The Economist

Prime Minister

I sent you in the first box (in the meeting folder for the Chancellor) a note by Alan Walters on the exchange rate. You may also like to glance at this Economist leader; while you will not agree with everything in it, the points in the highlighted passage are worth considering. PRCG 13/10

Through gritted teeth

AFTER ten years in government, Margaret Thatcher is facing her toughest test. At first glance that seems like hyperbole. A percent or two off sterling, a percent or two on interest rates—embarrassing, of course, to poor Nigel Lawson, her chancellor of the exchequer, but surely small stuff compared with the 1980-81 recession, the Falklands war, the miners' strike. That is true; and, in a way, that is the trouble.

Those earlier, deeper challenges posed a stark choice: victory or defeat. Certainly the Tories needed all their leader's nerve to succeed—but they had few doubts about where their political interests lay. Now there is no such clarity. In seeking to dig itself out of a pit of its own making, the government can abandon its principles for some soft economic options—and enjoy a burst of applause from most of its supporters. Or it can do what is best for the economy's long-term health—and risk a pasting that might weaken its chances at the next election. Political tests come no tougher than this.

What went wrong

The economy is in trouble for a depressingly simple reason: demand for goods and services has grown much too quickly in the past few years. Unusually, as Mr Lawson is always quick to point out, the cause was not the government's budget. The public sector is running a surplus so big that, if not for present distractions, it might be an embarrassment in its own right. Demand has surged because the private sector, and especially consumers, have been saving less and borrowing much more than they used to. Credit has fuelled both inflation (which has risen from 3% to 7% over the past three years) and the external deficit (which has swung from broad balance to a deficit of £20 billion a year). With fiscal policy, according to Mr Lawson, prudently tight throughout, the government has assaulted demand by doubling interest rates.

This has hit hardest at the mortgage-burdened, who are usually most inclined to vote Tory. As if that were not awkward enough, Mr Lawson has been faced with a run on sterling. No longer is he pushing up interest rates just to keep monetary policy tight; his main recent purpose has been to defend the pound. As a result, the headlines have been horribly reminiscent of sterling crises of old.

The government's critics note happily that ten years of Thatcherism have left at least one economic rule intact: as soon as the economy starts to grow at a decent pace, balance-of-payments difficulties bring its expansion to a sickening halt. In fact, it is a travesty to say that nothing has changed. Just look at the pattern of demand and output since 1983. In the three years to 1985, real demand grew by 10½% in all, and output grew by 9½%. In the following three years, output growth actually quickened, to a total of 12½%. The trouble is that growth in demand soared to 17½%, the fastest burst for decades. Yet that 12½% rise in output, after the recovery had been going for four years, shows that things really have changed. In the 1970s smaller surges in demand caused much bigger rises in inflation. So the past two years of higher inflation and lower pound are not proof that Thatcherism has failed to improve the economy's supply side. They are proof that the government mismanaged demand.

Mr Lawson could have made the monetary squeeze of the past year gentler and more effective if he had used his budgets since 1987 to make fiscal policy tighter than it already was. He didn't. So what matters now is to make sure that the squeeze on demand which has already been imposed curbs inflation as painlessly as possible. The key to this is to accept that some discomfort is unavoidable. The interest-rate tourniquet must be allowed to do its anti-inflationary work—even if it means a shallow recession next year. This is not exactly appealing. But consider the alternatives.

The policy with the greatest superficial appeal, and the greatest potential to do real damage, is to let sterling drop. If this happens, Mr Lawson (or his successor) will not lack for excuses. Industrialists are complaining that the pound is "overvalued", which in plainer English means that they have let their costs rise so are finding it hard to sell profitably in overseas markets. Industry also protests that interest rates are higher than is necessary to curb demand. Monetarists such as the prime minister's personal economic adviser, Sir Alan Walters, would broadly agree. They also object to exchange-rate targets on principle: let the market decide, they say.

So businessmen would applaud a lower pound and looser money, and enough academics could be wheeled on to justify the policy shift. And the voters? They would love it—at first.

But not for long. A fall in the pound would raise inflation by making imports and the goods that compete with them dearer. These price increases would fuel demands for higher wages. Companies would be happy to oblige: a currency devaluation would have bailed them out once, and would be counted on to do so again. With the anchor of a stable exchange rate cast aside, it would take a full-blown recession to get inflation down again. Everybody would hate that even more than they hate the latest rise in interest rates.

Some Tories would nonetheless like to bolster a "flexi-

ble" approach to sterling with other policies intended to grab votes. Credit controls would go down well, some reckon: blame the credit spree on the reckless banks. And cushion the coming slowdown by spending some of that fat budget surplus on schools, roads, hospitals and what have you. Never mind that previous attempts to use credit controls have been at best ineffective and at worst a microeconomic poison. Never mind that no sane government struggling to contain inflation could tell the financial markets that it is adopting a more expansionary fiscal policy. Please do something, anything, to appear sympathetic.

The kindness that kills

The mere possibility of such soft-headedness is harmful. The government's recent difficulties have been caused mainly by the fear that in the end it will let sterling slide. If the markets believed Mr Lawson's pledge to defend the pound, the present interest-rate differentials would be drawing in a much greater flow of capital; in other words, the pound could be held steady with lower interest rates. But the chancellor's promise has been continuously undermined by reports of disagreement between himself and Mrs Thatcher. This has neutralised a good part of the recent tightening, and may make even higher interest rates necessary.

The only certain way for Mrs Thatcher to help shave interest rates is to commit herself to a stable pound. To do that, much the best way would be to make sterling a full member of the European Monetary System. In the argument over the timing of membership, the balance has shifted decisively in favour of joining now. In last year's row with Mr Lawson, Mrs Thatcher could plausibly say that the domestic economy called for higher interest rates than would have been consistent with a stable pound. If, as it seems, she thinks this is no longer true, now is the time for a binding commitment to a stable exchange rate—in short, for the EMS.

Whatever the exchange-rate system, any government's best weapon against inflation is the credibility of its promise to control it. If its promise is believed, the task is easy: firms and workers set prices and wages accordingly. If it is not, inflation has to be clobbered with slower growth than would otherwise be possible, and perhaps with a recession.

For all its achievements, this government cannot expect its promises on inflation to be believed. Its decision in the mid-1980s to treat 4% inflation as a triumph instead of pressing on to stable prices (as it had promised to); its rejection of fiscal policy as an instrument for cooling demand; its tax break for mortagage credit; its internal squabbles over monetary policy—all these have left the markets with no choice but to say: don't tell us, show us. As a result, the coming months of disinflation will be far from painless. But the government can still choose, between a little pain or a lot. If it goes for the soft options, be prepared for a lot.

Make way for the Germans

They stand to be the main western beneficiaries of the upheavals in the East

POWER politics, like nature, abhors a vacuum. As Russia retreats from its 40-year-old dominance of Eastern Europe, who will fill the space? The answer is the twist in the tail of this tortuous twentieth century: Germany. It is an increasingly fair bet that Germany is set to win in peace the European supremacy that has twice eluded it in war.

The latest events in Eastern Europe show that the formula—communist ideology plus Moscow's military might—that created a "Soviet block" is breaking down. Marxism-Leninism? Hungary's ruling party has just said it was all a mistake and that it will contest the forthcoming free elections as a socialist party of the western type. The threat of Soviet force? The Poles have already acquired a non-communist government, and nobody has stopped them. Mr Mikhail Gorbachev's behaviour at East Germany's 40th birthday party last week was calculated to reinforce the message of non-interference: the days when that country's policy was decided in Moscow, he implied, are over.

This is a green light for change. The immediate result is mass demonstrations in still Stalinist-run East Germany and extraordinary leaps towards freedom in Poland and Hungary. But it also makes West German eyes gleam.

Leave aside for a moment the delicate question of German reunification. Liberalisation in Eastern Europe—and in the Soviet Union itself—means enticing opportunities for German influence and, in particular, for German business. Already West Germany is the leading trading partner for communist Europe. Communism's protectionist planners have so far kept sales to West Germany's markets in the East below 6% of its exports. As communist Europe goes capitalist, a market of 400m frustrated consumers beckons.

German businessmen are swarming in. Little noticed amid the excitement of the past week in Budapest and Berlin, the West German government has been busy too, pledging generous aid to help the reforms in Hungary and Poland. It is clearly set to become the biggest contributor to the bill for supporting Eastern Europe's reformers. This is not just charity (though the sense of repaying a historical debt for Germany's past aggression plays a part); it is a calculation that eventually Germany has the most to gain.

On the eve of last week's party congress in Budapest, the Bonn government told Hungary, which had so obligingly let East Germans through to the West, that it was doubling its limit for credit guarantees to DM1 billion ($530m). Baden-Württemberg and Bavaria then chipped in with similar offers worth DM250m each. West German help for Poland will be even bigger. On October 10th the two countries arranged (ahead of any agreement by the Paris Club of creditor governments) to reschedule DM2.5 billion of debt accumulated by Poland up to 1988; repayment is now put off to 1993-97. Half