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PRIME MINISTER

CHANCELLOR'S "ON THE RECORD" INTERVIEW AND APPEARANCE BEFORE
THE TCSC

You may find it helpful to glance this evening through the attached transcript of the Chancellor's "On The Record" interview yesterday. I think it demonstrates that there was substance in the various reports in today's newspapers. But the overall context of the interview was perhaps rather more rounded.

You will also want to be aware of the coverage of the Chancellor's comments to the Treasury and Civil Service Select Committee this afternoon. I sat in on this session, which lasted about one and a half hours. The majority of that time focused on the issue of ERM membership. It is difficult to judge how the press will write it up. There were some useful points the Chancellor made, which you yourself might want to pick up, but my guess is that the press coverage will focus on alleged differences of view with Alan Walters and, in turn, with you.

The session started with some general questioning from Terence Higgins about Economic and Monetary Union (EMU). The Chancellor responded on his well established Chatham House lines, and this material should cause no difficulty. When asked why the Government had signed up to the objective of EMU via the Single European Act, the Chancellor said that we had always interpreted this as meaning closer co-operation, not the kind of thing the Delors Report Stage 3 laid down. He laid stress on the objections to the transfer of sovereignty, and said he could not foresee us ever agreeing to a Treaty amendment designed to facilitate EMU. But he saw no difficulties with the quasi-transfer implied by systems such as the Gold Standard.

Another point that came up in the opening questioning was his attitude towards a current account deficit. The Chancellor said this was not the most important measure; the key variables were inflation and overall economic performance. In any event, exchange rate changes were unlikely to help reduce trade imbalances.

ERM

Most of the rest of the discussion was on the ERM.

The Chancellor said that the United Kingdom was already embarked on most of the Delors Stage One measures; the main thing we had not yet done was to join the ERM. But we would when the time was right. When pressed as to when that would be, he responded "wait and see".

Giles Radice then asked how well the Chancellor thought the ERM had worked in its first ten years; he quoted some of Alan Walters' comments on it. The Chancellor responded that it was difficult to escape the conclusion that the ERM had been successful, both in reducing exchange rate fluctuations within Europe and in helping EC countries to get inflation rates down. The EMS as such was not a substitute for proper monetary policy; but it was clear the EMS had not got in the way of achieving lower inflation. Alan's comments were difficult to reconcile with the facts.

Radice then asked what was the case for the United Kingdom joining the ERM. The Chancellor said this was the same as for other countries, ie it could help reduce exchange rate fluctuations and assist in the conduct of an anti-inflationary monetary policy. But the position on sterling was different from all the other non-DM currencies in the system; it was much more widely held and traded, and the practical problems of membership for us were therefore correspondingly greater. As to when the time would be right, the Government would of course find any advice from the Committee helpful!

Radice then asked whether the Chancellor agreed with the Governor that our joining the ERM would help us in other aspects of bargaining in Europe. The Chancellor said he thought there was potential help here either when the time was right and we had joined, or when it was clear that we would be joining within a given period; but this consideration could not be decisive in our taking a view on when we should join.

Terence Higgins then asked whether, if we joined now with high inflation and high interest rates and that led to large inflows, what action would we take? The Chancellor said he did not want to join now. He wanted to see inflation coming down first. The Committee needed to have patience; the time would come but not yet. As to the specific problem of dealing with inflows, there was a role for sterilised intervention as a first response; but if necessary, we would then need to revalue.

John Watts then took over the questioning. He was much more sceptical than some others about the merits of joining the system. He reiterated the Chancellor's own point about other non-DM currencies not being heavily traded; the Chancellor agreed but said the Government did not believe this factor alone made membership impossible. Watts then asked whether membership would have made it easier to resist the recent devaluation of the Pound. The Chancellor said he would not comment on current conditions. But in general he agreed with the Governor's earlier evidence that membership of the ERM would condition the market's expectations on the extent of fluctuations. Membership provided no new instruments of policy; we already had the power to intervene and set the right level of interest rates. But the issue was the context in which they were used. He accepted that market perceptions could be changed by the psychology of membership and the resultant scale of concerted intervention operations.

Watts then asked in what ways full membership would improve on the conditions we operated under in 1987-88 when we shadowed the ERM. The Chancellor said it would give greater

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credibility within a helpful framework. As a result, currency pressures in the markets would tend to be less. And once in the system we could make exchange rate realignments with much greater market credibility, and thereby remove the present tendency of the markets to overshoot.

Watts then asked whether the process of pegging exchange rates was a cure for inflation or only helpful in keeping it low once that state had been achieved. The Chancellor said that ERM membership was not a substitute for correct policy decisions. Monetary policy was the way to get inflation down, but ERM membership was about how to use a framework to buttress monetary policy; he said there were some similarities between the Gold Standard and ERM. He believed that periods of free and floating exchange rates had been rare in the past and would remain rare.

Watts then turned to the potential conflict of interest policy between internal conditions and external commitments if we were members of the ERM. The Chancellor stressed the flexibility in the ERM, both via the bands and the possibility of realignment. We must be prepared to make use of both dimensions. If there was a conflict, counter-inflation must come first. But history showed that periods of conflict are few; generally there is compatibility between exchange rate stability and getting inflation down.

Finally, there was some questioning from Lewis Moonie. He again asked when the time would be right. The Chancellor said he was going to give no hint at all. But he then went on to say that he thought a relevant consideration would be whether the ERM system could survive the removal of exchange controls by the main existing members; it was reasonable to wait for that and see how the EMS worked out; but he could not give a date. The second factor to consider would be when our inflation rate was again coming down; which he said he expected to happen "later this year". Moonie pressed as to whether there were any other factors to be taken into account; the Chancellor said "these are the two main things". Giles

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Radice then intervened to argue "therefore you are saying watch 1990". The Chancellor responded that he should not expect the Government to enter then, but that it would be sensible to wait until at least that date. He did not rule out joining before then, but he thought it reasonable to wait and see how things went with the removal of exchange controls, and then to form a view. Radice retorted by again mentioning 1990, and saying that by then your last remaining argument against ERM membership would have been removed.

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PAUL GRAY
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