THE TIMES 2 JANUARY 1991

Prime Minister
In case you did not see
AT 2/1

Dare Major devalue?

I did O.K. Cool

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Alan Walters

There is widespread agreement that Britain is in a recession. There is equally a consensus on the minimum programme required to prevent the recession becoming a deep depression. Lower interest rates, an increase of monetary growth, perhaps even cuts in tax rates (although that is more dubious) would, it is said, arrest the recession after six months or so. After all, interest rate cuts in 1980-81 arrested the sharp economic decline and promoted the expansion from mid-1981 that continued to almost the end of the decade.

Why cannot we repeat the feat? Every one of Nigel Lawson's teenage scribblers will know the answer. Because our monetary policy has been determined by the Bundesbank and the exchange rate speculators. Under Mr Lawson's tutelage, Britain joined the exchange rate mechanism (ERM) *de facto* in early 1987 and *de jure* in October 1990. With minor oscillations, Britain has been pegged for almost four years to a DM2.95 standard.

When Mr Lawson chose to peg the pound at around that figure in 1987, it soon became clear that the value was "too low"; if the value of the pound had been determined by the free market, the pound would have risen. Interest rates were dramatically reduced to repress the buoyant exchange rate. The flood of sterling resulted in the Lawson inflation which surged, pretty much on schedule, in 1989-90.

The inflation eroded the value of sterling and decreased British competitiveness. It set in train the expectation that the DM2.95 value was untenable. The forward market is telling us that it expects a devaluation of sterling. And so funds have started to flow out of sterling in anticipation of its downward "realignment" relative to the mark. The smart money got out on the morning after ERM entry in October when, for a while, sterling rose to near the top of its permitted range. The astute anticipation of a sterling slide was entirely justified.

But in the ERM, a downward realignment is politically difficult, if not suicidal. Reputations, notably those of the CBI, financial journalists and, indeed, that of the prime minister have been put on the line. They deliberately chose to be lashed to the mast at DM2.95. They wish to convince the markets that 2.95 will be held— but for their own good reasons, the markets are discounting the pound. The only way to keep the exchange rate from sinking dangerously near its floor is to maintain, perhaps increase, interest rates on sterling deposits.

The proverbial man from Mars or even from the Fed, having read this far, will, concealing his mirth, undoubtedly conclude that something is seriously wrong. In order to keep Britain at the *de facto* peg of DM2.95 in the boom of 1987-88, Mr Lawson added to the inflationary pressure. From the last quarter of 1988, to defend the same parity, the policy switched from prodigal ease to a severe monetary squeeze which continues unabated in the serious recession we see today.

The ERM medicine always induces a policy that is perverse. It alternates between promoting and feeding inflation, and deepening and prolonging a recession. We used to deplore the bad old policies of stop-go, but the ERM makes us step on the brakes and gun the engine more than in the exchange-control days of Selwyn Lloyd and Denis Healey.

Is there not some redeeming feature that compensates for this defect? The proponents of the ERM tend to play down the rollercoaster ride as either nonexistent or at least as unimportant. Or alternatively, they see it as part of the price, only a transitory one and well worth paying, for Germany to take over monetary control of the United Kingdom. All Europe will eventually have, if not the Deutschmark as currency, then the German rate of inflation. There are many commentators who are willing to pay the price of a prolonged and deep slump in order to join the German hegemony. According to announcements by the Chancellor, Norman Lamont, this is also the government's policy. It would, however, lead to electoral suicide.

What alternatives are there? First there is fiscal policy; we could compensate for the regrettably high interest rates inflicted on us by the ERM with reductions in taxes and increased government spending. But fiscal effects are most uncertain, even disconcerting. There is no way in which we could offset the high interest rates required to keep us in the ERM. Second, there is the reintroduction of exchange controls. A return to such a discredited system would be a very last resort.

The government has got itself into a fine old corner. As sterling sinks nearer to its floor of DM2.82, ultimately either interest rates will have to be raised or sterling devalued — or conceivably both.

In my view, the only feasible, let alone humane, policy is to engineer a substantial devaluation of sterling. Ten per cent (to about DM2.65) might be enough to convince the world that the rate was sustainable. Such a decision by Mr Major would require great moral and political courage. He would be pilloried by the opposition, Europhiles and some of the media — and above all by his own party. An acid test for a new leader.