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PRIME MINISTER

THE EXCHANGE RATE MECHANISM

The Chancellor argues that the presentation of our financial policy is now so unclear that we are paying the price in higher interest rates. We look at so many indicators that the markets believe that we can always find a justification for whatever we want to do. The original objective of the MTFS - creating a clear framework of intermediate rules such as monetary targets - has been lost. Interest rates are higher than they need be because they include a risk premium to allow for the possibility that policy will be relaxed. So we need to re-establish a clear financial rule by joining the ERM.

You might want to ask the following questions about this analysis:

Do we need to re-present the MTFS?

The Chancellor is trying to return to a golden age when the MTFS was clearly defined and rigorously followed. But:

- the most important component of the MTFS concerns fiscal policy. Joining the ERM does nothing to buttress our commitment to controlling public expenditure or ensuring the PSBR continues to decline as a percentage of GDP.
- like all such golden ages it never existed. We first adopted the MTFS in March 1980 and by July 1980 the removal of the corset led to the first 'distortion' of £M3. We have used £M3, M1, PSL2, and M0 in subsequent formulations of the strategy.
- this Government has painfully earned credibility for its commitment to reduce inflation. That is the ultimate objective. Do we need to nail new colours to the mast when the markets already know where you are trying to steer the ship. How great are the market's fears of your

commitment to a tight policy being undermined by the attractions of a pre-election spending spree?

This Government's financial policy boils down to cutting back on borrowing together with a willingness to raise interest rates when the pound looks weak or financial conditions look loose. It is the element of discretion in all this which makes the markets suspicious. But if we have managed so far why can't we continue to do so?

Will we not export this problem to Germany?

The Chancellor argues that the pace of financial innovation and deregulation in London is more rapid than in Germany and it is this which makes it difficult to read the financial indicators here.

But if we try sticking to the DM, we also bring together the British and German banking and capital markets. Competition between these markets will ensure that the pace of financial innovation and deregulation is similar in both countries. Hence we cannot avoid the innate uncertainties of reading money supply figures created by innovation and deregulation by moving this problem to Germany.

Will it Work?

The sterling Deutschmark rate has fluctuated between \$3.50 and 4.00 in the past four years. If we joined the EMS we would presumably need to hold in the DM 3.60 to DM 3.80 range at the most. But the financial world may continue to be as volatile in the future as it has been over the past few years:

- the oil price is still unstable and pulls sterling and the Deutschmark in different directions.
- if there is a flight from the dollar funds may not go equally into Britain and Germany.

What about the run-up to the next Election?

Can we actually stick to the exchange rate rule if there is a risk of Labour winning the next Election? There could be a run on the pound, in which case the Chancellor accept that we would have to withdraw from the ERM. He thinks this could be turned against Labour. This is the crucial political question. There is a risk that any such crisis would rebound against the Government. After all, the Government remains responsible for financial policy. And if the exchange rate is the only financial rule we have, and we are driven off that, then we really are in uncharted waters.

Do you wish to reduce your control over changes in interest rates?

At the moment, our changes in interest rates have an important discretionary element, though often provoked by crises in the exchange markets and driven by the clearing banks. You will now lose what political control over interest rate changes you have, as they will be determined by fluctuations in the sterling rate against the Deutschmark. The Chancellor sees this as positively desirable. He believes it will enable us to achieve lower interest rates on average. But from a political point of view it reduces your room for manoeuvre.

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