack any relevant experience with such a system we do not know the answer.⁹² If the EIB and ECOM were the result of a treaty of the EEC governments, however, it would be difficult for any particular government to play fast and loose with its constitutional provisions; but one should not be so sanguine about the institutions of the Community.

Conclusion

In reflecting on monetary constitutions I have wandered a long way from the immediate issues of exchange rates and monetary policy. Yet it is important to inject new ideas into the problems of monetary systems in Europe. I do not believe that

⁹². One form of "improvement" might be to specify the currency in terms of a constant rate of inflation, say 3 percent per annum. This could be done easily in the ECOM framework, and it might be argued that, because of downward rigidities in the prices, such a constant inflation would involve less frictional costs. In my view, however, adding 3 percent to all prices and wages will not solve problems of rigidities

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Chapter 5

To: Professor Brian Griffiths
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Monetary Constitutions for Europe

c. Andrew Turnbull

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The role of monetary institutions in the Community has been the subject of so much debate, one might think that it is foolish to try to contribute. After the Delors Report there has been a welter of further studies, much rhetoric about Eurofederalism, and plans or at least suggestions for the development of the Exchange Rate Mechanism (ERM) of the European Monetary System. Yet even though there has been so much talk, some fundamental issues appear to have been forgotten or subsumed in the debate. We appear to be moving towards a monetary union of Europe without any substantial agreement about the principles on which a monetary union should be based. In this paper I shall examine some of the basic notions of exchange rates and the advantages of monetary union.

I Exchange Rates, Unified Monetary Systems and Central Banks

Economic Union and a Unified Monetary System

One of the main claims in the Delors Report and elsewhere in many reports on monetary union is that a true economic union requires a common money and, although there is less unanimity on this point, a strong and responsible central control of the money supply. The example quoted so frequently is that of the United States and its Federal Reserve Board. With eyes firmly fixed below the 49th parallel, such observers ignore Canada and its relationship with the United States. If, by economic union, we mean the free flow of goods, services, and factors of production (labor and capital), then Canada and the United States are substantially an economic union. (Some limitations still exist but the few that remain are to be eliminated.) There is a larger value of trade between the United States and Canada than any other countries in the world. Yet no-one has suggested that a precondition for this union is a monetary union, that is to say for the extinction of the Canadian dollar or the linking of it to the US dollar at an irrevocable fixed rate. True the Canadian dollar has been linked to the US dollar for various periods in the past - all such fixings ended unhappily. Whether it would be a sound policy for the Canadian provinces to become districts of the Fed, and for the Bank of Canada and the Canadian dollar to be abolished are large questions which have engaged many intellects and elicited few conclusions. The Canadian view, however, is clear: there is no need for a monetary union in order to reap the benefits of an economic union. A fortiori, there is no reason to suppose that economic union requires any system of pseudo-fixity, such as that practised in the ERM.

Fixed, Floating, and Pseudo-Fixed

It is a paradox, and an interesting one, that while there is a close affinity between fixed and floating exchange rate regimes, there is a big gulf between fixed and pseudo fixed regimes. There is a common confusion, albeit understandable in view of the language used, that, somehow, pseudo-fixity is a nice half-way compromise between the wild swings of floating and the rock-like rigidity of fixity. In some contexts the pseudo fixity is advanced as an interim state to enable a smooth transition from free floating

to more and more fixity until the currencies are subsumed into one. (This is true of the Delors stages I, II and III). These views are seriously misleading.

With a truly fixed exchange rate, there is effectively one unified currency. For example Scottish bank notes and Bank of England notes are redeemed one for the other. There may be the same currency, as in all the United States and Panama - dollars throughout. Or they may be different currencies as in the Scottish case, and perhaps more interestingly different nominal currencies as in the case of Hong Kong since October 1983. The Hong Kong dollar is truly fixed at 7.8 to the US\$.

But one may ask: what is the difference between the Hong Kong dollar being fixed at 7.8 to the US dollar and sterling being fixed at 3 Deutschemark to the pound in 1987 or the 1988-89 rate of 3.368 French francs per Deutschemark? The crucial difference is that Hong Kong has no central bank and no monetary policy. It has a currency board that simply exchanges Hong Kong notes for dollar notes on demand at the going rate of 7.8 (with slight margin both sides to cover the costs of note exchange). On the other hand Britain, Germany and France all have central banks with the crucial power to create high powered money by engaging in open market operations. They can and do vary their discount rates in the short term money markets to create what they believe are 'appropriate' financial conditions. The currency board of Hong Kong has no such powers. It has no role in credit markets, no ability to influence interest rates, and no discretionary power at all. It is merely a currency swapping agency constrained to operate at this fixed rate. The central bank of Hong Kong is the Federal Reserve Board of the United States over which Hong Kong has no control whatsoever and very little or no influence.¹ In a real sense Hong Kong has surrendered its sovereignty over monetary policy to the United States. In terms of monetary policy, the currency board arrangement is the same as the United States dollar circulating in Hong Kong, but there is the difference that it is a separate currency with its legal tender connotations and with the seignorage accruing to the owners of the currency board - the government of the colony.²

The essence of the unified currency is that monetary institutions deliver automatically the truly fixed rate. The currency board is the epitome of such an institution. But with differing currencies there are many possible variations on this theme; for example one might extend automatic official convertibility to certain classes of deposits, as well as currency. The principle would be the same. With a pseudo fixed currency, however, there is no such automaticity. Pegging one currency to another is not a true fix if, at the same time, the pegging country maintains a central bank (whether that

¹. The distinction becomes blurred if the currency board changes its parity with the US dollar - or if it is thought to be likely to change the currency swap rate. Then the currency board takes on the attributes of a central bank by choosing a rate which implies an active monetary policy. The essence of the currency board is complete faith in the fixity of the parity.

². I believe that there are political reasons for not circulating greenbacks. And there is also the good practical reason that, if Hong Kong dollars are lost or destroyed the colony does not lose, whereas if US dollar notes are destroyed, the loss to the colony, like the gain to the United States, is real.

Central Bank be controlled by government or is independent or some bastard arrangement between the two). Of course it might be suggested that the central bank or treasury could just act like a currency board. But such behaviour is not in the nature of the bank beast; it is rather like expecting the lion to be a vegetarian. Political and economic pressures are bound to be brought to bear on the central bank to pursue the "right" monetary policy, as distinct from the monetary response required by a currency board...the eternal yearning to have the cake and eat it.

Bretton Woods and Other Pseudo-fixed Systems

The fundamental dilemma - to subordinate money policy to the exchange rate or to conduct monetary policy according to domestic needs - is a recurrent theme in all pseudo systems. History suggests that such pseudo systems can persist for many years - with the aid of large official capital transfers (lines of credit, swap arrangements etc), exchange controls, regulations on domestic financial institutions and trade barriers. The Bretton Woods system was one such system of pegged but adjustable exchange rates which, as a formal arrangement, persisted for over two decades. It induces a nostalgia for the short run stability of exchange rates and for the low inflation of those years. M. Ballardur in the Wall Street Journal, February 23 1989 is not alone in urging that the world return to what he recalls as the gentle shades of Bretton Woods.

Reality, however, differs from such nostalgia. First Bretton Woods was born into a world where the major currencies were inconvertible into dollars. The scarce currency clause meant that member countries could discriminate against the scarce dollar, and the European Payments Union was set up to clear inter-European balances. The major currencies did not all become externally convertible until 1960, and then for most currencies, exchange controls, often quite fiercely restrictive, applied to domestic residents. Second, and largely as a consequence of these restrictions, there were very limited movements of private capital until 1960, but throughout the rest of the decade capital became increasingly mobile. Thirdly, as soon as capital was allowed to move, Bretton Woods came under great pressure. Although one of the major currencies, sterling, did not collapse until 1967, from 1965 the UK had imposed such restrictions on payments and trade. In fact the liberal capital regime of Bretton Woods really lasted only from 1960 to 1965.

The role of the United States in ensuring that Bretton Woods lasted as long as it did is also important. Essentially the United States pursued fairly responsible long run monetary policies. And until the mid 1960s they were willing to tolerate large capital flows and their disruptive effects in the system. It is noteworthy, however, that the acceleration of monetary growth beginning in 1962-3 fueled the inflation which took hold in the late 1960s. Under the Bretton Woods pegged exchange rate system, the inflation had to be exported to Europe, but Germany, the Netherlands, etc were reluctant to import it - they preferred gold. A mortally wounded system staggered on from crisis to crisis until the formal burial in 1971.

It is ironic to note that while the great inflation got under way when the world was on a pseudo fixed system, the great disinflation from 1979 onwards was conducted under the auspices of a floating system. Of course it would have been a different story if the United States had not inflated in the 1960s. And it is worth recalling that,

in the early 1960s, everyone believed that the United States could be relied on to deliver a low inflation rate - after all it always had done so. (The cynical could be forgiven for recalling that much the same thing is said about the Bundesbank today) At least it should give some reason for hesitating before hitching one's currency to another historically trustworthy currency.

The conclusion is clear. The Bretton Woods era of fixed but adjustable exchange rates against a gold based dollar was no golden age. When the currencies became convertible the system could not, without resort to extensive exchange controls, contain the capital flows it induced.

II The European Monetary System

The EMS

So much has been said and written about the EMS that I might be brief. But, alas, it is necessary to rid the mind of misconceptions and many misleading accounts of the effects of the ERM

footnote

It is surprising to find that the issue of monetary union and exchange rate coordination is not mentioned in the Treaty of Rome as amended by the Single European Act. In the Bretton Woods ambience of the mid 1950s, with inconvertible currencies paying court to a scarce dollar, perhaps one would not envisage any such goal.

end of footnote.

The creators of the European Monetary System in 1978 were Chancellor Helmut Schmidt and President Giscard d'Estang. The motives for joining have been much discussed. It has been argued, for example by Samuel Brittan, that Helmut Schmidt was simply searching for a way of dealing with the flight from the Carter dollar into the mark and wanted a convenient way of diffusing the inflow to his European partners. I suspect that President Giscard d'Estang saw it as an opportunity to link France more closely to the mighty German economy, and at the same time he believed that it would give some French control over the tide of German monetary policy. And it was a step on the way to a world of managed exchange rates - a consistent theme of much French policy. Possibly it was seen as a way of reviving the ideal of a united Europe - a much tarnished ideal in the Europe of the late 1970s. It is also interesting to note that, at inception, the independent Bundesbank was against it, probably because of the unhappy experience with defending parities in the 1970s. Gradually the Bundesbank became "cautiously positive".³ Many of the smaller countries, such as Eire, went along with the EMS idea because they conceived it as a form of help from the mighty German economy. And to the Netherlands, it was little change from their existing fix.

Whatever the motives, the leaders and their expert advisers, had noted the problems with the snake, and believed that these could be solved by creating mandatory help

³. For this assessment, see Gottfried Harberler, "The International Monetary System, The European Monetary System (EMS) and a Single European Currency in a 'Single European Market'" in "Geldwertsicherung und Wirtschaftsstabilität", Festschrift für Helmut Schlesinger zum 65. Geburtstag, ed Norbert Bub, Dieter Duwendag, Rudolf Richter, Fritz Knapp Verlag, Frankfurt, 1990

with intervention. This arrangement - exchange rates contained in a band and mandatory assistance - comprises the Exchange Rate Mechanism (ERM).

All the countries of the ECE are members of the EMS and are entitled to join the ERM. However they are not required to join the ERM. Thus Britain, Greece and Portugal are members of the EMS but do not participate in the ERM. In common parlance it is said that these countries have not joined the EMS. Although not strictly correct, this usage is so widespread that I will occasionally use it in this book. Thus a member under exchange rate pressure could rely on short term support from other members.

In principle a weak currency country can have access to automatic and, in principle, unlimited credit through the Very Short Term Financing Facility.⁴

This mutual support system has varied over the life of the ERM. And different countries have given it different interpretations at different times. There have been numerous complaints however about the mechanism of central bank intervention in the foreign exchange markets. In particular Germany has felt the weight of the burden of support.⁵

The Band and Realignments

The normal requirement of the ERM is to maintain the exchange rate around the central value plus or minus 2.25 percent. Italy (until January 1990) and Spain, however, have elected to maintain their exchange rates within a plus or minus six percent band. Within these constraints, however, countries have pursued more restrictive policies. Thus the Netherlands, so closely tied in to the West German economy, has virtually locked itself to the Deutschmark. Other countries outside the EMS and ERM, but closely integrated with the German economy, have also pegged their currencies with some rigidity to the German mark: the most notable example is Austria. And it is generally true that members try to avoid straying near the limits of toleration. Rarely does a member allow its currency to bump along at the lower level of the band.

The EMS allows for the "realignment" of currencies at new central parities. In the ten years from 1979 to 1989, there have been 11 parity changes.

(Table of Exchange Rate Realignments Dollars Deficits and Trade p 217 to be inserted here)

These realignments were much more frequent in the early days when there was a need

⁴. See Rainer Masera L'unificazione monetaria europea, Bologna; il Mulino 1987, for a detailed account of the institutional changes of the September 12-13 1987 EC Council of Finance Ministers. The Very Short Term Financing facility was also lengthened, and there was an agreement to monitor exchange rates and monetary conditions in each of the EMS countries (including, one presumes, the UK).

⁵. See Helmut Schlesinger, "Zur weiteren Entwicklung der währungspolitischen Kooperation auf internationaler und europäischer Ebene", Deutsche Bundesbank, Auszüge aus Pressartikeln, no 84, Frankfurt, November 17, 1988

to adjust to very different rates of inflation. From January 1987 there has been only one adjustment of the central values, the devaluation of the lira in January 1990 as it entered the 2.25 per cent band. But it is widely thought that the disparities have become so large that a substantial realignment cannot be long delayed.

The process of realignment was meant to proceed from a deliberation on the fundamentals, in particular relative growth and inflation rates. In practice the currencies have often been pushed, often precipitously, into a realignment in order to counter speculative capital movements. The market has a number of signals it can read to see when a realignment is imminent. Ministers and central bankers become agitated and leaks soon spring forth. This provides a rich nectar for the busy bees of private speculators.

Aims of the EMS/ERN

The EMS was created to achieve "a zone of monetary stability in Europe" that would eventually develop into a European Monetary Fund. What is meant by monetary stability? Certainly the basic idea was exchange rate stability. But that can be interpreted in various ways. The first is that the EMS would reduce the day to day, or weekly and monthly variations in exchange rates. Much of the casual criticism of the floating system by traders and vacationers was in terms of the difficulty of planning short term operations. The second is that there will be more long term stability in exchange rates. That is to say the exchange rates will not sink or rise consistently year in year out. The corollary is that there will be little divergence in rates of inflation - this is the so-called "convergence" objective.

There is little doubt about which is the most important goal. It is useful to reduce the variability of exchange rates, provided that one does not thereby introduce even more damaging distortions elsewhere. But, for the majority of transactions, it is always possible to buy cover in the thick forward market for short periods ahead. On the other hand it is impossible to buy any cover for inflation losses (with the rather limited exception of indexed gilts.) The long term stability of exchange rates, provided that it is not behind a barrier of controls, is clearly the most important objective. But it needs to be interpreted in a subtle way. The underlying objective is, of course, stability of prices or, at least, stability of low (circa 2 percent) inflation. Then to achieve, say, zero inflation in the long run may require a long term appreciation against the dollar or even against the European Currency Unit (a basket of European currencies) or against the SDR (a basket of the five most important currencies). In short if the world or Europe or even Germany goes on an inflationary, or deflationary, binge the long term stability of the exchange rate is a recipe for importing such price movements.

EMS and German Hegemony

This discussion highlights a central issue: who actually runs the EMS/ERM? Like most multinational institutions, the EMS was set up formally as an institution with equal

participation by all members.⁶ National prides demand no less. In a democratic institution all nations were to be equal. The reality, however, was quite different. Some were more equal than others. In the event Germany became the price leader and in effect dominated policy. This German hegemony has been much resented by France and Italy, among others. Because of their reluctance to realign, French financial policy is largely determined by the Bundesbank, over which the government of France has virtually no control and little influence. Indeed, because of the statutory independence of the Bundesbank, the German government has only influence not power to affect monetary policy - so even if France brought pressure to bear on the German government, such pressure would be much dissipated by the time it found its way from Bonn to Frankfurt. Bundesbank ruled.⁷

This should have surprised no-one. Germany was the biggest and richest economy with the most liberal markets. The German reserves were unmatched, and, corresponding to its role as a major exporter of goods, Germany had become an important exporter of capital. Above all the Deutschmark was rightly seen as the most inflation-free of all the major currencies (including the dollar).

The Bundesbank enjoyed credibility as the guardian of monetary propriety. The other countries believed that by joining the ERM they would also acquire credibility for their currencies and credibility for their policies. But this would be possible only if the Bundesbank were seen to be in a position to maintain its responsible policies. And it was widely accepted that the Bundesbank's independence, as well as the abiding fear of inflation in Germany, was a critical element of that credibility.

Here was a central dilemma. In order to have more "democratic" control of the EMS policy, what the French call symmetry, it is necessary to allow French, Italian etc due influence in formulating German monetary policy. But such influence would clearly erode and eventually destroy the independence of the Bundesbank on which the whole edifice

⁶. The institutions of Bretton Woods, however, did not accept the system of equal voting. The votes in the IMF and World Bank were according to the share holdings of the participating governments.

⁷. The dominance of the Bundesbank is a common theme of most contemporary accounts of the EMS, see for example Jaques Melitz, "Monetary Discipline and Cooperation in the European Monetary System: A Synthesis", in Francesco Giavazzi, Stephano Miscossi and Marcus Miller (eds) The European Monetary System, Cambridge University Press, London 1988. This view has been disputed by Michele Fratianni and Jurgen von Hagen in "German Dominance in the EMS: the empirical evidence", Open Economies Review, Vol.1 No.1, p67-88, Kluwer Academic Publishers, Dordrecht, 1990. Primarily from analysing interest rate policies, they argue that the Bundesbank policy is largely independent of the policies of its fellow ERM countries. But that does not mean that the Bundesbank dominates the others. France and Italy, through realignments and financial controls, can diverge from the Bundesbank line if they so wish.

of credibility is built.⁸ Thus if the EMS is to achieve its major function, it must be dominated by the elite and unelected Bundesbank, and democracy be damned! Obviously such a concentration of power has caused much tension. For example in January 1987, because France differed so much with the Bundesbank's restrictive policy, France refused to intervene when the franc fell to the floor. In the event the Bundesbank, fearful of wrecking the ERM, bought francs to put it back in the fold. The resentment of German power and influence is a worrying resuscitation of an old theme of European politics.

As we shall see, this fundamental dilemma is inherent in any system similar to the EMS. And it gives rise to similar types of political tensions. There is little to be done that would resolve the inconsistencies of objectives. One ideal way would be for France, Italy etc to acquire, in their own right, a credibility as convincing as that of the Bundesbank. Not only is this idle speculation, but of course there would be no need for an EMS for achieving the convergence of inflation rates. Then there would be a possibility for more non-German participation in policy. But still the union would be dominated by Germany. This has led some commentators, among whom one must number several Presidents of France, to suggest that the only way to solve the problem of German monetary hegemony is a return to a gold standard. But later I shall suggest other solutions.

It may appear that, as the leader of the EMS, Germany has substantial freedom to pursue its own monetary and fiscal policy. It looks like Deutschland uber alles - or at least alles participants in the ERM. But, paradoxically, Germany is also a prisoner of the ERM. Because of the reluctance to realign, Germany is prevented from pursuing a monetary policy that the Bundesbank believes is consistent with its obligation to avoid inflation. Just as in the late 1960s and to August 1971, the United States complained that, as the anchor of the Bretton Woods system, it alone could not devalue the dollar against the mark, so, as the linchpin of the EMS, Germany cannot unilaterally revalue the mark against its main trading partners in the ERM. The Bundesbank has some apparent freedom to raise interest rates, but pressure to prevent such a rise from France and Italy is as likely to be as intense as the resistance to realignment. Germany is hardly the dog that wags the ERM tail. As Karl Otto Pohl must know, it is the tail that dogs the wag.

The Performance of the EMS - Exchange Rates. ⁹

⁸. The central banks of France and Italy, like the Bank of England, are simply creatures of the government. In Europe only the central bank of Switzerland has an independence approximating that of the Bundesbank.

⁹. There is an enormous and rapidly growing literature on this subject. My selected reading would include Michele Fratianni, "The European Monetary System: How well has it worked?", in Dollars, Deficits and Trade, ed James A Dorn and William A Niskanen, Cato Institute, Washington DC 1989, Roland Vaubel, Comments on Manfred Wegner, "The European Monetary System: A Regional Bretton Woods or an Institutional Innovation" in J. Vosgerau (ed) New Institutional Arrangements for the World Economy, Springer-Verlag, Berlin 1989, and Patrick Minford, European Monetary Union and 1992, Selsdon Group Special Paper, London 1989.

It is extraordinarily difficult to make assessments of the performance of the EMS that command everyone's confidence. The normal method of judging the EMS is to pursue two sorts of comparisons. First one may compare what happened to participants before 1979 and after - a time series approach. Secondly from 1979 a comparison may be made between those countries involved in the ERM and those which stayed aloof - a cross section approach. The time series has the advantage that one can compare the same country, with all its many constant individual characteristics, before and after. But of course countries would have changed their performance in the absence of the EMS, and consequently we do not know how much of the change to attribute to the ERM membership. The cross section comparisons suffer from the fact that countries will vary in performance considerably, and participation in the ERM will be one factor among many others. Nevertheless these two approaches do give some basis for judging performance. A third - the modelling approach - has been tried by Patrick Minford. In order to produce a standard for comparison, he models what would have happened in the absence of ERM membership, thus giving a "counterfactual" account against which to compare the real record.

One quite remarkable result of these empirical enquiries is that they all tell broadly the same story. First, let us look at exchange rate variability. The most obvious point is that bilateral exchange rate variability between ERM participants is less than in the years before 1979. This was one of the aims of the EMS and it has been achieved. This does not mean, however, that there has been any gain in stability of effective exchange rates or that exchange rate variability with other OECD has not increased. Indeed the second result confirms that, whatever stability had been achieved in bilateral rates was more than offset by increases in variability with respect to non-ERM currencies.

The summary on variability of nominal rates is really quite simple: the ERM provided some intra ERM stability which was more than offset by increased external variability. And this result carries over to real exchange rates. Thus the increased external variability in nominal rates was not fully offset by differential rates of inflation. All these conclusions held whether one compared experience before 1979 with that after, or whether one analysed the ERM countries compared with those outside.¹⁰

The Performance of the EMS - Inflation, Trade and Growth¹¹

¹⁰ The bases for these statements is contained in Horst Ungerer, Owen Evans, Thomas Mayer and Philip Young, The European Monetary System: Recent Developments, International Monetary Fund, Occasional Papers 48, Washington DC 1986. Note that Ungerer's analysis ceases with 1985, so it covers the period when the major countries were not conducting massive intervention, and in particular Britain was not shadowing the deutschmark. From 1986 onwards the results have been confounded by many attempts to influence the dollar, yen and deutschmark.

¹¹ The best summary of all the experience on inflation and growth rates is to be found in Roland Vaubel, Comment on "The European Monetary System: a Regional Bretton Woods or an Institutional Innovation" in J.J Vosgarau (ed) New Institutional Arrangements for the World Economy, Springer-Verlag, Berlin 1988

But one of the abiding claims for the EMS is as a discipline on inflation - the participants acquire the credibility of the Bundesbank. Perhaps so, but it is not evident from the statistics.

In the ERM countries the (weighted) average inflation rate decreased more slowly than in the rest of OECD countries. Even confining the discussion to Europe, the decline in the ERM countries was less than that in other OECD European countries. Furthermore the inflation rate in the ERM was, in 1986, rather higher than that in the other OECD countries. From 1987 on, these relationships become blurred by the sterling shadowing of the mark and, overall, the various interventions and monetary policies induced by the Louvre and other "agreements".

What about the variability of inflation. Contrary to assertions frequently made by the pro-EMS lobby, convergence on inflation took longer in the EMS than in the rest of the OECD. Furthermore over the life of the ERM (to 1986) the dispersion of inflation rates has been much larger in the ERM countries than among the major OECD countries. Indeed, comparing the 7 years before with the 7 years after 1979, among ERM countries the dispersion of inflation rates increased, whereas in the other OECD countries the dispersion fell.

The argument that stability of nominal bilateral exchange rates should, according to the EMS apologists, promote trade by reducing the exchange risk. The growth of trade within the ERM compares, however, most unfavorably with the growth of trade with non-EMS countries.¹² The (unweighted) average of the five old EMS members growth of trade with one another from 1979 to 1984 was 0.6 percent compared with 4.1 percent with non ERM countries

Finally growth. The growth of real investment and GDP was much slower in the ERM countries than in the other OECD countries. And after 1979 growth and investment declined more than in the other OECD countries: and in European non-EMS countries investment growth actually increased.

(Put Table No. 1 from de Grauwe (1987) in here)

The EMS - Modelled Results

All these conclusions are from the actual historical record. And they are properly subject to the argument that we do not know what would have happened in the absence of the EMS in the years following 1979. It might be suggested that, if the EMS had not been created the performance of the ERM countries would have been much worse. Although there is no irrefutable way of dealing with such allegation, Patrick Minford has performed a great service by modelling the EMS in its world

¹². See Paul de Grauwe, Memorandum in : Memoranda on the European Monetary System, of the Treasury and Civil Service Committee, Consequences of UK Membership of the European Communities, House of Commons, London 1985.

context.¹³ The results are complex but clear. As Minford puts it: "...the EMS system gives somewhat poorer overall stability than floating to the 'dependent-currency' participating countries - that is France, Italy and the UK...the reason...is that the EMS, with its deflationary bias for the dependent-currency countries, causes them to over-react in a deflationary direction to the shock (of 4 percent increase in monetary growth for two years)."

The (shock) increase in monetary growth would be associated, in the absence of the EMS, with a fall in the nominal and real exchange rate. There is an increase in the inflation rate, but demand increases and output and net exports increase. In the EMS the constraint on the movement of the exchange rate means that prices and wages increases cause an appreciation of the real exchange rate. Thus the dependent countries suffer from the reduction in net export demand due to the real appreciation and from an increase in inflation. These are, of course, the transitory effects. Ultimately the dependant country must either devalue (realign) or deflate, in order to counter the effects of the original monetary expansion.

Minford's model does seem not to conflict with the descriptions by Vaubel, Fratianni etc. The EMS induces a perverse appreciation of the real exchange rate and induces unnecessary output losses in adjusting to the monetary shock. On the other hand countries that are not Bundesbank dependent gain somewhat from the overvaluation of the French franc and Italian lira etc. The obvious example is Germany, but also the United States and Japan are able to secure some of the markets of France, Italy etc.

EMS adherents will, of course, argue that these model runs are not really relevant, since the EMS will be more likely to prevent a monetary shock than if one is outside the ERM. Such an allegation requires more than assertion to give it credibility, especially in view of the behaviour of the United Kingdom during the shadowing of the Deutschmark in 1987-88. Indeed, on that occasion "joining" the ERM club actually caused the monetary explosion.

The EMS and Persistence of Overvaluation

Granted that there is more inertial inflationary pressure in France and Italy, it is possible that this Minford mechanism explains some part of the chronic overvaluation of the franc and the lira. And this overvaluation has occurred in spite of the use of exchange controls, on occasion most restrictive controls, during the life of the EMS. It is never easy, however, to demonstrate that an exchange rate is above the value that would emerge on a free market, but the persistence of the large German current balance of payments surpluses with respect to its EMS participants does suggest that the overvaluation has been chronic and substantial.

¹³ The results are to be found in A. Hughes-Hallet and Patrick Minford, "The European Monetary System - does it achieve its aims", Konstanz Seminar on Monetary Theory and Policy, 1989, Liverpool University, Liverpool. The Liverpool model of the world economy has been used extensively to explore many issues of fiscal and monetary policy.

I suspect that the reason must be sought in the lore of politics. There is no doubt that, politically, realignment, however justified, is viewed as a policy failure. The long reluctance of politicians to concede to a devaluation contributes to chronic overvaluation of the dependent currencies. But there is the additional question: when they do devalue, why is it that the devaluation is such that the currency is just about brought into line with its deteriorated purchasing power? Why do not they devalue sufficiently so that, on the average up to the time of the next realignment, the currency is not persistently overvalued? If, for example, one examines sterling's devaluation in 1949, most authorities were clear that in PPP terms it was overdone (from \$4.20 to 2.80). Sterling was then undervalued for some years. At the time it was thought that this was an appropriate policy, since one had to ensure that the markets would certainly not expect another devaluation to follow for many years. So it turned out. One suspects that the reluctance of ERM members to sharply devalue is that the central banks believe, rightly or wrongly, that such devaluations would signal a country's choice of a lax policy on inflation. The country would be thought to be not merely making up for past laxity but also preparing for new monetary expansions. If so the persistent overvaluation of the currency is a high price to pay for such a reputation and credibility.

Germany and Credibility

One of the oft-repeated arguments for ERM membership is the "credibility" argument - members latch on to the stability of the Bundesbank. The view that by hanging on to the tails of the Bundesbank members reduced the costs of disinflation has been discredited by the data. Countries outside the ERM did rather better. But we must ask the additional question: what does Germany gain from being in the ERM?

Initially the Bundesbank strongly opposed the EMS. In one of the rare capitulations of the Bundesbank to political pressure, Helmut Schmidt foisted it on them. There is no doubt that Schmidt saw considerable political gains to be garnered from polishing up a very tarnished image of the Common Market. The relaunch of European integration was one of the achievements of both Schmidt and Giscard d'Estang. Of course the creation of a free-trade area and the removal of controls on capital and labor flows could have gone ahead, I believe rather more easily, without the apparatus of the EMS. But it was an important political symbol. As the Bundesbank surmised however, the economic benefits to Germany were, and remain, much less clear.

The Bundesbank's responsibility was defined in its constitution as the defence of the domestic value of the mark. It had never relished the role of the mark as a reserve currency. The demands on the mark as a reserve currency may often be inconsistent with the policy of domestic stability. But the emergence of the mark as a one of the three great currencies meant that it could not avoid some of the problems of being, for example, one of the main custodians of speculative flows out of the dollar. In such circumstances, the EMS might be seen as a way of diffusing those flows to other members. However, the other members of the EMS (excepting the Netherlands) maintained not merely exchange controls but also a formidable battery of other credit and capital regulations which were designed, inter alia, to ward off such speculative flows. Ironically the non-ERM member, the United Kingdom with its wide open capital markets in the 1980s, that was, after Germany, the next most important recipient of speculative flows. If the price of the ERM was continued capital controls, then German was, on this score, a net loser.

The Bundesbank behaviour with the EMS is almost certainly different from the policy it would have pursued in the absence of the EMS. The pseudo-fixed system ensures that, if Germany pursued an expansionary monetary policy, the inflationary costs would be more spread over the other members than if there was a floating rate regime. Thus there would be less incentive for the Bundesbank to keep money tight, and more incentive to inflate.¹⁴ This raises expectations of a higher average rate of inflation throughout the EMS. Not only does Germany not gain from her membership, but also the credibility gain is more disputable.

In general, one may conclude that the fears expressed by the Bundesbank, and overridden by Helmut Schmidt, were well founded.¹⁵

A Fundamental even Fatal Flaw in the EMS

In the old gold standard system, there were automatic mechanisms which, in response to some external event such as a physical calamity or to some internal "error", would restore the equilibrium of the system. For example the loss of an a country's main grain crop would give rise to increased prices and net imports which would be financed in part by exports of gold. This would reduce the reserves and the money stock to bring the price level back into line with the rest of the world (where both gold reserves, money stock and prices would rise). It was a self-correcting system.

There is no inherent self-correction in the EMS. On the contrary, in its pure form the system will provide perverse signals. In order to demonstrate such perversity, I fear that we must specify more precisely how an ideal EMS works. Of course such an ideal will not include either exchange controls or, more important, those barriers and restrictions which are imposed on domestic institutions which prevent or inhibit the residents choosing freely the denomination of their assets and debts. I shall therefore assume that, in this broad sense, there are no exchange controls. Since the objective of the EMS was to provide an "area of stability", let us assume that the exchange rates between participants are actually fixed for a specified period, then realigned. The actual period during which they can be presumed fixed will vary according to the divergencies in inflation rates - the smaller the diversion the longer the time between realignments. Let us suppose that the period is one year.¹⁶ If everyone knows that exchange rates are fixed for that year, then nominal interest rates on financial instruments which originate and mature in that year will be approximately the same for all participants in the ERM. Arbitrage will ensure this near equality. For if the rate

¹⁴ See Francesco Giovazzi and Alberto Giovannini, Limiting Exchange Rate Flexibility: The European Monetary System, Cambridge, MIT Press 1989.

¹⁵ On the effects of the EMS on Bundesbank behaviour during the Plaza and Louvre accords, see Yoishi Funabashi, Managing the Dollar: From the Plaza to the Louvre, Institute of International Economics, Wahsington DC (1988).

¹⁶ The reductions in the dispersion of inflation rates over the period 1985-9 have resulted in a period of three years, up to January 1990, when there were no realignments.

of interest in Italy substantially exceeds that in Germany, then it will pay all asset holders to switch to lira, to borrow in Deutschemarks and invest in lira for that period of fixity of the lira-mark exchange rate. This is no more than the application of the "law of one price" to financial instruments. (In this case, because of the fixed rate of exchange, the cost of forward cover for the transaction is zero)

Thus the EMS forces countries to have the same nominal interest rates. If, however, Italy is inflating at a rate of 7 percent and Germany at a rate of 2 percent (both over the relevant period of fixity), then there is a problem of perversity. With the same interest rate at, say, 5 percent, the real rates of interest for Italy is minus 2 percent and for Germany plus three percent. Thus Italy will have an expansionary monetary policy, while Germany will pursue one of restraint. But this will exacerbate inflation in Italy and yet restrain further the already low inflation in Germany. This is the opposite of "convergence", namely it induces divergence.¹⁷

Realignment Dynamics

Such perverse forces cannot continue for long. As the date, assumed known and fixed, for realignment approaches, so the interest rates, for shorter and shorter maturities, will reflect the expected depreciation of the lira. It will pay speculators to borrow lira and buy mark financial asset to cash in on their appreciation at the realignment. This will cause lira interest rates on maturities that cover the realignment date to rise well above corresponding German rates; the difference will reflect the expected change in the exchange rate. When the maturity is overnight corresponding to the realignment, lira rates of interest may rise to hundreds of percent. Of course the interest rate differential is at last in the right direction; the high inflation country with the high rates and the low inflation country with the low ones.

It is unlikely, however, that these interest rates would be the pattern which would be chosen by a Minister of Finance who, unconstrained by membership of the ERM, was pursuing a domestic disinflationary policy. But, more important, after realignment and with Italy still inflating at 7 percent and Germany at 2 percent, the system reverts again to the status quo ante. With the exchange rates fixed for the next year, Italy and Germany will have the same interest rates and the same perverse effects on monetary growth.

This sort of effect can be observed in the Lawson decision to peg sterling to the mark at 3.00 in early 1987. With British interest rates at about 5 percent above those in Germany, a fixed exchange rate gave rise to a great influx of capital. This put considerable pressure on British interest rates and, in spite of the manifest inflationary pressure, they were brought down to 7.5 percent. Although, as we shall see, the authorities allowed the mark-sterling rate to rise from March 1988, this was an overshoot

¹⁷. This effect has been called the "Walters critique" by the Economist January 27th 1990, p. 71. "Italy, you might say, is a working example of the "Walters critique"...(because the ERM) will force interest rates down in the highly inflating countries. That is exactly what is happening in Italy"

before the inevitable high interest rates and devaluation (or "realignment").¹⁸ The details of that story will be told in chapter 7.

Uncertain Realignments and Moving in the Band

This model of the ERM is a caricature. It delineates, even exaggerates, the strengths and the weaknesses of the pure EMS. But as a working institution the EMS is anything but pure. For example the exchange rates can move within the band, so that in principle there can be a 4.5 percent devaluation (or 12 percent in the case of Spain). Participant countries however usually try to keep their rates somewhere in the immediate vicinity of the central rate, presumably because any bumping against the limits would signal the likelihood of a realignment. This brings us to the assumptions we made in the model, namely that the time of the realignment is known with certainty. This is not the case. Although they are not complete surprises, the realignments of various dimensions can be predicted only with large uncertainties attached. It is however usually quite easy to predict the direction of the realignment - the French franc and the lira will go down against the Deutschemark. Thus the shadow of devaluation is cast forward in time and increases interest rates in Italy relative to these in Germany. But again whether that devaluation-shadow effect is consistent with what a prudential Finance Minister would require to cope with domestic conditions in Italy is another matter.

One may reflect that it is odd that it is the uncertainty of exchange rates in the ERM that makes it possible for Italy to pursue disinflationary monetary policies and for Germany to avoid deflationary policies. The EMS was to be an island of stability and certainty in a sea of floating flotsam. But it is only the uncertainty that keeps it above water.

Exchange Controls and the Consequences of Freedom

Participants in the ERS can pursue deviant interest rate policies if they are protected by suitably high controls. Behind the controls the authorities can increase interest rates, knowing that they can regulate the import of capital. Such exchange controls have been characteristic of France and Italy during the life of the EMS. They are required to be eliminated by mid 1990. Indeed overt exchange controls have been substantially reduced over the years 1987-89. As one would expect the Eurofranc and Eurolira market rates have more closely approached the rates of interest on domestic markets in France and Italy. And in January 1990 Italy embraced the 2.25 percent band. All this suggests that the equality of nominal interest rates will become more of a reality of the ERM.

In 1990, it has been suggested by Messrs Francesco Giavazzi and Luigi Spaventa that now overt exchange controls have been eliminated among the main participants of the

¹⁸ I discussed this process in Britain's Economic Renaissance (Oxford 1976), and, in application to the current situation in Britain, in articles in the Financial Times April 6th 1988, The Times, June 3rd 1988, and finally in the Independent, "Money on a Roller-Coaster", July 14th 1988. By the end of July, I was asked to keep quiet and cease publishing. I did.

ERM, governments cannot risk a realignment.¹⁹ Any hint of a realignment will cause such speculative capital flows, untrammelled by controls, that governments will not be able to maintain domestic stability. It is conceded that there will be downward pressure on real interest rates in the inflating countries and this will push up inflation in the short run. But it is argued that the appreciation of the real exchange rate, together with rigid nominal exchange rates, will so influence expectations that business men will become convinced that they cannot raise prices and that they must resist trades union pressure. Thus will inflation be conquered, convergence will be complete and the old central rates maintained.

This argument may well be correct. It leans very heavily on expectations all accommodating to the fixed exchange rate. We know very little about expectations and they may behave in the manner the authors claim. One must have grave doubts that any such adjustments occur. We have a long historical record - Britain in 1926-1931 and in 1987-90, Chile in 1979-83, and many other examples - to show that too high a real exchange rate distorts the economy, raises the relative prices of domestic goods and depresses the prices of traded goods, rather than defeats expectations of inflation. Furthermore, for their system of fixed parities to be validated, it must mean that over some period the inflationary countries must inflate at a value less than that of Germany. For example, if Germany's inflation rate is 2 percent and Italy has been inflating for, say 3 years at 6 percent, then to recover lost ground in the next three years, Italy must have a deflation of 2 percent for those years. Possible, perhaps, but hardly plausible.

Similarly it appears that the Italian authorities, while conceding that the lira interest rate is constrained by the ERM to be negative in real terms and a powerful stimulus to demand and inflation, would be simultaneously intoning their absolute opposition to "long run" inflation as manifest in their determination to hold the nominal exchange rate. It is analogous to the drug addict who swears off drugs, but only after the next fix. I find it difficult to believe in such an inconsistent package of policies. It will be accepted only by the most credulous.

Messrs Giavazzi and Spaveta are really describing a knife-edge type of equilibrium. Suppose for example that Italy and Germany have converged so that they have the same rate of inflation. Then they may comfortably have the same nominal and real interest rates. There is de facto union, and exchange rates can remain fixed. Everyone may well be convinced that they will remain so and expectations will be validated. The ERM will be required to cope with incidental increases in the demand for money by one country and the reduction in demand by another country, by maintaining the same interest rates. But this state of perfection is hardly of interest. We know that we cannot identify all the trials and tribulations and offset them to produce such a model of stability. What we need is a system that will deal with perturbations and shocks, such as monetary mistakes and natural disasters. Suppose, for example, someone makes a mistake and there was an accidental increase in the Italian inflation rate. Then, alas, we have all the inconsistencies and perversities discussed above.

¹⁹. See Francesco Giavazzi and Luiga Spaventa, "The 'New' EMS", CEPR Paper No. 369, Centre for Economic Policy Research, London, 1990

Covert Exchange Controls

Although overt exchange controls have been largely eliminated in the EMS, this does not mean that there is complete or even substantial freedom to move capital and currencies over borders. Continental Europe has substantial control over national banking systems and over financial institutions. These are most apparent in the cartel structures that are characteristic of banking and finance in France and Italy. French bankers conceded, albeit privately, that their their high margins and high costs are due to a cartelized market which the government continues to sanction because it makes it easier for government to maintain covert control.²⁰ Similarly it is well known that Italian banks have extensive cartel arrangements, and that government controls percolate throughout all large banks.

Perhaps more surprising, however, is the extent of covert exchange controls in Germany - apart from Britain and perhaps the Netherlands, the most liberal member of the Community. German insurance companies, which control probably more than 70 percent of long-term savings, are not permitted to buy non-Deutschemerk denominated assets. By regulation they must have a complete currency match for their obligations. They can only hold 5 percent of their portfolio in equities (and necessarily mark equities). In a corporatist society, the purpose of these regulations, although ostensibly prudential, is to ensure a recycling of capital, usually via the intermediation of the banks, as loans to the large firms of German industry. Similarly there are restrictions imposed on foreigners (that is non citizens of the Federal Republic) holdings of Bundesbankobligationen.²¹

Whatever the reason for these restrictions, the effect is to prevent the free flow of capital within the Community. They act as exchange controls, and perhaps even more effectively than the conventional exchange controls, in preventing any mass flight of capital or in stemming the tide of an inflow. Even more important it their role in maintaining a corporatist system in the continental members of the Community. But that is another story.

III A Parallel Constant Value Currency for Europe

²⁰ See Guy de Jonquieres, "The break with French tradition", Financial Times January 17th 1990. He quotes a foreign banker as saying "The authorities have'n't bitten the bullet by signalling to the local market that it has to compete internationally". France's high tax on capital income may well encourage a larger outflow over the longer term.

²¹ It may appear surprising that these covert exchange controls have not played a more important role in Treasury and other discussions about the EMS. In Britain's Economic Renaissance, Renaissance, I talked about the "restraints on the free flow of capital" but I was not aware of the true state of affairs until 1988. Most commentators ignore them and just remark on the remarkable reduction of exchange controls - with no great effects on the EMS. It is noteworthy that, at the summit meeting in Madrid in June 1989, Mrs Thatcher and Sir Geoffrey Howe, when agreeing to join the ERM, explicitly required that these regulations and controls be eliminated.

The discussion so far has been decidedly negative. But I believe that one may properly conclude that the EMS/ERM framework is not even a politically feasible let alone the best basis on which to build a monetary union of Europe. Furthermore one would not like to impose a standard money on Europe by a monopoly fiat of the central banks acting in concert. There is no overwhelming evidence that such a monopoly solution is the best solution; on the contrary, the most astute scholars have argued that competing currencies would avoid the temptations to which the dispenser of a monopoly currency is subject.²² In keeping with the avowed liberal principles of the ECE, it is surely best to maintain a choice of currencies. People, not governments, should be allowed the currency of their choice. One currency on the menu should be the incipient Euro-union currency. That currency should be at least as attractive as the national currencies in order to qualify as the currency of the union. (The ECU has proved to be an unsuitable currency for Europe, since generally people have shunned it)

In this final section I try my hand at sketching a monetary system which will ensure stability of the general price level. This, albeit in a wobbly sort of way, Western Europe enjoyed under the gold standard for centuries. The norm for a civilized society was a stable currency and not inflation. After these many decades of depreciating currencies, it seems that the world yearns again for that ancient stability. Anchors are needed. Institutions such as the Federal Reserve Board, the (old) Bank of England, and the Bundesbank have provided such anchors in various periods of the historical record. But all have, at times and to varying degrees, failed to give that that rigidity when under pressure.

Rather than relying on authorities and institutions, one would like to rely on rules. It is rather easier to agree on rules and procedures than to agree on policies and outcomes. Furthermore those rules should be transparent and unavoidable, rather than, as under the gold standard, obscure and escapable. In this chapter I discuss the problems and prospects of basing a European currency on a commodity basket. Thus one unit of money will always be able to purchase certain quantities of commodities which represent the budgets of consumers. I also consider some paths from the present situation to the commodity currency, and how commodity money may exist side by side with present national moneys and ECUs

Of course this is not a complete monetay plan for Europe. It is merely a mixture of some ingredients of a monetary constitution. It is really half-baked. But it is proposed simply to test the ideas, not to inflict on suffering humanity. The underlying spirit of these ideas is that the people of Europe should be free to chose whatever currency they wish in order to carry out their business. Governments should impose neither restrictions nor penalties. Competition between currencies is the best way of preserving both our freedoms and reliable units of account. But also, in cooperation with the private sector, the governments of the Community should promote a monetary unit which, by virtue of its own operating rules, is free of inflation.

²². See the persuasive account of the case against a monopoly currency by Roland Vaubel "Monetary Integration Theory" in International Economics, Surveys of Economics pp 223-262, George Zis et al, London, Longman 1988

The Need for a Stable Currency

Money performs three basic functions: it serves as (1) a store of value, (2) a unit of account, and (3) the medium of exchange. Inflation erodes all three functions, but to very different degrees. As we know from many historical inflations, money still serves as an intermediary in exchange even though inflation is very high. For example, in the many Latin American inflations that have occurred in the 1980s, although the increase in the price index may be as much as 30 per cent per month, the currency is still used for the host of small household transactions. But no-one keeps notes as a store of value and virtually all contracts are not in terms of the currency as a unit, but are calculated in US dollars or perhaps in some agreed indexed form of money.²³ The separation of the unit of account from the rapidly depreciating medium of exchange involves considerable costs - as anyone who has lived in Argentina, Brazil, etc can readily testify. One main business is to minimise any currency holdings so that one is not substantially expropriated by the State. And it seems that everyone gives up many a useful employment to become a currency dealer. The main business is getting rid of currency as quickly as possible.

Maintaining a constant unit of account is as important as maintaining constant standards of physical measurement - where a kilogram and a metre are always the same. With money it is more difficult since, unlike distance or weight at sea level, there is no natural and immutable definition of the value of a monetary unit. Money exchanges against a host of goods and services. In the past the definition of money has been in the form of goods, such as ounces of silver or gold of specified purity. Thus there is usually just one particular good, defined and widely used as money. This is ideal only when the price of gold (say) in terms of representative baskets of other goods and services in the economy does not much change. Then gold is good surrogate for all goods. But, over the years, gold has not behaved so well. Gold discoveries and new technologies have reduced the price of gold relative to other goods, and so induced inflation. At other times, the stocks of monetary gold have stagnated and so, as production of other goods increased, given many years of deflation. (See Table 7.1 Wholesale Price Changes under the Gold Standard) The legendary stability of the gold standard is indeed legend. Allan Meltzer has shown that predictability of the price level and GNP was far, far less under the gold standard than under the floating rate system of the 1970s.²⁴ Little wonder that Keynes described gold as a "barbarous relic".

A Broad Commodity Money

The natural question is whether it would be wise to include more goods in the

²³ Deflation, it will be noted, increases the attraction of money as a store of value and increases, if anything, its use as an intermediary. As a standard of account, it may suffer somewhat, but not if the deflation is gentle (as in the United States after the Civil War)

²⁴ "Some Evidence on the Comparative Uncertainty Experienced under Different Monetary Regimes", in Alternative Monetary Regimes, ed Colin D. Campbell and William R. Dougan. Baltimore, Johns Hopkins University Press, 1986

definition of the monetary unit. Other precious metals are obvious candidates. Bimetallism, for example, became an active issue in Britain in the 1850s as people became concerned about the gold discoveries inducing inflation. Bimetallism involves fixing the ratio of the prices of gold and silver at the mint - and both are given the status of legal tender. Under propitious circumstances - in particular where the mint ratio is approximately the same as the free metal price ratio - the bimetal standard can function as such. But if, for example, many new easily accessible silver deposits are discovered, then the price of silver will fall relative to that of gold, and so silver currency will drive out gold; at the fixed mint ratio, Gresham's Law works - bad money drives out good. This is the normal fate of bimetallism.²⁵ Nevertheless, throughout history the periods of bimetallism have exhibited much more stability than those of gold monometallism.²⁶

An obvious way out of the Gresham's Law effect is to avoid fixing the mint ratio. The unit can be defined simply as a basket of the two metals - say one ounce of silver and 0.02 ounces of fine gold. The price ratio could then fluctuate. The coins would be composed of an alloy of gold and silver in the fixed ratio. No doubt there are many technical difficulties in minting and maintaining such coins. But for our modern economies this does not matter since we circulate bits of paper rather than coin. Under this metallic commodity standard, the currency note would be a claim to the 1/0.02 ounce mix of the metals. The monetary authorities would stand ready to convert notes into the metal mix, and vice versa. This requires the authorities to hold stocks of silver and gold sufficient to meet any convertibility demands. Any shortfall of such stocks will be reflected in people's suspicion that the authorities will not honour their obligations and the currency will become inconvertible. There have been too many cases in history where convertibility has been suddenly revoked to allow any monetary authority to get away with small stocks of the precious metals.

A Commodity Money without Commodities

The idea of a commodity money that is not based on the narrow basis of silver or gold stocks, but is founded on a broad range of representative commodities or services has surfaced periodically in discussions about anchors. The attraction of convertibility into a basket of commodities, or even services, is that one avoids the idiosyncracies of gold or silver supplies and all the political problems associated with the gold producers or owners. Furthermore it seems quite absurd for scarce resources to be devoted to digging a hole in the ground to extract gold, only to return that gold again to the deep vaults of the world's central banks. Convertibility into the ordinary useful commodities of trade appears much more attractive as an anchor in the real economy.

Obviously the commodity basket must be very large to accommodate normal lot sizes

²⁵ The United States went on a bimetallic standard in 1792, but as the price of gold rose relative to that of silver, so silver drove out gold and the United States was on a de facto silver standard for some 40 years.

²⁶ See Michael Bordo, "Bimetallism" in The New Palgrave Dictionary of Economics, ed John Eatwell, Murray Milgate and Peter Newman, Macmillan, London 1987.

of wholesale trade. Similarly the commodities must be readily storable and of identified uniform quality, just as under the gold standard the gold content was of a given purity. And the monetary authority would clearly enter the lists as a major commodity dealer.

The prospects of a monetary authority sitting on large stocks of commodities, and the likelihood that one would add to the present grain mountains, cheese hills and oil lakes has been sufficient to chill the enthusiasm of most economists. (Although some economists have also been entranced by the prospects of introducing a world Commodity Reserve Currency to replace the old role of gold and which, in addition, would enable the world authorities to intervene massively in "smoothing" the oscillations in commodity prices and in reducing the variations in the incomes of producers of primary commodities.²⁷).

However it has also occurred to many economists, although I believe the Irving Fisher was the first to enunciate the idea, that one does not really require commodities as the reserve asset.²⁸ Instead one could simply supply a financial asset which gave the holder sufficient resources to buy the commodities if he so wished.²⁹ The point is that the value of the currency is preserved in terms of the commodity basket. If, for example, one defined the currency in terms of a fixed fraction of the basket of goods and services that enter into the retail price index, then one unit of the currency would be of a sufficient value to purchase that fraction of a basket.

As indexed money, it appears to be closely analogous to an indexed gilt-edged security. But there is a crucial difference. An indexed gilt has a fixed maturity, usually many years, at which time the principal is paid duly enlarged in proportion with the change in the retail price index. The authorities, however, do not guarantee to redeem the gilt at par, duly uprated for the retail price index, at any time. With an indexed gilt, one takes one's chance on whatever price one can get on the market for such bonds. For this commodity money, the authorities always redeem at slightly below the par value of the retail price index. The "slightly below" condition is to ensure that there is some disincentive against too ready redemption, and that the issuing authority earns sufficient profits to pay for the costs of operating the system.

A Stable Commodity Money for Europe

²⁷. See Albert Gailord Hart. "Commodity Reserve Currency" The New Palgrave Dictionary of Economics, ed John Eatwell, Murray Milgate, and Peter Newman, Macmillan, London 1987. Lord Kaldor was the primary force behind these suggestions.

²⁸. See Irving Fisher, The Purchasing Power of Money, 2nd edition, New York, Macmillan 1913. Warren L. Coats has developed these ideas in: "In Search of a Monetary Anchor: A New Monetary Standard", IMF Working Paper, October 11, 1989, Washington, DC.

²⁹. The seminal paper is Robert L. Greefield and Leland B. Yaeger. "A Laissez-Faire Approach to Monetary Stability", Journal of Money Credit and Banking, Vol 15 August 1983, p 302-15. See also Irving Fisher, Stabilizing the Dollar, Macmillan, New York, 1920.

How would one provide this alternative of a stable European money? I believe that it should be introduced as a parallel currency to the existing national moneys in Europe. In accordance with the liberal principles nominally embraced by the Community, all citizens should be allowed freely to use what every currency they would wish with no restraints of legal tender or overt and covert exchange controls. Thus they should be able to hold and transact in the commodity money. Thus people could choose to conduct business in any of the national moneys or in the Euro commodity money, the ECOM.

The next issue is to specify the paper assets in which the ECOM is redeemed. The natural candidate is any of the national currencies. Thus if the commodity basket is bought by 100 stg at the beginning of the year and by 108 stg at the end of the year, and if one ECOM buys the basket, both at the beginning and the end, then the redemption value of the ECOM will rise in sterling terms by 8 percent over the year (ignoring the profit margin of convertibility). Thus the European Bank of Issue (EBI) would have to maintain a reserve of sterling, or easily realizable sterling assets, and other Euro-currencies in order to redeem its pledge. Then the EBI would be acting like a currency board, except that the redeemable values would be defined as the equivalent money to buy the fixed commodity basket.

An alternative redemption arrangement might be more efficient. First one would restrict redemption operations to wholesale quantities of money. Thus instead of exchanging ECOM against sterling, one would specify that the ECOM would be exchanged only for large treasury bills (say of 100,000 stg equivalent). On one ECOM note it would promise that "this note is redeemable for a fraction (or number) of treasury bill(s) sufficient to purchase the basket of goods defined as one ECOM".

To see how the system would work, imagine that we begin in a nice equilibrium, but then there is some accidental overissue of ECOMs. Prices in ECOMs would then rise as people got rid of their ECOMs by spending them on goods and services. But the ECOMs can be exchanged for an amount of treasury bills equivalent to the base value of the ECOM, and these treasury bills are worth more than the ECOM notes by the amount of the price rise. So people will be induced to redeem their ECOM notes; they will take their ECOMs to the EIB and receive treasury bills in exchange. This will reduce the quantity of ECOMs and so depress the ECOM prices of goods, until equilibrium is again restored with the ECOM value in the market at its original goods value.³⁰ Private arbitrage will thus keep the standard ECOM constant in value.

Problems with the ECOM

There are obviously a host of problems in setting up an ECOM. Many of them are basic policy issues. For example, I have discussed linking the ECOM to the consumer basket - and obviously I would mean the weighted average consumer basket in the Community. The ECOM would be kept in line with the weighted average of retail price indices. This would have the advantage that no single country would have any incentive, in addition to those they have already, to distort the index. But there would

³⁰. For a clear account of the process of arbitrage, see Warren Coats 1989 op cit.

be also the problem of "harmonizing" the indices and, preferably, calculating them more frequently than the present monthly figures. A more substantive issue is whether the retail basket is an appropriate anchor. It is probably better to index to the prices of things produced, rather than consumed, by the Community; then holders of ECOMs (as do indexed gilts) will not be shielded against changes in the terms of trade. But the retail price indices are much used throughout the Community and represent a more accepted unit of standardization of value.

In order to set up the EBI, the various central banks would contribute reserve assets, defined as outlined above, in exchange for shares on a pro-rata GDP basis. Analogous to the introduction of indexed gilts in the UK, it would be best to begin with a relatively modest issue of ECOMs - though there needs to be sufficient to give a sufficient momentum to the market. In its constitution the EBI would have the sole role of issuing and redeeming ECOMs.

If the arbitrage from reserve instruments to ECOMs is to be left solely to the initiatives of the private market, the reserve instruments must be designed carefully so that they perform their function of automatically adjusting the quantity of money. Clearly the yield and expectations must be such that a suitably large quantity of reserve assets is willingly held by the private sector. When there is no inflation in terms of the ECOM unit, there is no incentive to redeem reserve assets for ECOMs or to reduce stocks of ECOMs in buying reserve assets. If, however, ECOM prices rise, then the reserve assets, defined in indexed terms, are more valuable than holdings of equivalent ECOMs, and the private sector will then reduce its ECOM balances, and acquire the more valuable reserve assets. I conjecture - and it is only a guess - that the market would respond very quickly even smoothly to quite small variations in the price level in ECOMs. Rational expectations would anticipate a quick reversal of any ECOM inflationary pressure, and there would be a great incentive to cash in one's ECOMs while the going was good, in anticipation of a fall in the price level to come. Similarly I would guess that the price response of goods and services to variations in the quantity of ECOMs would not involve the long lag normally associated with monetary policy. The main reason for this conjecture is that there would be virtual certainty that any deviation would be soon corrected, and everyone would know the long term price level. But I am by no means certain of this process, and this gives additional reason to be cautious about the introduction of the ECOM

Thus it might be efficacious if there were developed first an external eurocurrency as suggested by Jacques Riboud.³¹ This, in M. Riboud's proposal, would be a market in constant-value dollars. The Community could encourage this market and guide it by suggesting that the standard of value should be related to the weighted retail (or producer) price index for the Community. The ECOM could then take over the external unit of account, accepted and even hallowed by use, and then internalise it.

There is no doubt that creating an ECOM would not ease the task of the constituent monetary authorities in dealing with the liberation of financial markets to which all constituent countries are committed. But it is doubtful if it would make the task much more difficult. If, for example, Greeks can transact in Deutschmarks rather than

³¹. Op. cit

drachmas, the possibility of substituting ECOMs will not be any great change. As people in Greece switch out of depreciating drachmas into either Deutschmarks or ECOMs, the Greek monetary authorities will have to reduce their drachma monetary expansion to keep inflation at its existing rate.

A ECOM Monopoly for the Community ?

If there is to be a monetary union which develops as Delors envisaged through the EMS becoming more stringent, that is to say with narrower bands and virtually no realignments, then it must be based on the dominant role of Germany (FRG and GDR). There are obvious political objections to this arrangement which Delors tried to solve by building up a central bank of Europe (a European System of Central Banks) which would control Europe's monetary policy. But the Bundesbank, along with Britain, has strongly resisted any encroachment on its powers and prerogatives. In fact the Bundesbank must be the main agent controlling Europe.

The reluctance of countries in surrendering their monetary sovereignty to another sovereign state is entirely understandable. And this must be an especial concern if that state is a Greater Germany - so much the dominant power in the Community. It is, however, a different matter if monetary sovereignty is surrendered not to any state but to the standard of an inflation-free currency. The government of Britain, for example, would not be giving up its sovereignty to any other legislature or to any foreign central bank. It would be surrendering its power to expropriate its citizens by inflation. Monetary policy would be depoliticized. Neither domestic nor foreign politicians and functionaries would have any control over the money of Europe.

This suggests that once the ECOM has been introduced and used for some time, it might well be that an ECOM currency union could be formed for Europe. If the ECOM displaced national currencies to any considerable extent, it would be a natural development to adopt the ECOMN as the currency for the Community. Indeed, just as the gold standard was widely adopted throughout the world in the 1870s, so might the ECOM, in one or other its many mutations, be embraced by countries outside Europe - even the United States and Japan. But these are, of course, pipe dreams of an inflation free world.

Pros and Cons of the ECOM

When discussing the likely consequences of an ECOM system, one must always specify, as best one can, the best feasible alternative. A point by point discussion would try any reader's patience. It might be useful instead to lay out what I believe are the major issues and indicate my judgement about where the balance of advantage lies.

Consider first for Britain the alternative of the free float and a monetary policy that maintains a constant quantity of Mo, preferably through the operation of a monetary base control system. This, I believe, would be superior to the ECOM arrangement.

The constancy of the monetary base would ensure that there was no runaway inflation or crushing deflation. True, one would not enjoy the great price stability of the ECOM, but it is often more efficient to adjust to technological progress, changes in the terms of trade (increases in the price of oil, for example) etc., by allowing exchange rates

freedom to move to their market value. The central point is that if markets are not allowed to adjust exchange rates, then the burden of adjustment will fall on other markets: commodity, labor, money, bond and stock markets. A change in exchange rates is likely to be the best way of making such adjustments.

The objections to this system of monetary-base-control with floating exchange rates, compared with the ECOM, are easy to list. The change in the velocity of circulation may be different from the 3 percent upward drift that we have conveniently assumed. (Although I believe it is consistent with the history of the last two or three decades, there is no guarantee that trends can be extrapolated). The great advantage of the ECOM system is that the velocity adjusts endogenously, whatever happens to the demand for (base) money, to keep the price level constant. There is no opportunity for making mistakes in forecasting money demand; if there are changes in technology or monetary markets that increase the demand for money, then the ECOM system will ensure a response at the fixed price level. There will be no monetary excess or starvation of the economy.

An interesting question is whether it is indeed plausible so to divorce monetary and exchange rate policy from political control. In the case of monetary base control, I very much doubt it. In practice, in order to deal with liquidity crises and dramatic changes in the public's choice of a cash-deposits ratio, we must allow some over-ride discretion on the part of the monetary authorities. This has been demonstrated in many liquidity crises throughout history, and most recently in October 1987. In the ECOM system, however, there is no need for any such over-ride. Provided there is a wide enough spread of reserve assets (and substantial quantities of reserve assets can be sold by making their price attractive), the EIB will provide ample liquidity to prevent any deflationary slump. But would not governments be tempted to "improve" on the performance of the EIB? Since we lack any relevant experience with such a system we do not know the answer.³² If the EIB and ECOM were the result of a treaty of the EEC governments, however, it would be difficult for any particular government to play fast and loose with its constitutional provisions; but one should not be so sanguine about the institutions of the Community.

Conclusion

In reflecting on monetary constitutions I have wandered a long way from the immediate issues of exchange rates and monetary policy. Yet it is important to inject new ideas into the problems of monetary systems in Europe. I do not believe that monetary integration of Europe is desirable unless there are considerable obvious gains to be so made. The only test of desirability is that people freely choose one currency as the vehicle for their transactions and wealth holding and accounting. The fabulous success of European civilization was founded on freedom. Liberty is as important in money as in anything.

³². One form of "improvement" might be to specify the currency in terms of a constant rate of inflation, say 3 percent per annum. This could be done easily in the ECOM framework, and it might be argued that, because of downward rigidities in the prices, such a constant inflation would involve less frictional costs. In my view, however, adding 3 percent to all prices and wages will not solve problems of rigidities