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SECRET AND PERSONAL

PRIME MINISTER 11 September 1990

MEETING WITH THE CHANCELLOR: ERM

Tomorrow you have a meeting with the Chancellor. Should the issue of the ERM come up the enclosed comments by press and analysts may be useful.

I was particularly struck by the article in The Times on Monday by Graham Searjeant as well as by the weekend press and the comments by Greenwells. They argued:

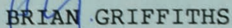
> that it was positively a good thing not to join the ERM now;
>
> that while they firmly expect us to join probably before the end of this year, they accept delay because the Madrid Conditions are still not met.

All of this supports the line you took in the meeting last week.

I was also struck by press comment on the strengths of the recession which could hit us post-ERM.

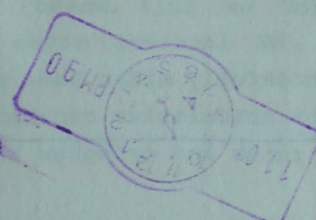
Since the meeting last week I have looked briefly at the Spanish experience. The main point which emerges is that the management of entry to the ERM is very much easier if there is policy convergence between the leading countries. For us this means that if UK inflation were clearly coming down, UK interest rates could move closer to German levels (which would hopefully might have moved up) on entry. We would as a result face less speculative capital flows, and therefore less turbulence in interest rates and exchange rates.

The case for waiting remains strong and the commentators response is very encouraging. In no way is press comment suggesting that delay is "negative".



BRIAN GRIFFITHS

SECRET AND PERSONAL



Correspondent

Poised to play the ace

ECONOMICS: GAVYN DAVIES

CAN something be postponed if it has never been arranged in the first place? Probably not. So why did Mr Major's radio interview on Friday, designed to persuade people that his master plan for ERM entry was still in place, positively reek of procrastination? Because, whatever the Chancellor may claim, government policy is now drifting.

In the spring, the economy was thought to be growing too fast, with inflation the real threat. The Chancellor had wantonly missed the opportunity of doing anything about this in the Budget. With his hands tied on interest rates, the only way to tighten policy was to move sterling up.

The best way of doing this was to foster the belief that ERM entry, at quite a high central rate against the deutschemark, was imminent. Once inside the ERM, a high exchange rate would be preserved by the confidence effects generated, and interest rates could be safely reduced in time for an election in June or October 1991.

Initially, the strategy worked like a dream. Sterling started to rise against all other currencies a long while before the Gulf crisis came along to push oil prices higher. But as soon as the economic consequences of the Iraqi invasion began to clarify, Treasury officials became resigned to moving the ERM decision from the front to the back burner.

For one thing, ministers became (rightly) too obsessed with the wider problems of the Gulf to have any time left over to undertake a huge new economic initiative in a separate field. For another, the pound started to misbehave. It become very much more volatile, raising doubts whether it should be tied into a fixed rate system like the ERM during an oil crisis. It also stayed strong against the European currencies, while moving far too high against the generally weak US dollar.

One thing is certain. If sterling stays anywhere near present levels against the dollar, British companies exposed to American competition are going to be decimated in the markets in the next year. Few observers have noticed that sterling is now at an *all-time high* against the US currency after adjusting for inflation differentials between the two countries. The Chancellor admitted he was concerned about this on Friday; even if sterling is at about the right level against the deutschemark, should it really join the ERM while it is trading at so ludicrously high a level against the dollar (and, incidentally, against the yen as well)? Would this not just exacerbate the recessionary tendencies that are now bubbling away? Perhaps it might be best to wait a while for things to clarify.

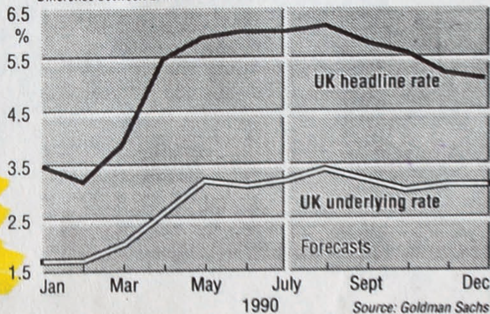
That, I suspect, is as far as the Chancellor has got. Although his Treasury officials are no doubt still keen on intensifying the economic squeeze, he is wondering whether the ERM might now impose too high an exchange rate on the economy to be compatible with victory in the next election. Many still view John Major as a rather grey technocrat. In fact, his every move in the last year shows him to be a politician to his fingertips, a far more political Chancellor than either Lawson or Howe. And his political instincts tell him that an easing in policy, possibly with a somewhat lower exchange rate, may soon be needed. My guts tell me that all talk of ERM entry at rates of DM3 or above will soon evaporate.

That does not mean that the ERM has no role from here in the election formula. The fundamental truth remains that, without the ERM, it could be very difficult to get interest rates down enough next year to stand a chance in a general election. Furthermore, the Chancellor is somewhat hoist with the success of his own earlier petard. The markets have an ERM premium still in them, and will not forgive an indefinite delay on this question. Sometime in the next few months, they will turn thoroughly nasty if the Chancellor continues to dither.

The graph shows that Mr Major's inflation condition for ERM membership will start to look a whole lot more credible by about mid-November. The Inter Governmental Conference on European Monetary Union is still due to start in mid-December. These two dates constitute a good window for entry. Any delay beyond that threatens a market debacle. So entry still seems imminent, if at a lower rate than was earlier in the frame.

■ *The author is Chief UK Economist at Goldman Sachs.*

Convergence starts in a couple of months



On rec

HARDLY a day goes by without a leadi British company confronting the harsh reality of the Government's high intere rate policy. Last week the chairman of construction group Wimpey, Sir Cliffo Chetwood, echoed the views of many when he described the recession in his industry as "the worst I have seen in a lifetime".

Empty blo

By Matthew Crabbe

THE BUILDING boom of the Eighties promises some lasting monuments to the Thatcher years. But even as the tower of the Canary Wharf project in docklands soars to become Europe's tallest building, the City of London is threatened with collapse in its commercial property market.

Supply heavily outweighs demand. A frenzy of office building since Big Bang in 1986 has produced an office vacancy rate in the City that will probably reach 20 per cent by the end of 1990, according to Chris

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ERM membership hinges on German rates

ECONOMIC AGENDA

by TONY BARON

LAST week again witnessed rampant City hysteria about the timing of sterling's entry into the European Exchange Rate Mechanism. A number of commentators convinced themselves the Government would use this weekend's Rome meeting of Community finance ministers to announce ERM entry. This brought with it hopes of a base rate fall and the Bank of England was forced to act in the money markets to stop rates falling. On Friday, Chancellor John Major squashed the hysteria.

Last Sunday I said hopes of imminent ERM entry were likely to be disappointed. It was never likely Major would take sterling in and risk a premature base rate cut before inflation had peaked. Major said one Madrid condition for sterling's entry, the need for inflation to fall closer to that of the rest of the Community, was still outstanding.

This does not mean the headline figure as measured by the Retail Price Index has to fall to the EC average. Instead, the Treasury is looking at the underlying inflation rate excluding mortgages and the poll tax. This is because European inflation measures do not include those items.

Looked at this way inflation is still above that in almost all EC countries. At 7 per cent British underlying inflation is higher than the 4·4 per cent average and more than double the rate in West Germany and France. In the months ahead the inflation differential between Britain and other Community countries is likely to moderate as the economy slows down but also because inflation is tending to rise on the Continent.

One of the dangers alluded to by Major was that interest rates overseas, particularly in Germany, could rise soon. The political consequences of the Tories reversing a premature base rate cut are clear. Indeed, German interest rates may rise soon. Latest German retail sales figures showed a 14 per cent rise in July compared with a year earlier. After monetary union between East and West the pent-up demand for western goods is finding its way into West German consumer figures.

This, coupled with rising oil prices, is lifting German inflation. In consequence the Bundesbank will bear down on inflation by raising interest rates. Furthermore, German rates are likely to be lifted by Chancellor Kohl's decision to finance German unification through debt. With pan-German elections due in December Kohl has made a Bush-type promise not to raise taxes.

It seems likely Major would prefer to go into the ERM after any rise in German interest rates. Once sterling is in inevitably there will be downward pressure on UK interest rates towards the German level. UK residents would be able to substitute cheap German loans for their expensive UK debt at little exchange rate risk. This would be true both for companies refinancing their borrowings and for individuals swapping UK mortgages for cheaper German ones.

The ability to borrow abroad with little currency risk after ERM entry would make credit controls inoperative. This would be true both of specific controls and of informal controls in the form of moral persuasion.

The act of converting these overseas borrowings by UK residents into sterling would put upward pressure on the pound and force the authorities to reduce interest rates. If the Government did not allow rates to fall sterling would tend to rise through the top of its ERM range. This would be true no matter what level was chosen for sterling's entry. No-one would believe the monetary authorities of the ERM countries would fail to defend sterling on the down side at least for the first year after entry so the perceived down-side risk for sterling against the Deutschemark would be limited to sterling's lower intervention within the ERM.

The need to get inflation down before sterling's exchange rate with the Deutschemark and other European currencies is fixed is demonstrated by the fate of the East German economy following monetary union.

The huge differences in productivity between East and West German companies has left much of East German industry uncompetitive and unemployment is rising. Once sterling is fixed against the Deutschemark the opportunity for a sterling devaluation to maintain the competitiveness of British industry will be removed. Thus if costs and prices continue to rise more rapidly than those in the rest of the Community British companies will lose market share. As this happens unemployment will rise — the extent of the rise reflecting the degree to which costs move out of line with those in Europe.

ERM membership, therefore, should not be seen as a soft option. Indeed Britain, like France, is likely to experience much pain in adjusting to a lower inflation rate environment. The adjustment process would be eased if wage settlements were based on a company's ability to pay while maintaining its competitive position.

Superficially, last week's call by the TUC conference for talks between Government, industry and unions to decide what the economy could afford to pay might seem attractive. But the danger is that as in the past talks would give rise to a high target based on current inflation. The sad experience of the 1980s has been that employers have only controlled wages by cutting numbers rather than moderating settlements.

Major needs to push inflation down and there is no substitute for proper domestic monetary control. There is no reason why the Bank of England cannot perform as good a job as the Bundesbank. But this would mean giving the Bank independence. Only if monetary policy were determined by an independent Bank would it be possible to hold talks between Government, industry and unions that did not run the risk of lifting inflation.

Mountleigh looks a bargain

MARKETS IN FOCUS

"GULF fatigue" hit world markets last week and the City's focus returned to the knotty how high interest rates and strong pound are hitting corpc rate earnings. Housebuilde ... interim profit

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CITY COMMENT by JOHN JAY

THIS paper has never subscribed to the theory that Britain would enter the Exchange Rate Mechanism on September 8, so it did not cause any surprise to see John Major quashing ERM frenzy or the Bank of England holding the base rate at 15 per cent. The reasons are clear: inflation must come down for ERM entry and monetary conditions must improve for a base rate cut. Major has said this many times and has again shown *sang froid* by refusing to be bounced by fair weather friends of Tory economics.

That said, the Gulf, the oil price rise and the pound's petrocurrency surge have combined to complicate policy, as Tony Baron shows on page 26. Before the Gulf, Major could happily play an elegant game of talking up the pound to take the steam out of the feared post-entry surge as sterling becomes a high-yielding British Deutschemark — and improve the inflation outlook next year. Now he has to cope with far greater uncertainty.

But, inflation should still peak with the figures for August and the trend should be down later this year with the pound's strength reducing the impact of rising dollar denominated oil prices. Some things political are even starting to move Major's way with Spain throwing its weight behind the hard ECU and Germany backing away from a Delors style monetary union. This strengthens his hand in Cabinet. So subject to Madrid conditions being met, ERM entry can still come this year and Major can time it to maximum political effect. My favourite would still be an announcement to coincide with the party conferences.

Major should not delay too long as he risks a fall in the pound that could undo the recent anti-inflationary gains. And once in the ERM, interest rates can start to fall, alleviating the real problems now facing industry. One only has to glance at recent results to see that well-run well financed big companies are feeling the squeeze. For the first time in years corporate UK may make less money this year than last. The problems should focus Treasury minds more on working out how to achieve tight money at lower interest rates without credit controls. I side with Sir Martin Jacomb of Barclays who wants greater incentives for saving.

If people save more and borrow less, the cost of money and consumption fall. It is that simple. Major with Tessa became a convert to incentives and fresh initiatives on share ownership and saving must be in the next Budget.

Meantime, where does the economic cocktail leave a market that looks cheap on fundamentals, with a low p/e and the highest yield outside Australasia? A real Gulf war may produce a panic which could cut prices 10 per cent within days but any panic could be a buying opportunity. It will bring out predators. Already the market is throwing up shares like Thorn EMI, yielding 6·7 per cent at 598p. Thanks to problems with disposals, with defence, lighting and Rumbelows on the block but without buyers, Thorn is unloved, yet chairman Colin Southgate has built music and rental businesses which are worth far more than its market value. If investors fail to spot this, Thorn could be ripe for a predator.

Ronson's mistake

THE tabloids cannot get enough of Guinness. The reporters camp outside Ford open prison and each day we read more about prison life for Messrs Saunders, Ronson and Parnes. It all gives new meaning to the phrase "inside information".

In the City, all conversation turns to Guinness. Were the sentences too lax? Did the defendants do well in

Major: balancing act

court? How did Gerald Ronson get a year and Ernest Saunders five? If the money had been stolen from a bank would the robbers have spent more time in prison?

Ronson intrigues me, not least because of the mail we have been receiving, a strange mixture of sympathy for a successful and generous businessman and some of the most ugly anti-semitic junk I have ever read. A fortnight ago, the *Mail on Sunday* suggested it was not in Ronson's best interest to tell the truth to the DTI and Guinness and last week it apologised to Ronson and his advisers, noting the judge had commended him for the truthfulness of his evidence.

Ronson was a big player in the bid battles of the mid-1980s and saw nothing wrong in profiting from the market power his wealth gave him. In Guinness he negotiated an illegal up-front payment with the person he and anyone else would regard as

TODAY'S STOCKMARKETS

The Risks ar

Sunday Times

Agony of post-ERM depression

Economic Perspective

David Smith

WAITING for the government to take the pound into the European exchange-rate mechanism is like a child's longing for bonfire night. The anticipation is exciting but the event often turns out to be a damp squib. And some people might get hurt.

Since he returned from his summer holidays a fortnight ago, John Major has watched sterling's increasingly bumpy flightpath towards the ERM. The Gulf crisis has contributed but so too have some blatant examples of market nonsense about ERM entry.

The ERM factor, which has usually boosted the pound, also showed that it could work in the opposite direction a few days ago when strong rumours swept the markets that the Bank of England was intervening to push the pound *down* before entry into the ERM.

The chancellor, having had something of a free ride by tantalising the markets with ERM-entry hopes, knows that he has to take the rough with the smooth.

Even so, and after a relentless stream of propaganda from both the Treasury and the Bank of England on their desire for a strong pound, the idea that the authorities would be seeking a deliberate depreciation of sterling was not one he was expecting.

What has also started to emerge is a condition that could be described as post-ERM depression. Even those who have long advocated full sterling membership of the system are viewing Britain's adjustment prospects with concern.

Economists at the Confederation of British Industry, in their report last week, UK Inflation Performance, were clear that a stable pound must be part of the environment in which industry operates.

Sterling stability, however, also means that competitiveness has to be achieved without outside help.

Industry's prices, and the most important determinant of them, unit-wage costs, need to be growing in line with our European competitors.

The CBI sees the need for 3% inflation by the mid-1990s and warns that, on present trends, absolute pay levels in Britain will overtake those in Germany by 1995, without a commensurate catch-up in productivity.

With average earnings growing at 10%, gloom about Britain's labour market, and its ability to adjust to the disciplines of the ERM, is widespread.

The CBI sees pay bargaining in Britain (although also to a lesser extent in France and Germany) as occcupying an uncomfortable middle ground.

In some countries, for example Japan and Switzerland, pay negotiations are decentralised and the outcome is generally good. In others, for example Austria, a highly centralised system also delivers low settlements.

Britain's framework, with elements of both centralised and decentralised pay bargaining, appears to be the worst of both worlds.

A thoughtful paper from union leaders John Edmonds and Alan Tuffin, Bargaining for Prosperity in the 1990s, discussed at last week's Trades Union Congress, also addresses itself to pay in the context of ERM membership.

Membership, it says: "Will heighten the need to stay cost-competitive with our leading European partners, with unavoidable consequences for bargaining and pay levels . . . Badly handled, entry into the ERM could mean stable prices but many lost jobs."

The paper, treading carefully through the minefield of TUC, Labour party and government sensibilities, proposes increased centralisation in pay negotiations.

Although this would involve nothing as crude as a pay norm, the idea is of tripartite discussions between the government, the TUC and the CBI to set the agenda for individual negotiations.

Governments that have accepted interference in the currency markets by joining the ERM may have to be prepared to accept greater interference in the labour market. Under the Tories it is, of course, a non-starter. Under a future Labour government, it could well feature.

That does not, however, solve the present problem. With double-figure average pay rises in prospect this autumn more than two years after the Treasury embarked on its tightening of monetary policy, one could be forgiven for thinking that Britain's labour market is a law unto itself. ERM entry, on this view, will fail to break the inflationary psychology that forms the basis of pay negotiations, as happened with monetary targets in the early 1980s.

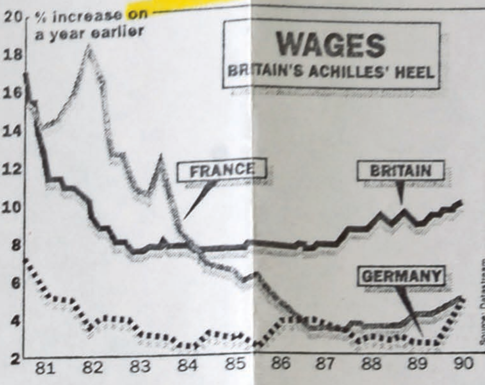
The result is that, assuming sterling's level within the ERM is held, the process of grinding pay increases in Britain down to, say, 3% will be a painful one.

The old rule of thumb from the Treasury model, that every 1% off wages requires a 100,000 increase in unemployment, could in such circumstances underestimate the pain.

Most pay negotiators would claim, however, that they respond to the temperature of the inflationary climate, rather than creating it.

In this, although they may not care to admit it, they are at one with monetarists, in saying that the cause of inflation is lax monetary policy and high pay settlements are merely an effect.

The optimistic interpretation of the consequences of ERM entry is that it will reinforce anti-inflationary policy and change the inflationary psychology in Britain. The French example of the success of the *franc fort* policy has been over-used but it shows that realistic expectations of low inflation can be more important than labour-market reforms in changing the behaviour of pay negotiators.



Indeed, worries about politicians abusing ERM entry, by using it as an excuse to cut interest rates prematurely, may have been overstated. Far more likely is that full membership of the system will present a useful scapegoat when tough policies have to be continued during periods when it is politically inconvenient to do so.

Achieving low pay settlements in Britain will be far from easy. In the mid-1980s, when unemployment approached 3.5m, the annual rise in average earnings never fell below 7.5%.

High pay settlements have survived two recessions and four major reforms of trades-union law.

Many sectors of the economy, notably those producing goods and services which are not internationally traded, will be only indirectly affected by ERM membership and pay levels will be slower to respond than in export and import-competing industries. This could mean, paradoxically, that one of the temporary effects of entry will be to provide an incentive for workers to move into those sectors that are not making a much-needed contribution to reducing Britain's trade gap.

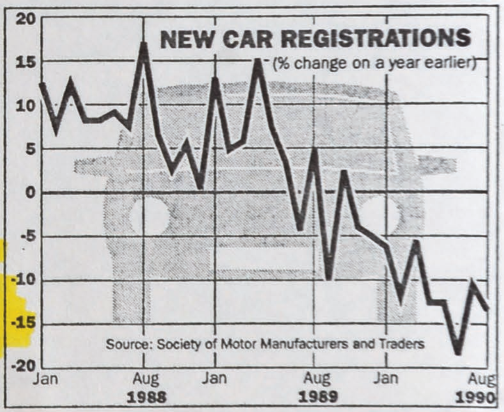
Pay, of course, is only one area in which Britain's competitive position is at risk. An Institute for Public Policy Research report, Learning by Right, to be published tomorrow, highlights the lamentable training gap between Britain and the rest of Europe.

Only 38% of the workforce in Britain has skilled vocational training, compared with 56% in Spain, 67% in West Germany and 80% in France. And this at a time when the Department of Employment is under pressure from the Treasury to cut its training budget.

None of this means that full membership of the system is a bad thing, merely that it requires complementary action elsewhere in the economy. Initially, the effect will be to create additional pain in the economy and the chorus of "I told you so" from long-standing opponents of the system will be deafening.

Ultimately, entry will force competitiveness on the economy in a way that policy outside the system has failed to achieve. Meanwhile, pass the pills for post-ERM depression.

Indicator of the week



NEW car registrations in August, the first month of the new H prefix, totalled 432,867, a drop of 13.45% on a year ago, providing further evidence of the weakness of the economy.

The Confederation of British Industry, in its latest survey of the distributive trades, pointed to particular weakness affecting the motor trade. In every month this year, new-car sales have been well below their 1989 level. For the first eight months of 1990, registrations were 1,544,626, a fall of 11.61% on the corresponding period of 1989.

Imported cars accounted for 59.56% of registrations last month, slightly down on the 60.18% share of August 1989. In the January-August period, however, importers increased their share to 57.35%, from 56.91% in the corresponding period last year.

Among the top manufacturers, Ford's market share has dropped to 25.02% this year, from 27.03% in January-August 1989. Vauxhall rose from 14.83% to 15.74%, and Rover from 13.62% to 13.98% but Peugeot-Talbot slipped from 6.06% to 5.85%. Nissan, despite its successful UK manufacturing presence, suffered a drop in market share from 6.17% to 5.75%.

The weakness of vehicle registrations is not confined to cars. August commercial-vehicle registrations were 25.9% down on last year. The last time there was a similar sharp drop was during the 1980-1 recession.

The week ahead

Date	Event	Expectation	Previous
Mon 10	UK retail sales (Aug)	–0.2%	1.0%
	UK input prices (Aug)	1.6%	0.6%
	UK output prices (Aug)	0.4%	0.3%
Thu 13	UK unemployment (Aug)	+15,000	+10,900
Fri 14	UK manufacturing output (Jul)	0%	–0.5%
	UK retail prices (Aug)	0.7%	0.1%
	US producer prices (Aug)	1.2%	–0.1%
	US industrial output (Aug)	–0.1%	0%

Source: IDEA

TO BUSINESS
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Agony of post-ERM depression

Sunday Times

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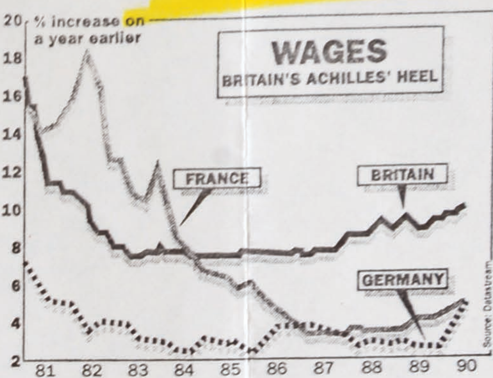
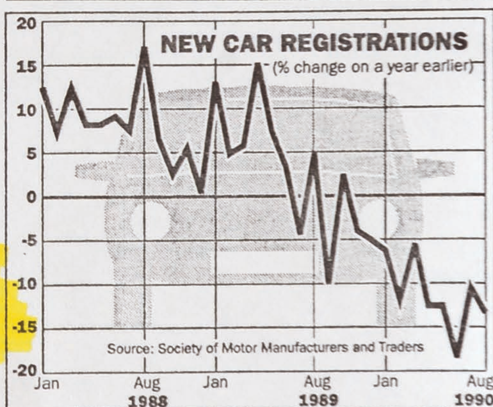


Indicator of the week



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Agony of post-ERM depression

Economic Perspective

David Smith

WAITING for the government to take the pound into the European exchange-rate mechanism is like a child's longing for bonfire night. The anticipation is exciting but the event often turns out to be a damp squib. And some people might get hurt.

Since he returned from his summer holidays a fortnight ago, John Major has watched sterling's increasingly bumpy flightpath towards the ERM. The Gulf crisis has contributed but so too have some blatant examples of market nonsense about ERM entry.

The ERM factor, which has usually boosted the pound, also showed that it could work in the opposite direction a few days ago when strong rumours swept the markets that the Bank of England was intervening to push the pound *down* before entry into the ERM.

The chancellor, having had something of a free ride by tantalising the markets with ERM-entry hopes, knows that he has to take the rough with the smooth.

Even so, and after a relentless stream of propaganda from both the Treasury and the Bank of England on their desire for a strong pound, the idea that the authorities would be seeking a deliberate depreciation of sterling was not one he was expecting.

What has also started to emerge is a condition that could be described as post-ERM depression. Even those who have long advocated full sterling membership of the system are viewing Britain's adjustment prospects with concern.

Economists at the Confederation of British Industry, in their report last week, UK Inflation Performance, were clear that a stable pound must be part of the environment in which industry operates.

Sterling stability, however, also means that competitiveness has to be achieved without outside help.

Industry's prices, and the most important determinant of them, unit-wage costs, need to be growing in line with our European competitors.

The CBI sees the need for 3% inflation by the mid-1990s and warns that, on present trends, absolute pay levels in Britain will overtake those in Germany by 1995, without a commensurate catch-up in productivity.

With average earnings growing at 10%, gloom about Britain's labour market, and its ability to adjust to the disciplines of the ERM, is widespread.

The CBI sees pay bargaining in Britain (although also to a lesser extent in France and Germany) as occcupying an uncomfortable middle ground.

In some countries, for example Japan and Switzerland, pay negotiations are decentralised and the outcome is generally good. In others, for example Austria, a highly centralised system also delivers low settlements.

Britain's framework, with elements of both centralised and decentralised pay bargaining, appears to be the worst of both worlds.

A thoughtful paper from union leaders John Edmonds and Alan Tuffin, Bargaining for Prosperity in the 1990s, discussed at last week's Trades Union Congress, also addresses itself to pay in the context of ERM membership.

Membership, it says: "Will heighten the need to stay cost-competitive with our leading European partners, with unavoidable consequences for bargaining and pay levels . . . Badly handled, entry into the ERM could mean stable prices but many lost jobs."

The paper, treading carefully through the minefield of TUC, Labour party and government sensibilities, proposes increased centralisation in pay negotiations.

Although this would involve nothing as crude as a pay norm, the idea is of tripartite discussions between the government, the TUC and the CBI to set the agenda for individual negotiations.

Governments that have accepted interference in the currency markets by joining the ERM may have to be prepared to accept greater interference in the labour market. Under the Tories it is, of course, a non-starter. Under a future Labour government, it could well feature.

That does not, however, solve the present problem. With double-figure average pay rises in prospect this autumn more than two years after the Treasury embarked on its tightening of monetary policy, one could be forgiven for thinking that Britain's labour market is a law unto itself. ERM entry, on this view, will fail to break the inflationary psychology that forms the basis of pay negotiations, as happened with monetary targets in the early 1980s.

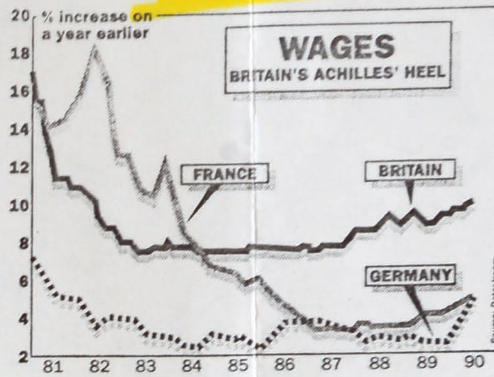
The result is that, assuming sterling's level within the ERM is held, the process of grinding pay increases in Britain down to, say, 3% will be a painful one.

The old rule of thumb from the Treasury model, that every 1% off wages requires a 100,000 increase in unemployment, could in such circumstances underestimate the pain.

Most pay negotiators would claim, however, that they respond to the temperature of the inflationary climate, rather than creating it.

In this, although they may not care to admit it, they are at one with monetarists, in saying that the cause of inflation is lax monetary policy and high pay settlements are merely an effect.

The optimistic interpretation of the consequences of ERM entry is that it will reinforce anti-inflationary policy and change the inflationary psychology in Britain. The French example of the success of the *franc fort* policy has been over-used but it shows that realistic expectations of low inflation can be more important than labour-market reforms in changing the behaviour of pay negotiators.



Indeed, worries about politicians abusing ERM entry, by using it as an excuse to cut interest rates prematurely, may have been overstated. Far more likely is that full membership of the system will present a useful scapegoat when tough policies have to be continued during periods when it is politically inconvenient to do so.

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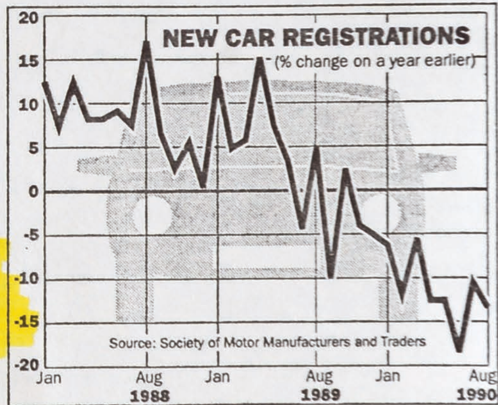

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The Message from Sterling's Recovery

– Robert Thomas & Ray Richardson

In his radio interview last Friday Mr Major confirmed that sterling's entry into the ERM still lies some way off in the future. This article looks at sterling's recovery over the last four months and concludes that, as was suggested in an article in the issue of the Greenwell Gilt Weekly of 18th June, it is likely that sterling has already taken most of the benefits of entry into the ERM. The article then considers the implications for sterling in the coming months and whether the market could begin to lose confidence if entry were delayed too long.

Mr Major's Interview

Mr Major began his interview by stating clearly that sterling would not enter the ERM last week-end. Sterling immediately fell over 2 pfennigs, but partially recovered when he reaffirmed that he "believed without any doubt whatsoever that it is the right policy for sterling to enter the ERM". But his remarks suggest that entry is still some weeks, if not months, away. Inflation remains the Madrid Condition which still has to be met, although he refused to state categorically that inflation has to be falling before entry. But his doubts about the trend in inflation and the strength of the real economy surfaced more than once.

Our interpretation of the interview is that sterling will enter the ERM, but probably not for a month at least. November becomes the most likely time for entry. His remarks, however, are consistent with entry being delayed until next year, and it is significant that, at one point, he said that he will recommend entry as soon as he thinks "it is **safe** to go in".

Cuts in interest rates will depend on how the economy develops. Mr Major is still concerned about the strength of retail sales as well as inflation. He emphasised that interest rate reductions will not be necessarily tied to ERM entry, and could start before entry. But both Mr Major's comments and last Thursday's action by the Bank of England suggest that the first reduction will wait until other countries have decided whether or not to tighten policy in response to higher oil prices.

Sterling's Recovery

Since mid-May sterling has rallied strongly, as the three charts show. Even after its slight softness of the last few days it is up by nearly 9% on its trade weighted index, 13% against the US dollar and by 8% against the deutschemark. In order to understand how sterling will now react we must first consider what has caused it to strengthen over recent months. There are a number of candidates to consider.

Chart I
Deutschemark per Sterling

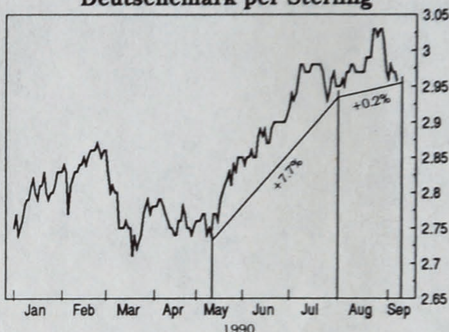


Chart II
US Dollar per Sterling

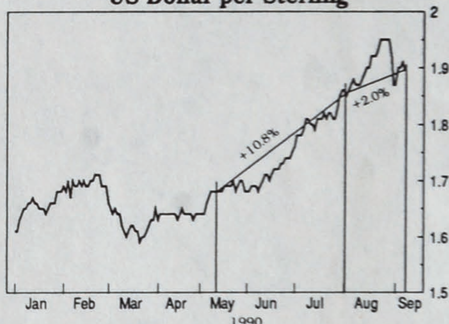
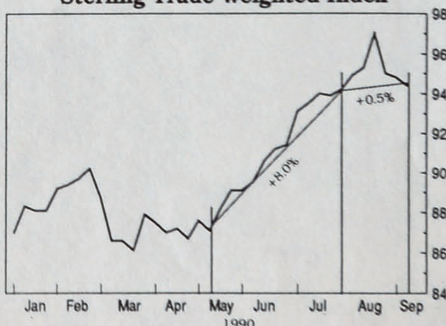


Chart III
Sterling Trade Weighted Index



High Interest Rates
Sterling interest rates have been well above those in other major economies. But short term interest rate differentials have not widened significantly in the last four months.

There are signs that investors have been favouring the high yielding currencies, but sterling has been significantly stronger than other higher yielding currencies. For example, since early June, it has risen 10% against the Australian dollar.

It appears that interest rate (or bond yield) differentials, therefore, do **not** on their own explain sterling's strength.

Bank of England Intervention
In every month since April the UK's underlying foreign exchange reserves have risen, in total by $716m. Even though this has been boosted by funds flowing in to meet the call on the Water issues, if the Government had been pushing sterling up by intervention there would have been a fall, not a rise, in the UK's foreign exchange reserves. It seems, therefore, that sterling's stength cannot have been associated with intervention by the authorities.

Politics and Economic Data
In the first few months of the year the Conservatives were in a real mess. Not only were they way behind Labour in the opinion polls, but talk of replacing Mrs Thatcher as Prime Minister resurfaced. This may well have been a contributory factor to sterling's weakness.

The Conservatives' better than expected performance in the local elections on 3rd May effectively ended talk about the demise of Mrs Thatcher, and the Conservatives began to whittle down Labour's lead in the polls. The improving political standing of the Government raised hopes that it has a sporting chance of winning the next General Election, which after all does not have to be until 1992.

Moreover, signs of a much weaker economy began to appear more frequently in the second quarter. The first monthly rise in unemployment since 1986 was published in May and there was a much lower current account deficit announced in late June.

The improving political and economic climate may well have contributed something to the strength of sterling. However, it must also be said that this effect may well have been associated with prospective ERM entry, in that an improving economic climate has enhanced the chance of entry.

The Impact of the Gulf Crisis
What about sterling's position as a petro-currency? In the month following Iraq's invasion of Kuwait on 2nd August, sterling's strength has been underlined, especially against the US dollar and the deutschemark. But the Gulf Crisis has **not** contributed much to the overall rise in sterling. Its index rose 8% between mid-May and end-July, but less than 1% since then.

Attraction of Other currencies
The trend in sterling cannot be considered in isolation. Its recovery coincides with growing concern about the cost of German unification, with the deutschemark being weak in the ERM until late August. Similarly, the weaker US economy focussed attention on the poor outlook for the US dollar, and easing by the Fed on 13th July highlighted the policy dilemma there.

After falling from a peak of Dm3.28 at the start of 1989 sterling was beginning to be oversold. This contributed to its attractions. When there are few particularly attractive currencies, the high yields offered by a currency which has already fallen a long way can be a draw.

The Impact of ERM Entry
Nevertheless, none of the above provides a sufficient explanation on its own for the turn round in sterling, which closely coincided with a stream of statements by the Prime Minister and the Chancellor that were interpreted as a shift in policy towards the ERM. Mrs Thatcher was believed to have dropped her veto on entry. This was signalled in her speech on 12th May to the Scottish Conservative Party Conference when she made a comparison between the 6.5% underlying inflation in the UK and the comparable European level of 5%, and drew the conclusion that UK inflation was not far above the European average. The belief then grew that sterling would most probably be in the ERM by the end of the year.

When sterling's entry into the ERM was just a very uncertain prospect, there was no obvious downside limit to the fall in sterling. At the other extreme, once sterling is in the ERM there will be a high degree of confidence that it will remain within its

bands, at least until after the next General Election. As the probability of sterling's entry rose, from a low level, through 50% to its current level of, perhaps, 90%, the currency risk from investing in sterling deposits to gain the extra income of some 0.5% a month fell sharply. After all, if sterling is around the central rate of its ERM band it can only fall a maximum of 6%, and in practice slightly less.

Sterling's Recent Fall

One recent event may give a further insight into sterling's possible behaviour. Why was sterling so weak on Friday 31st August, when there were rumours of ERM entry? Was it profit taking, especially as there were rumours of a central rate of Dm2.95 rather than Dm3.00? Or was it fears that interest rates would be cut on entry or soon after? We will never be sure of the actual reasons, but the event highlights the risks to sterling, if the market suddenly decided sterling was not about to enter the ERM.

But what has become clearer after Mr Major's interview last Friday and the Bank of England's action on Thursday is that interest rate cuts will be decided separately to ERM entry. They will not necessarily immediately follow entry or, indeed, even have to await sterling's entry into the ERM.

Implications for the Future

The main factor behind sterling's recovery since April has been the rising prospect of its entry into the ERM. The better trends in the economy and in trade, the lack of really attractive alternative currencies and sterling's overall position have doubtless helped, but they do not seem to be the prime reason. What will happen now that entry appears to have been delayed?

The fact remains that the Government had up to last Friday done nothing to prevent the build-up of a considerable bubble of market expectation that ERM entry was imminent. This raises three questions: What really is the Government's position on entry? Have their intentions changed? How will markets react to delay?

The manner in which this whole episode is being handled suggests to us that the Government does not have a completely settled policy. This may just reflect the fact that Mrs Thatcher, deep down, does not want sterling to join at all. It is not hard to see her arguing that, given the Gulf crisis, entry was not opportune at this time. Underlying this might be an expectation of military conflict in the Gulf. Objectively, this is by no means a clear cut reason for delaying entry. Indeed, sterling might well benefit from the protection of membership, if war were to break out.

The other possibility is that Mr Major himself is still unsure about the terms of entry. In his interview last Friday he made it clear that he does intend to have sterling in the ERM. But inflation has been raised by the Gulf crisis, and probably by the drought, so that even if he had hoped to enter this month he may now feel that he has to delay until he is more confident that the inflation peak has been reached. Also, the real economy has kept going for longer than he probably expected. He will certianly not want to be forced by the foreign exchange market to cut interest rates soon after entry, if he does not think a cut is justified by domestic economic conditions.

All this suggests that entry is most likely a month or more away, with the Gulf Crisis being the rogue factor which could delay entry into next year. Markets have probably given insufficient weight to this and the strength it could give to any delaying tactics which Mrs Thatcher might wish to use.

But how will the market react to continued delay? As long as it still believes that the delay can be justified, sterling should not come under severe pressure. The greatest danger would come if markets began to believe that the delay was turning into an excuse for not joining at all, or that the central rate would be a good deal below Dm3.00. The need to contain inflation is likely to rule out the choice of a rate close to sterling's low of earlier this year. But a rate slightly below Dm3.00 would probably provide more room to reduce interest rates than a rate of Dm3.00 or higher. As the choice of central rate is likely to follow the pattern of other currencies, such as the peseta, and be close to the market rate at the time of entry, the Government may try to manipulate the market or choose the date for entry when sterling is close to the desired level.

As long as entry occurs before the inter-governmental conference on 13th December, which despite recent events is still very much our central view, sterling should not have any difficulty remaining relatively close to its current level. The prospect of a further lasting surge through the recent high of Dm3.04, however, does not look very likely.

At long last, the time is still not right

ECONOMIC VIEW

GRAHAM SEARJEANT

John Major is, fortunately, a lot calmer than the foreign-exchange markets were last week. The September Euro-gathering had been booked as a desirable moment for the chancellor to pop sterling into the European exchange-rate mechanism ever since the prime minister made it clear that entry would come sooner rather than later. As a curtain-raiser to the party conferences, this would have been politically perfect.

Mr Major was wise to leave the rabbit in the hat. After a decade of arguing, with shrinking credibility, that the time was not right, Britain had changed its mind just as the time really stopped being right.

Economic reformers must obey one rule above all others. They must always distinguish between the benefits of a different system and the likely effects in a free economy of making the change.

The difference was well demonstrated when Labour introduced its corporation tax, now long forgotten, in 1965. The new system, intended to boost industrial investment, imposed a higher tax on dividends and a lower tax on retained profits, giving companies an incentive to plough more back. But the process of change produced the opposite effect. Companies maintained their dividends at higher cost, so retained profits fell sharply.

Fixing sterling against the currencies of nations that account for half our trade should produce the inestimable benefit of stability. A stable currency should cut the risks of companies that export or compete with imports, helping them save money and plan ahead. By cutting the risk of holding sterling, it should allow interest rates to be lower. Once wage bargainers get the hang of it, a stable currency tied to the strongest in the system should dissolve inflationary expectations and be an anchor for stable prices, allowing faster growth.

By contrast, moving into the ERM at the wrong time, at the wrong rate or in the wrong way can damage and destabilise the economy for years ahead. That would have happened had the chancellor succumbed to temptation at the weekend, and will happen if he accedes to political or market pressures for entry in the coming weeks.

The crucial error would be to use entry as a short-term anti-inflationary measure. This idea seems to have crept into official thinking since early summer. High interest rates did not seem to be working, notably on rising pay settlements. Sterling was soft and the impact of any further rise in mortgage interest on prices would make things worse.

As an international report on Britain suggested, the monetarist strategy so effective in the early Eighties had fallen apart. Swift entry into the ERM, previously rejected as impractical until inflation had come down to continental levels, might itself do the trick, ruling out devaluation and making policy credible again.

This seemed attractive with sterling just below DM2.80. That was about average for the decade, allowing for the higher price rises in Britain than in West Germany. Respected analysts at City firms such as Goldman Sachs and BZW thought it a sensible level to fix the pound for the long term. The authorities, however, skilfully talked the pound up in the markets by offering a tasty dish of security with high returns: ERM entry with 15 per cent base rates.

The final step was to see a high fixed exchange rate plus sustained high interest rates as the ultimate weapon with which to slash inflation.

These logical steps had led to nonsense, which has been compounded by the unpredictable resurgence of sterling as a petrocurrency. Lower interest rates should be a prime benefit of being in the ERM, but the Treasury and the Bank want high interest rates in the short term. Sterling would therefore have to be fixed at so high a rate that the risk of an exchange loss from holding it would remain, so that interest rates could be kept up.

Almost by definition, this has to be an economically unrealistic rate now, since Britain has been running a trade deficit of about 4 per cent of output with sterling at lower levels. If it takes three years to bring inflation down permanently to the average rate of other ERM members, industry might well be a further 8 per cent less competitive and could not realistically recoup that loss.

On this plan, the government would soon be forced into a dire choice. It must accept a long, deep slump, costing the permanent loss of many factories sensitive to relative European exchange rates, such as chemicals, building materials, engineering components, capital goods and textiles. Or, horror of horrors, sterling would suffer humiliating devaluations within the ERM, just as the franc did, for different reasons, in 1983.

The better way is to fit into the long-term logic of a stable currency. Entry must wait until inflation is decisively down, ideally until the short-term inflation gap can be covered by the currency's widest permitted range of movement within the ERM. This will allow interest rates to be cut to a level suitable to keep the pound at a realistic rate. Mr Major could then fix sterling at a central rate equivalent of about DM2.80. The time will not be right before mid-December, when talks on monetary union start, and probably not until next spring.