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From the Principal Private Secretary

SIR ROBIN BUTLER

SIR ALAN WALTERS

I duly telephoned Sir Alan Walters this afternoon about his article in yesterday's Independent.

I was frank with him that certain statements in the article had caused disquiet next door, to put it mildly. He said that he had made such statements many times before. I said that I did not think that the particular paragraph to which you had drawn my attention had been said in public before. In any event, his situation had now changed as the press were apparently realising. Such statements could be replayed back to the Prime Minister at question time, to her and the Government's embarrassment. Alan readily took the point. He said that he would refrain from such statements and would clear with me anything that might conceivably cause difficulty.

N.L. WICKS

15 July 1988

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PRIME MINISTER

You should know that some of the statements in Alan Walters' article in yesterday's Independent have riled the Chancellor - for example the reference to "Mr. Lawson's misguided shadowing of the mark". I have had a word with Alan and suggested that while no-one would want him to change his views, it would be better if he did not express them in quite that form in public. He took the point and will show me anything which might conceivably cause offence.

N.L. WICKS

15 July 1988

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Money on a roller-coaster

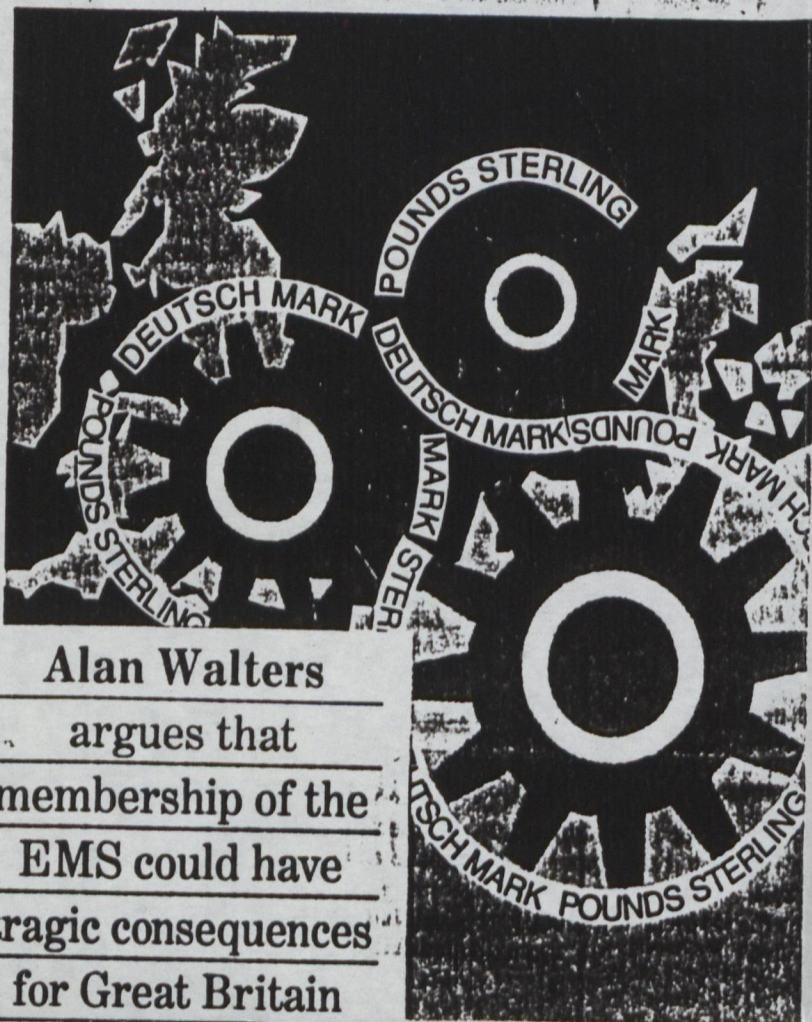
I am a firm believer in the advantages of great monetary unions, such as that of the United States. I am quite convinced, however, that the half-baked European Monetary System is a long step away from a monetary integration of a United States of Europe. The EMS is a major source of uncertainty, of massive flight of footloose capital, of great oscillations in interest rates and of repressive policies. If Britain, with its open capital markets, joined the EMS mechanism, such evil effects would be exacerbated. And the cause of monetary union would be damaged, perhaps irreparably.

First the technicalities. If Britain joined the mechanism, the EMS would fix the mark price of sterling — suppose it were fixed exactly at three marks to the pound — and everyone agrees that that is the "right" value at that time. But it is not really fixed for ever and a day, but only until the next "realignment", which we may assume is, say, in one year's time. Then, since prices will have been rising at about 5 per cent in Britain compared with zero in Germany, everyone knows that sterling will most likely be devalued to the next "right" value of 2.85 marks. This stately progression of stable exchange rates with periodic "realignments" has a most disruptive effect on interest rates and monetary policy.

Suppose that the deposit interest rates in Germany and Britain are 3 and 8 per cent respectively, beginning with a fixed three-mark pound to last one year. Anyone holding a deposit denominated in marks will be induced to exchange his marks for pounds, deposit pounds in Britain for up to a year, and so collect the extra interest, confident in the EMS mechanism maintaining the three-mark pound up to realignment.

Consequently money would flood into Britain from Germany — from the country with stable prices to the country with 5 per cent inflation — thus driving Germany towards deflation and Britain to yet higher levels of inflation. A perverse policy indeed! And this massive flood of money would reduce interest rates in the United Kingdom and raise them in Germany, to values of, say, 5 and 4 per cent respectively. It will also give rise to the familiar pressures on exchange rates — with sterling in such demand that it would be difficult for the authorities to keep it from appreciating above the three-mark level. The Bank of England would be busy buying marks, reducing its short-term interest rates and flooding the market with pounds in order to contain sterling's buoyancy. Furthermore, to accommodate this inflow of short-term capital, the current balance of payments of the United Kingdom would have to move sharply into a deficit. (The other possibility is that long-term capital outflows would be greatly enhanced, with, for example, British takeovers financed by these large, short-term capital inflows.)

As the year went by and as realignment day approached, there would be a great reversal of capital flows. Instead of the rush to lend sterling, people would now want to borrow pounds, and buy and lend marks.



Alan Walters
argues that
membership of the
EMS could have
tragic consequences
for Great Britain

Realignment day would provide everyone with a sure-fire bet against sterling. But, in the run-up to realignment day, the punters would drive short interest rates in Britain sky-high — even 500 per cent overnight would not deter a punter who knew that sterling would fall 5 per cent next day. After realignment, the punters would then collect their winnings from the central banks (taxpayers), and so the cycle would begin again. The oscillation in interest rates would generate similar roller-coasters of inflationary pressures and lurches of stop-go in policies.

These are likely to be the tragic consequences of Britain joining the EMS mechanism. Unfortunately for Britain, we can witness a performance of this tragedy, currently still running, enacted by Mr Lawson's misguided shadowing of the mark during 1987 to March 1988, following the great interventions consequent upon the Louvre agreement. We saw base rates sink from 11 to 7.5 per cent, and then rise again (and here I conjecture) to some 11 or 12 per cent in the coming months. The growth rates of money, even M0 (which comprises mainly the notes and coins in circulation), have expanded, and the current balance of

payments has been deteriorating rapidly into record deficits. We have yet to see the final inflationary consequences and the full fall of sterling against the mark, but, as in a Greek tragedy, the end is not in doubt; it is only a matter of time.

Then we shall see the characteristic reluctance of all countries, including Britain, to allow their currencies rapidly to be devalued, or indeed revalued, to the extent that is needed (shades of Harold Wilson in 1964-67). The procedures of the EMS, like all the bureaucratic processes of European agencies, will exacerbate this rigidity.

For example, throughout its membership of the EMS, France has suffered from a continuing overvaluation of the franc. As Bela Balassa has shown in a recent issue of *Commentaire*, this has eroded exports and generated a structural current account deficit in the balance of payments. The miserable growth rate of the French economy in the 1980s, compared with the buoyant British economy (at least until 1988) bears testimony to the negative effects of full membership of the EMS. And it is entirely understandable that the French want to have some influence over "their" (that is the Bundesbank's) monetary policy.

Small wonder also that the French (as have the Italians) retained exchange and domestic credit controls in order to mitigate the capital movements and the effects on interest rates. Even so, in Britain, after shacking-up with the EMS for these past months, there is a call for the reimposition of credit and exchange controls, for the use of the "Regulator", for import surcharges, indeed for much of the panoply of controls and fine-tuning that so ruined the economic performance of Britain in the 1970s. Ironically, by 1992 most members of the Community have promised to follow the Thatcher model by removing exchange controls and liberating credit markets, en route with the EMS, to a Central Bank of Europe... some hope.

Suppose, however, that the constituent states are willing to surrender their sovereignty to the Bundesbank or some other European authority. What is the path then to monetary union? Clearly we should examine the history of the many successful monetary unions, such as the United States, the sterling area to the early 1960s, Hong Kong's 1983 union with the dollar, and the more dubious case of Panama, to serve as guides for the union of Europe. (We should also examine the failures of systems similar to the EMS, such as Bretton Woods from the end of the 1950s to its *de facto* demise, after being battered by enormous flows of footloose money, in 1967). The essential feature of these successful unions was first *absolute fixity* of the exchange rate (no realignments), and second *monetary institutions that guaranteed such fixity*. Is Europe prepared for such draconian reforms?

Finally I realise that I am in a very small minority in my opposition to membership of the EMS. The City, the CBI and the media are convinced it would be a good thing. It is easy to see why the City financiers would welcome sure-fire bets on realignments at the expense of the taxpayer. However, I am not at all clear why the CBI likes the idea, but, since the "bare knuckles Beckett" episode (when the then CBI director-general launched a full-scale attack on the Government's economic policies, ironically at the very moment the economy had begun its recovery from the recession), perhaps one should not expect any sound economic rationalisations for their policy proposals. The media seem convinced that we are "missing the bus", although they have only recently begun to inquire the price of the ticket. European bureaucrats issue urgent warnings and dire threats in the hope of cajoling Britain into the creaking mechanism of the EMS. Germany wants us to counter the French pressures for symmetry, and France hopes that we shall join with them in modifying the Bundesbank's hard line. Meanwhile, I suspect many people in Britain are having second thoughts. I urge that they reflect calmly and deeply on such momentous issues.

Sir Alan Walters is adviser to the Office of the Vice President of the World Bank.