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10 DOWNING STREET

Prime Minister

Here is the Guardian article I mentioned.

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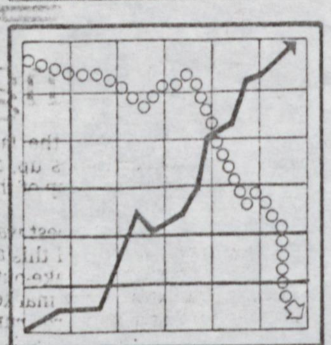
FINANCIAL GUARDIAN

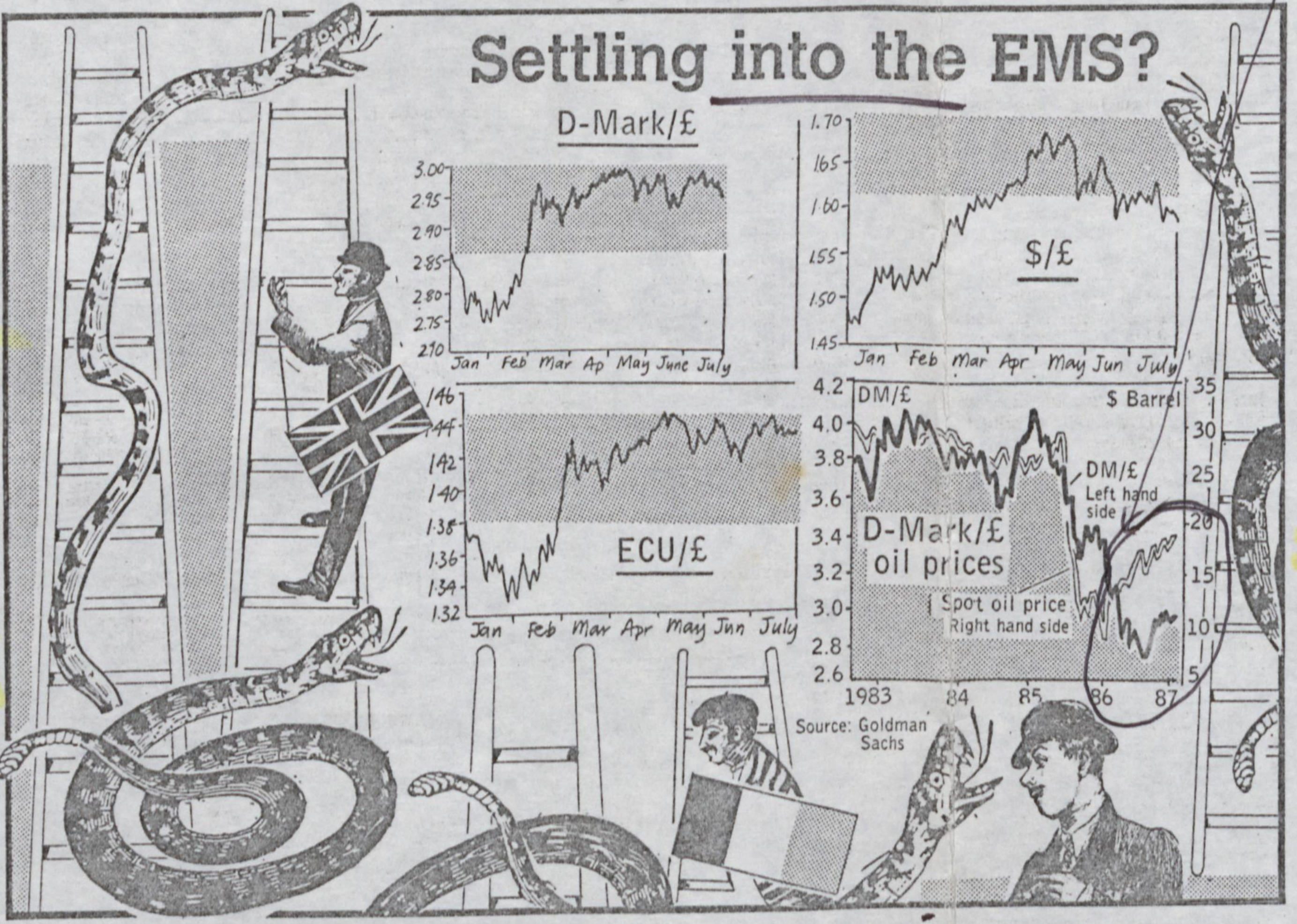
NB the divergence

Lawson's secret membership card



ECONOMICS

Christopher Huhne



THE CHANCELLOR'S secret monetary policy — closet membership of the European Monetary System — is about to undergo a baptism of fire. The death of the Iranian pilgrims in Mecca and the associated political fall-out are the type of circumstances which critics of EMS membership believed that the petro-currency pound would not weather if it were a member.

However, the pound is now almost a participating member of the exchange rate mechanism, as the graphics show. Since early March, the pound has stayed within 2.25 per cent intervention limits, not only against the Deutsche-mark but the European Currency Unit and the French franc too.

Indeed, the Bank of England has excelled itself, for the pound has stayed well within the range.

There are two other pieces of evidence for shadow membership of the EMS. The official foreign exchange reserves have become suddenly much more variable, building up sharply from $21.9 billion to $34.9 billion on yesterday's figures. Given the degree of political massage to which the reserve figures— particularly the underlying figures — are subject, this is tantamount to advertising large-scale intervention in the markets in neon.

Indeed, the Chancellor said as much to the CBI annual dinner on May 19, when he pointed out that he had let sterling fall to reflect the loss of oil revenues last year and that his actions in the sharp reserve build-up of March to May showed that he was committed to keep it there.

"I share the overwhelming view of British industry that a period of exchange rate stability is now highly desirable" he said.

Also, the easing of British interest rates, despite rapid rates of credit growth was clearly in part the result of trying to keep a relatively strong exchange rate within a target range.

Nor is this stability of the pound against the EMS currencies merely an accidental by-product of the agreement(the details of which are secret) concluded by the Group of Five / Group of Seven finance ministers at the Louvre on February 22. All of the major currencies have been more stable since the Louvre accord, but the graph shows that the variability of the dollar has broken the 2.25 per cent intervention limits of the EMS on several occasions. (In all cases, the limits merely take the observed highs over the post-February period as the permitted ceiling of the notional target range).

Certainly, the pound was the unexpected (and unintended) beneficiary of the Louvre Accord, because the markets perceived that the downside risk in holding sterling had been removed while UK returns — interest rates — were still very high. But the rally was capped early in March by intervention and interest rate cuts: since then, the pound has behaved like a very good European currency.

One of the advantages of shadow membership of the EMS, from the Chancellor's point of view, is that it commits him publicly to nothing. He can change target parities (or central rates) overnight without consulting his EEC partners — as we would have to do if we were a declared member of the EMS — or he can decide to let the pound float where it will.

He does not have to battle periodically with the advocates of full membership — in London and the rest of the EEC — since he can effectively say it is on trial. He has avoided the unpleasant task of finally deciding whether the " time is ripe" to join, or abandoning the pretence that it would ever happen, as he must have done had there been no change in policy after the election.

Yet he can also meet the Prime Minister's desire to keep those Europeans at the nether end of a long boat hook.

In short, closet EMS membership admirably suits a Chancellor bent on keeping his options open.

The disadvantage, compared with full membership, is that it really is not the same. The public commitment to fixed rates of a group of finance ministers who collectively control the supply of their currencies (and thus their relative prices) is qualitatively entirely different to a private practice of one minister which can be changed on a whim.

The benefit for domestic policy of attempting to hold a particular exchange rate is similar except that it is less likely to persuade exporters to invest on the basis of its permanance. There will be less benefit, too, from running a lower level of interest rates for a given exchange rate target because of the public confidence engendered by declaration.

The Chancellor may well feel, however, that he is sacrificing little given that the rapid growth of credit and market fears of an "overheating" economy would probably forestall interest rate cuts anyway.

So we have a classic British compromise: milk and water EMS membership. Moreover, the Chancellor has so far been successful in reconciling his domestic objectives with his shadow target range. But the fact that the pound has been behaving as if it was an EMS member for five months does not, of course, mean that it will go on doing so. We have seen relatively prolonged periods of stability against the other Europeans before under the Government (notably in 1983 and then again in 1984.) The next year may not be so easy, requiring either a shift in parity or an end to the shadow.

One threat is external. The financial markets have not yet taken a firm view of the latest events in the Gulf. They may mean a stronger oil price because production will be disrupted, or a weaker one because the Iranians and the Saudis will find it more difficult to reach agreement on the quotas which have determined the renaissance of OPEC's power in the oil market.

A shift either way is likely to yank the pound in the opposite direction to the German Mark, simply because Germany is a big oil importer and Britain is a net oil exporter. Higher oil prices improve Britain's balance of payments current account relative to Germany's. The Germans pay out more marks for their oil, and thus force down their value to persuade foreigners to hold on to them.

As a result, there has been a loose relationship between the price of North Sea oil and the price of the pound against the German Mark, as the fourth graphic shows. It is becoming less important in part because of the lower level of oil prices compared with the early eighties, and in part because Britain's net oil exporting position is eroding. But it is still there.

(The recent strength of oil prices and the support which that gives to the pound may be one explanation for the build-up in official reserves during July, when many in the markets had expected to see a fall as the Bank intervened to support sterling after the poor May trade figures released on July 22. Indeed, the strengthening oil price so far this year has probably been the main reason behind the demand for sterling.)

Another threat to shadow EMS membership — or at least current target ranges — is that domestic objectives will get in the way. The Chancellor has two conflicting objectives for the early part of his second term: keeping inflation down (which means tightening policy at some point over the next year, unless he is to do a U-turn on incomes strategy) and giving away money in tax concessions in the next budget, if only as a lubricant to the losers from tax reform.

However, the rise in oil prices ironically helps him out of that particular conflict, since for Britain it is to all intents and purposes similar in domestic economic effects to a rise in indirect taxation such as VAT or excises. Much of the marginal rise in oil prices goes straight from the consumers' pockets to the government in extra North Sea oil revenue, damping consumer demand and improving government finances.

The only snag is the fillip rising oil prices also give to domestic inflation, at a time when other inflationary pressures are already mounting. Factory gate prices are rising well ahead of unit wage costs, implying widening profit margins. Earnings are edging upwards, reflecting high profits. Commodity prices (not just oil) are rising.

The odds on the Chancellor holding on to his shadow EMS membership are if anything narrowing. He may even want to tighten policy a notch or two by raising his exchange rate target.

Alternatively, he may want to raise interest rates and hold the current target range if this summer's trade figures show that May was not just an aberration.

Mr Lawson is a rather practised rider of the electoral economic cycle, and it is another four years at least to an election.