

PRIME MINISTER

SIR ALAN WALTER'S VIEWS ON EMS

The Financial Times of 18 October carried the story at Flag A about Alan's views on EMS/EMU. The eye-catching statement was that Alan thinks EMS is "half baked" but would not oppose full monetary union with permanently fixed exchange rates.

Although this was presented as a new statement, the origins lie in an article he wrote some time in 1988 for an American magazine. When approached by the FT for an interview Alan declined but sent them a copy of the article at Flag B.

The passage in question is on pages 19-20. At Questions, the Chancellor and the Lord President were asked whether Sir Alan's views represented those of the Government. Both answered that they did not and that the Government's views were as set out at Madrid.

At first sight, Alan's position on EMS/EMU appears to be 180° from that of the Government - he is totally opposed to EMS, but prepared to contemplate EMU. HMG is prepared to contemplate EMS but is totally opposed to EMU.

In practice, the two positions are a good deal closer. First, HMG wants changes to the EMS, in particular the removal of exchange controls, before it will consider joining. This will change the nature of the EMS and allow it to evolve towards EMU via a long period in which current competition causes inflation rates to converge on the best, with exchange rate changes becoming rarer and rarer. Secondly, Alan qualifies his willingness to contemplate EMU as being "on economic grounds". He has not attempted to address the problem of advising political accountability for the central monetary institutions.

The main difference between Alan's position and that of the Government is that he wishes to move straight from floating

rates to locked parities without going through the intermediate stage of closer and closer links during which parity changes are still theoretically possible.



(ANDREW TURNBULL)  
19 October 1989

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PRIME MINISTER

FINANCIAL TIMES ON ALAN WALTERS AND THE EMS

When you have time you might like to read this paper by Alan Walters. Paul's note sets out the text in which this has arisen. Although it appears to have been written in 1988, before his reattachment to No.10, it caused quite a stir yesterday.

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AT

(ANDREW TURNBULL)

19 October 1989

AIR  
MR TURNBULL

FINANCIAL TIMES ARTICLE ON ALAN WALTERS AND THE EMS

I mentioned to you the piece in the 18 October Financial Times; extract attached.

I have this evening managed to track Alan down in Boston. He tells me that the article in question was written a long time ago. He says it must have been three years ago, although I think it may be a bit less than that. But for some reason it seems not yet to have been published - although Alan says he has circulated it widely in the past. I also attached a copy of the full article which I have obtained from Alan's office in Washington.

Terry Perks was given a hard time on this at the lobby this afternoon. But having got all the background, the line the Press Office will now be taking - and which will be given to the Lord President for Question Time tomorrow - is:

- the Government's views on the EMS are absolutely clear, as in the Prime Minister's post-Madrid statement, and as repeated by the Lord President on Tuesday.
- there is absolutely no news in the FT piece. Alan Walters' views on the EMS are well-known to anyone who has read his earlier writings. And we understand that this particular article, although it may not yet have been published, was actually written a long time ago - well before he rejoined the No.10 staff.

REC6

Paul Gray

18 October 1989

MJ c:FT

FT. 18/10/89.

## PM's economist adds his guarded support

By Simon Holberton, Economics Staff

SIR ALAN WALTERS, the Prime Minister's personal economics adviser, has entered the debate over Britain's place in Europe and given guarded support to European monetary union and a common European currency.

Sir Alan says he is not opposed, on economic grounds, to the development of a proper European currency administered by a European central bank. This would be preceded by "absolutely fixed exchange rates and appropriate monetary institutions to support that fixity."

His views are contained in a forthcoming biographical essay to be published in the US by the journal, *The American Economist*. The essay gives a rare glimpse of a man at the centre of economic policy-making in the UK, who is often heard about but rarely heard from.

Sir Alan remains, however,

implacably opposed to Britain's full membership of the European Monetary System. Arguments for British membership "have never attained even a minimum level of plausibility" and the EMS remains "half-baked," he says.

Although the official policy of the UK envisages eventual membership of the EMS, it is hostile towards economic and monetary union, or at least the version of Emu as delineated in the eponymous report of Mr Jacques Delors, President of the European Commission, earlier this year.

Mr Nigel Lawson, the Chancellor, who tomorrow goes to the City for his annual Mansion House speech, has proposed an "alternative" route to Emu through the removal of barriers to using and transacting business in any community currency. This concept, known as "competing currencies," is the subject of a

recently completed Treasury draft paper, which has yet to be circulated to Community finance ministers.

In the essay, Sir Alan gives a warm and human account of his early life and academic career, presenting himself as a man of humble origins who, at Birmingham University in the early 1950s, discovered the delight of fierce but friendly intellectual debate. He attributes much of his life's success "to one lucky break after another."

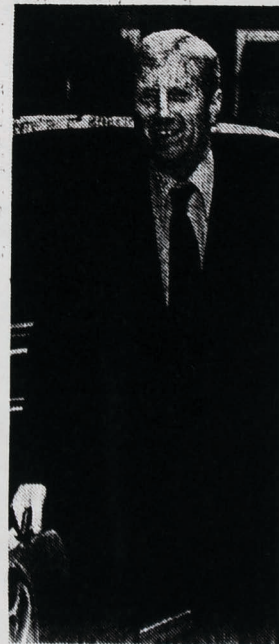
The son of a communist, brought up in a slum in Leicester, his horizons were initially limited - he aspired to be a draughtsman in light industry - but he was guided by "selfless, dedicated schoolmasters" to achieve higher things.

It was one of these schoolmasters who, after the Second World War, suggested he read economics instead of becoming a teacher. "He was quite blunt.

Since I had forgotten what I had learned at school, and since I had learned nothing in the Army, clearly I knew virtually nothing - so, he concluded, the only subject for me was economics."

Although in the article Sir Alan displays an engaging self-deprecatory sense of humour, he leaves the reader in little doubt as to his importance in British economic policy-making in the early Thatcher years. "I acquired a considerable influence on economic policy," he says.

He takes credit for proposing the content of the Government's 1981 Budget and winning the Prime Minister's support for a cut in the Budget deficit equal to 2.5 per cent of gross domestic product - the biggest peacetime budgetary squeeze. This, he says, laid the foundation for the UK economy's success in the 1980s.



Sir Alan Walters: EMS remains "half-baked"

A Life Philosophy

A. Walters

For: The American Economist

Doc code: Philos-1

M. ~~French~~ <sup>Jourdain</sup> ~~liberal~~ who discovered that for all his life he had been speaking prose and had not realised it, I suspected that, having professed a deviationist economics all my life, I was now expected to expose it. But the temptation was too enticing. I agreed to write this portentous "life philosophy" partly, of course, due to ego, but also partly because I believe that my life has been rather unusual and may be useful in illustrating some surprising aspects of the alledged rigidity of British society and the development of ideas and economic policy.

Born in 1926 of working class parents in a Leicester slum, I was unpromising material. My father was then a clerk in a grocery chain store. He had left school at the age of 13, but he was, as we would say nowadays, both numerate and literate. From 1917 until 1937 or 1938 he was a communist, but, unlike many

others, he was revolted by Stalin's terror, in particular the massacre of the POUMS in Spain. He remained a staunch ultra left wing socialist until the end. My early intellectual domestic diet was one of romanticised revolutions righting the capitalist exploitation of the working class, etc.

In the 1930s, schools, even in such slums, were well-structured and disciplined. Corporal punishment was administered firmly and fairly. The pupils learned or else. School was highly competitive - and a good preparation for life. One was rewarded for performance and punished for perfidy and laziness but not for failure. The critical test came at the age of 11. Then all pupils were set an examination, the outcome of which decided whether they were to win a scholarship and be sent to the superior 'secondary schools' where one was educated to the age of 15 or 16 (and even to the age of 18), or to the 'senior schools' for the 70 per cent who did not qualify for the secondary schools. The senior schools were intended as the last rung on the educational ladder for those who would not repay further training beyond the age of 14.

Since I was thought to be one of the better pupils, I was expected to pass the '11' examination and qualify for a secondary school. Indeed, I thought I would pass and the secondary school would prepare me for a skilled job in one of the light engineering factories which were a very fount of prosperity in 1937. Disaster struck, however. Not only did I fail the examination, but I failed in arithmetic! My ambition to be a

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skilled worker, such as a draughtsman, was largely dashed by that failure.

The senior school which I then attended was, however, staffed by some of the most selfless, dedicated schoolmasters who regarded their pupils, with their demonstrably modest abilities, as worthy of enormous effort and application. Both my mathematics and English masters were convinced that I had the right stuff for higher things. Through various negotiations, I know not what, they managed to get me transferred to a well respected secondary school - Alderman Newton's - at the age of 13. The first step up, and the first year of World War II. For me a fortunate conjunction. My father had lost his job in 1936 or 1937, and had been on the dole for about two or three years. He could ill afford to keep me at school beyond the statutory age of 14. But 1939 saw my brother, another grocery store clerk, mobilized, and my father stepped into his shoes. So he had the means, however slender, to give me the opportunity "to better myself" by an additional year or two at a worthy school.

Again I was extraordinarily lucky. My mathematics and English teachers identified me as a suitable pupil for the stream which did two years work in one year (called the "remove"). I repaid their faith with a very good matriculation result at the early age of 15. This meant that I could be enrolled as reading for a degree in a recognised university in the United Kingdom - if they would have me. But in 1940 and 1941, no such thought ever crossed my mind. The seemingly endless war was the only



concern and, with the impetuosity of my years, I wanted to join the forces as quickly as possible. Meanwhile, with the objective of making as much money as possible, I went to work first as an errand boy in a surveyor's office and then as a machine operative in a munitions factory. At the age of 17, I volunteered for the Army.

After three years of uneventful service as a private, the war was over and I was soon to be demobilized with no clear idea of my prospects. Everyone thought that unemployment would return, and so job security loomed quite large. I believed that the best job I could hope to get was that of school teacher. I was particularly attracted by the long holidays, the high steady incomes and the easy life of the school teaching profession. I saw my old schoolmaster and I told him of my assessment and my ambition. He insisted, however, that I should aim higher and apply to read for a degree at a university since, he said, "they are taking anyone now" - meaning that they may take someone who had only a school education limited to matriculation. When we discussed the subject of the proposed degree, he was quite blunt. Since I had forgotten what I had learned at school, and since I had learned nothing in the Army, clearly I knew virtually nothing, so, he concluded, the only subject for me was economics.

Fortified by the belief that for the study of economics, knowledge was no asset perhaps even a liability, I applied for admission to many universities; for very good reasons, all sent rejection letters except, almost as an act of local charity,

University College, Leicester accepted me as an external student for the London B.Sc. degree. In those days, Leicester had a very limited range of courses, compared with London whose faculty set the crucial examinations. But I was a beggar and no chooser. Because of my alleged mathematical aptitudes, however, I elected to read statistics, rather than economics, as my major. This decision was based also on the vague feeling, which has persisted to this day, that, for obvious reasons, the bottom might well drop out of the market for economists. But, as the age of chivalry dies, there would always be a demand for statisticians and accountants.

Since there was only one elementary statistics course at Leicester, this meant that I was left largely to find my own way in the library with the aid of a primitive barrel-type calculating machine. A most damaging handicap, you may think. But not if one judges, as scientists do, by the results. After three years (and much part-time work to eke out an ex-serviceman's grant), I came out first in the thousands of hopefuls, external and internal students, who sat the London B.Sc.(Econ) examinations in 1951.

From thence my future prospects moved to another level and place. In Britain this meant that, without masters or doctorate, I could become a tenured university teacher within a period of two or three years. (Incipient university teachers in the United States, I have found, see much virtue in this shortcut to the groves of academe; I would now argue strongly against it

for reasons other than my obvious self interest! There is a need to ensure that the university teacher has a basic knowledge of the discipline; I believe that the Ph.D. system does, albeit inefficiently, provide the assurance of that basis.) The presumption was that my bacalaureat had equipped me adequately to pursue research. And so I spent an academic year at Nuffield College, Oxford supervised by David Champernowne and attending the famous seminars of Sir John Hicks.

Oddly enough, I learned much more from my fellow students (there were about half a dozen in economics) than I did from the various luminaries on the faculty. But my fellow students eventually became most distinguished economists, and many, such as Robert Clower, Peter Newman and Hugh Rose, remain friends to this day. I did not attempt to write a thesis for a D.Phil degree - mainly because I thought it would not pass the rather fitful standards of the examiners. In fact, I do not recall any of that most distinguished band of students receiving a D.Phil (Oxon), although many tried and failed. You may draw the conclusion that there was something wrong, not with the students, but with Oxford.

My real piece of luck came when Terence Gorman and Gilbert Walker offered me a job teaching statistics at the University of Birmingham in 1952. With a shrewdness that belied his bohemian facade, Gilbert Walker - a distinguished scholar of transport economics - had gathered together a veritable galaxy of boundless young talent. At the very pinnacle was a man who I

continue to regard as the only obvious genius I have ever encountered in the economics profession - Terence (W.M.) Gorman. His vaulting imagination combined with an analytical sharpness and sophistication was rounded out by a very broad knowledge of the social sciences, history and culture. Just below this pinnacle was Frank Hahn, who pursued economic ideas with an infectious ebullience and a talmudic delight in following through an argument wherever it may lead. In applied economics, Birmingham boasted the young Michael Beesley, Ezra Bennathan and David Rowan. For good reasons the students were also a distinguished fraternity - including Maurice McManus, Sig Prais and Ed Mills. In Birmingham one was driven not merely to learn economics in order to join in the fierce and often hilarious debates, but also one had to be sharp and incisive, otherwise you lost the day. Competition was exhilarating. In this intellectual firmament the fittest not only survived but, in a few short years, that is by the end of the 1950s, they were recognised internationally as a fount of new ideas, even new standards in British economic theory and econometrics.

During the discussions of the 1950s, most of that Birmingham vintage developed the basic approach and ideas which would carry them through the next two decades of their professional lives. For example, the astonishing insight of Terence Gorman into the aggregation problem was developed around a lake in Birmingham in 1952. My work at Birmingham changed focus. Hitherto I had worked in the traditional areas of

mathematical and economic statistics. But at Birmingham, I discovered the efficacy of free markets first in 'getting prices right' and in allocating resources efficiently, but also as the key freedom in a liberal (I use that term in the European sense) society. And that peculiar mixture of analysis, interpretation of evidence, and imaginative invention - so characteristic of policy analysis and prescription - seemed to me to be enormously attractive. (Incidentally, I cannot understand why such pursuits are so out of favour in modern departments of economics in the United States.) The fantastic follies and the egregious errors of past policies made the targets quite irresistible. And, whatever nit-picking one may do on the carcass of theoretical welfare economics, the application of the most simple analysis, provided it was carried out in a sophisticated way, seemed to pay handsome dividends.

The presence of Gilbert Walker at Birmingham gave me my first field of application - transport economics. My first major contribution was in the field of public utility pricing - and, in particular, in the pricing of road services. Conventional wisdom in the track costs debate was that in order to charge people the appropriate price for road (or railroad) usage, one should measure the additional costs of building the road and then divide those costs up among users according to some criteria - such as the value of the damage inflicted by use, or according to "what the traffic can bear" (a sort of Ramsey rule). A formal development of a long-run-marginal-cost pricing rule was

veloped eventually by the Harvard group - Meyer, Peck, Stennason and Zwick.

But these methods generated results which were clearly absurd. They produced road user prices for underutilized roads which were considerably greater than the prices for obviously highly congested roads. In my "Track Costs and Motor Taxation" - a paper written in 1952, but not published until 1954, I argued that price theory, properly interpreted, gave us exactly the opposite result. There should be tolls on congested roads in urban areas, while the uncongested intercity and rural roads should have only low user fees. More generally, the argument was that short-run not long-run marginal costs were the principles which should guide utility pricing policies.

After more than 35 years I am still involved in these arguments - still, as it were, battling for the application of sensible policies. Although I believe that, after many articles (I think the most influential was in Econometrica 1961) and books (particularly The Economics of Road User Charges 1968), the principle has been largely conceded, the applications are much more timorous and messy. Perhaps my greatest reward was Singapore's adoption of a pricing policy to enter a congested downtown area. This area pricing scheme of 1975 was very similar to the model I had outlined more than twenty years before. The scheme turned out to be not only a considerable economic success but also, which I did not foresee, a great political success. But Singapore was an exception: in general, rational road pricing

has been elsewhere treated as a political hot potatoe. However, I do retain a faith that, because it is so rational and liberal a solution, ultimately it will be widely adopted.

Congestion was not restricted to roads. It had become a desperate problem at the world's major airports, and apparently was quite acute in London. In 1968 I was appointed as a member, the only economist, of the Commission on London's Third Airport (known, after the chairman, Lord Roskill, as the Roskill Commission.) After two and a half years, during which the commission's research team carried out the largest cost-benefit study in history, the commission wrote what I believe was a good report and a sound recommendation. Although Mr. Heath rejected the recommendation and instead started to lay out an airport off the coast of Essex (Maplin), I believe subsequent analysis and events justified the commission's views, particularly on the fact that one could use existing capacity much more efficiently. This took the form of the first introduction of congestion pricing in the use of airport facilities. Heathrow started charging high prices for peak slots, and it worked.

In working on the congestion problem, I had discovered that I had a relative advantage in what appeared to be a new school of applied economics. My knowledge of statistics and econometrics gave me the formal tools for handling data, but it was evident to me that what was much more important was, first, to be able to distill all the empirical implications of a theoretical principle - in effect to show how the process

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produced observable data; and secondly, to seek data, of various kinds and with varying provenance, to bring to bear on the propositions at hand. (The model for this approach - Friedman's Theory of the Consumption Function - appeared in the mid 1950s and greatly boosted my confidence in what was possible.) Thus, as an example of this approach, I believe that I was the first to use the data collected by traffic engineers to measure the marginal social costs and estimate the best congestion tax.

It seemed also then quite natural to extend my interests to the econometric exploration of cost and production functions, not only in utilities but also in manufacturing industry. After a number of papers, I wrote a survey article for Econometrica 1963. Although such exercises were interesting and instructive in using various forms of data and in wringing seemingly surprising implications from theory, I found them fundamentally unsatisfying, largely because the policy implications were quite remote. I found that I did my best work when I had my teeth into a policy proposal that challenged conventional wisdom. From the free spirits at Birmingham in the 1950s, I had acquired a taste for being an enfant terrible.

Thus I was a natural candidate for the vanguard of the monetarist revolution in the United Kingdom. I had been fascinated by the institution of money even as a wet-behind-the-ears undergraduate, and I wrote what I thought at the time was a devastating critique of Hicks' Contribution to a Theory of the Trade Cycle (1950) for his cavalier-like treatment of such an



important aspect of business fluctuations. My interest however was rivetted by, first, the Conservative government experiments with monetary policy in the mid-1950s, and secondly, the Chicago essays, Studies in the Quantity Theory of Money (1956). By 1959, after a spell as visiting professor at Northwestern and some peripheral contact with Friedman, I was convinced that the view prevalent among British economists, and confirmed by the Radcliffe Report - that the quantity of money was of little consequence because of the (Radcliffe) infinite variability of the velocity of circulation - was dangerously wrong. And so from 1960, with a small group of young hopefuls at the University of Birmingham, we started research on money in the United Kingdom. But first we had the monumental job of preparing the historical series on money and credit supply, etc. I applied for a modest research grant to the Bank of England. The Bank refused to support such research since, it said, the quantity of money was of little consequence and there would be few people interested in such statistics! Such was the wisdom of the day.

Nevertheless, I can claim that the empirical and particularly the statistical analysis of money was substantially pioneered in the University of Birmingham in the first half of the 1960s. We challenged the conventional wisdom of the primacy of fiscal policy and the need for an accommodating monetary stance. Our analysis revealed substantial monetary multipliers and more dubious reactions to fiscal stimuli. Unfortunately, this monetary work at Birmingham lapsed as I left for a visiting

professorship at MIT en route to the Sir Ernest Cassel Chair of Economics at the London School of Economics in 1967. At that time, LSE seemed like a reincarnation of the 1950s Birmingham, with Terence Gorman and Frank Hahn, but with the added weight of Harry Johnson and his Chicago ideas. The unique contribution of my move to LSE, however, was my association with one of the most distinguished scholars, Peter (now Lord) Bauer. I learned to appreciate his skeptical and reflective attitude and his pure intellectual integrity. I believe that my work and friendship with Bauer gave a maturity and a greater integrity to my work, particularly on policy. Location in London was important for my work on monetary economics and policy. I was brought into much closer contact with the City, which was developing as one of the great international financial centers, and Westminster, where a factious House of Commons and socialist government were providing endless opportunities for illustrating the fallacies of ideas and the follies of policy.

The election of the Conservative government in 1970 was, I thought, a great opportunity to restructure economic policy. I had been involved with that most influential think tank, the Institute of Economic Affairs and IEA's ebullient director Ralph (now Lord) Harris, for many years in framing a new economic policy based on monetary stability, fiscal rectitude and free and unfettered markets. We imagined that this policy had been largely accepted by the Conservative leadership both in its election manifesto and in a famous meeting at Selsdon. With

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great hopes, I accepted a job in the cabinet office as part time advisor (that is, at one remove, to the Prime Minister, Mr Edward Heath) on macro-policies.

I think I can say that I was utterly ineffective. In the second half of 1971, in pursuing an elusive goal of "full employment", the Heath government began a massive fiscal stimulus and tripling of the monetary growth rate. Virtually all economic advisors and commentators thought that there would be such an expansion of employment and real output that there would be a reduction in the rate of inflation. My view was quite the opposite. I forwarded to Mr. Heath a memorandum entitled "Inflation, Devaluation and More Inflation", where I predicted that by 1974 the inflation rate would be at least 10 and possibly as high as 15 percent, that there would be a current deficit of as much as one billion sterling, and that he would be driven to reimpose prices and incomes controls. My advice was rejected and I was relieved of my part-time job. The Heath policy, pursued with increased vigor in 1972, came to grief in 1974 when the inflation rate reached 14.7 percent, the current account deficit was more than 3.3 billion sterling, and prices and incomes controls had been reimposed. I published my memorandum in July 1972, so my cassandra-like performance was in the public record. In retrospect, it seems no big deal to have made and persisted with such predictions, yet the pressures to conform were considerable; but all the arguments made me even more convinced that I was correct.

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In 1974 the electorate, in two elections, threw out Heath and elected Harold Wilson and his curious band of expropriating socialists. In the words of one of Wilson's ministers, Mr. Douglas Jay, "the man from Whitehall really does know best". Then I decided that Britain, facing alternatives of Wilson and Heath, had a choice between the devil and the shallow blue sea. Whatever the political outcome, Britain was in for a pronounced decline into the absurdities of controls, planning and dirigism. In 1974, I decided to leave Britain and, after a year at the World Bank, to join the department of political economy of Johns Hopkins in 1976. Meanwhile, what I thought was politically impossible had happened: Heath had lost the leadership and by a series of split votes and accidents, the party had elected a woman who was regarded as an upstart - a mere housewife and junior minister - Margaret Thatcher.

I knew Mrs Thatcher as an ardent student of economics on the various occasions I had talked to her over the past few years. I confess that I had not thought of her as a leader at all. But right from the beginning, she began to display those traits that have become so much her own: the strong belief in the morality of individual responsibility, the government's duty to restore and protect freedoms, the need to secure financial stability and a non-inflationary environment, the belief that, freed from government's constrictions, Britain could become an enterprising, prosperous nation - and a firm linchpin in the Alliance. Of course we had heard the same sort of thing from

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Edward Heath, so, even when the Thatcher government came to power in 1979, one reserved judgement. But right from the beginning it was clear that Mrs Thatcher was no Heath. In contrast to Heath, who disliked ideas and hated people who went on about them, Margaret Thatcher passionately, and with complete commitment, devoted her every hour to furthering the idea of a liberal society and to the permanent demise of socialism in our land.

By 1980 I had been at the Bank and Hopkins for four years, working in deregulation, financial reform, monetary policy, exchange rate policy, tax reform and housing finance, as well as in the familiar fields of transport. Although Bank employment brought with it many inhibitions, these were compensated by being able to observe the breadth of experience of many countries and the consequences of many policies. But in 1979-80 my attention was rivetted on Britain, and all the evidence suggested that Mrs Thatcher really did mean to reform the nation - and I surmised that there was a good chance (but I recall thinking that the odds were less than even) that she would pull it off.

In response to the invitations extended by Sir (now Lord) Keith Joseph and (now Sir) Alfred Sherman, I decided to return to London in 1980 as personal economic advisor to the Prime Minister for a period of two years. My appointment was greeted with protests, partly about the salary (50,000 sterling) and partly because I was thought to be the rigid monetarist whom Mrs Thatcher would use to clobber the more pragmatic officials

and ministers in the Treasury and the Bank of England. There was much pressure to put me in the cabinet office or in the Treasury, but the Prime Minister and I agreed that I would be most effective at her elbow in No. 10. The job was unique. My role was defined by the Prime Minister with the words: "you know what you can do best and you know what needs doing". Thus began what I believe was the apogee of my career. I had the best job anyone could devise. Since I soon earned Mrs. Thatcher's trust, I acquired a considerable influence on economic policy.

Yet the first months were most difficult as I worked to bring about immense changes in monetary and fiscal policy. First, in 1980, I had become convinced that monetary policy, as measured by the narrow aggregates, had drastically tightened from mid 1979. (The growth rates had fallen from some 15-17 percent to virtually zero by 1980). High real interest rates and a massive (circa 45 percent) real appreciation of sterling together with the rapidly escalating recession corroborated this diagnosis (later confirmed by my old colleague from Hopkins, Jurg Niehans). Secondly, as the fiscal situation unfolded in the first weeks of 1981, I believed that, contrary to all conventional wisdom both in and out of government, it was essential to cut in half the borrowing requirement of the public sector (PSBR). I proposed the biggest budgetary squeeze in peacetime history - a reduction of more than 2.5 percent of GDP - and that during a time when output was falling faster than in any year since World War II and when the monthly unemployment figures

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were soaring. After much fierce debate, Mrs Thatcher became convinced and, with characteristic courage, adopted this fiscal squeeze.

Professional judgement was swift and virtually unanimous. In a letter to the Times on March 31st 1981, signed by Frank Hahn and 364 economists including all living ex chief economic advisors to the government, the policies were said to "...deepen the depression, erode the industrial base of our economy and threaten its social and political stability". It was clear that they had been looking for an increase in the PSBR as a countercyclical measure against the recession. My argument, per contra, stressed the unsustainability of yet another large PSBR (estimated at about 6.5 to 7.5 percent of GDP) following a decade of such deficits, the soaring effect on real interest rates, and the need for a consistent and, above all, credible fiscal-monetary policy before there could be any hope of sustained recovery. So the deficit was cut and interest rates fell some 500 basis points below their peak.

The results appeared in the summer of 1981. Contrary to the dire predictions of the 365, the economy turned sharply upwards. Nor was it a flash in the pan, as it was so confidently asserted by many of the 365. From 1981 to this day (a still continuing boom in 1988), Britain has grown for the longest expansion on record. For the first time since World War II, Britain has been at the top of the OECD growth league instead of its usual place at the bottom. Furthermore, inflation was

reduced from an ambient 15 percent in the 1970s to less than 5 percent from 1983 on. It became the accepted view, except among academic economists, that the budget of 1981 together with the adjustment of monetary policy was the foundation of Britain's economic renaissance.

After this auspicious beginning, I acquired a considerable reputation at the Treasury and the Bank of England, and I received their full cooperation during the next three and a half years. We managed to produce a fairly stable monetary policy (the growth rate of M0 remained in the 3-6 percent range). And from 1981 onwards the British could look forward to tax reform and steady but sizeable yearly reductions in tax rates, at least as long as Mrs Thatcher remained in office. And such tax reductions combined with the transformation from an unmanageable deficit to a budgetary surplus in 1987-8.

In my role as advisor, there was one other major controversy where I found myself in a beleaguered but rather select minority. The issue was exchange rate intervention and in particular the advisability of Britain joining the exchange rate mechanism (ERM) of the European Monetary System. For more than 35 years I have been convinced that the various forms of pseudo-fixed exchange rates, dignified by various names such as crawling pegs, reference zones, etc, had only deleterious consequences - especially encouraging overvaluation and repression (on the part of dependent currencies such as sterling, the French franc, etc.) and massive capital flight or inflow when the 'realignment' was



imminent, which would in turn give rise to proposals for more exchange controls and trade barriers. The pressure from Europe and the British establishment to conform and join the ERM has been enormous. But the arguments have never attained even a minimum level of plausibility. My advice has been for Britain to retain its system of flexible exchange rates and to stay out of the present arrangements of the ERM. So far Mrs Thatcher has concurred. (Of course I would not be opposed, at least not on economic grounds, to the development of a proper European currency administered by a European Central Bank preceded by absolutely fixed exchange rates and appropriate monetary institutions to support that fixity. But that is another story.) It would not be in Britain's or, I believe, Europe's interest to join the present half-baked system.

#### Conclusion

So far, that is my life. My final reflection must be on my extraordinary luck. My life has been one lucky break after another - although I am reminded of Pascal's dictum that "luck visits the prepared mind". I am reminded that to many people, it seemed positively foolhardy for me to join Mrs. Thatcher at No.10 in 1980 when the chattering classes were confidently predicting that she and her policies were finished. Events did not turn out that way. It was my great privilege to serve as trusted advisor to one of the greatest political leaders who would thrust Britain into the renaissance of the 1980s. As so often the case in Britain, my working class origins were no handicap in attaining

one of the most influential jobs that any economist could wish. This surely is evidence that discredits the widespread notion that, in important respects, Britain is dominated by rigid class barriers. I suspect that Britain is one of the most mobile societies in the world today, and that mobility has been much enhanced by the reforms of Thatcherism.

I have learned one important lesson in the last nearly four decades. Virtually all economists too readily accept received opinion, especially if it is thought to be fashionable and being propogated by clever and influential minds. Yet most of the most serious errors perpetrated by the most eminent economists, particularly in the analysis of policy, have resulted from, on the one hand, the neglect of the simplest and most basic principles of economics, and, on the other hand, of the merely casual and partial examination of the evidence. It is often difficult and sometimes painful to face reality; frequently it reminds us how wrong we have been or how we must regard as redundant much of what we thought we knew. But it is also a great liberator.

Finally, one should never give in to pressure - to be popular or fashionable or in the main-stream. One should concede only if the argument and evidence win the point or the day. "To thyself be true".

# Lawson rejects Walters' criticism

NIGEL LAWSON, the Chancellor of the Exchequer, yesterday repudiated the view of Sir Alan Walters, the Prime Minister's personal economics adviser, that arguments for full British membership of the European Monetary System had "never attained even a minimum level of plausibility".

Sir Alan's views, in an article to be published in the United States, were "clearly not the views of the Government", Mr Lawson said at Question Time. The economics professor also described the EMS as "half-baked".

The Chancellor was supported by Sir Geoffrey Howe, the deputy prime minister, who said Sir Alan's advice was just one of the factors taken into account by the Prime Minister and the rest of the Government.

Both Sir Geoffrey and Mr Lawson are understood to have

## Treasury questions: Membership of the EMS

been at odds with Sir Alan over entry to the exchange rate mechanism of the EMS. Both ministers are said to favour early entry to stabilise the pound and reduce interest rates.

Challenging Mr Lawson on Sir Alan's views, to appear in the journal *The American Economist*, Gordon Brown, a Labour economics spokesman, said the professor claimed the Prime Minister concurred with them.

Who was in charge, Mr Brown asked the Chancellor. "Is it you or is it Professor Walters who should be giving the Mansion House speech this evening?"

Mr Lawson replied: "The views you quote on the EMS from Sir Alan Walters are not the views of the Government. The Govern-

ment has made its views clear, the Prime Minister has made them clear. We are fully committed to joining the EMS as part of stage one of economic and monetary union."

Neil Kinnock then raised the issue with Sir Geoffrey Howe, standing in at Question Time for the Prime Minister who is at the Commonwealth summit in Kuala Lumpur. "Now that the Chancellor has repudiated Sir Alan, who do you expect the Prime Minister to repudiate? Her personal advisor or her Chancellor?" asked the Labour leader.

Sir Geoffrey said that throughout the time he was Chancellor — 1979-83 — Sir Alan was advising the Prime Minister. "In those circumstances, as today, his advice is

# Biffen attacks 'tribal chanting'

CALLS FOR the Government to place sterling in the European exchange rate mechanism were dismissed as "tribal chanting" by John Biffen, former Leader of the Commons, yesterday.

He said on the BBC radio Today programme that he did not find it extraordinary that the pound was not a member of the ERM. "I find it for once a sign of healthy regard for our national interest.

"If we are going into this organisation, this European arrangement, we want to be in on equitable terms. If people think it is a sort of rescue line, I must say they have very convenient memories." Mr Biffen said the Government was certainly not right to spend billions of pounds trying to prop up the exchange rate, and he added: "It is very foolish to have a

fixed exchange rate system when what you do is use high interest rates to try to damp down demand at home.

"That is the core of the Chancellor's counter-inflation policy. But to hold up the exchange rate abroad? To what end? To make it more difficult for British exporters to sell into Germany where 40% of our deficit exists?"

"If you want to make a critique of the Government's policy and to challenge it, the point to challenge is on the exchange rate policy."

Mr Biffen was last night joined in his criticism by his long-time ally on such matters, Enoch Powell, who suggested in a speech at Milton Keynes that the Chancellor of the Exchequer's desertion of monetarist principle had created a wretched situation.

Mr Powell said: "It is a solemn reflection that an administration which 10 years ago was bent upon eliminating politician-made distortion from the functioning of the British economy, could have tumbled into repeating so ignominiously the errors of a past when fixed exchange rates, which of course means fudged exchange rates, were current wisdom."

He said: "They immolated their economic policy and the country's economic achievements upon the altar of European Monetary Union."

"It was in offering incense at that shrine that Nigel Lawson ran himself, and us, into the miseries of the last 18 months."

ANTHONY BEVINS  
Political Editor

STEPHEN GOODWIN  
Parliamentary Correspondent

# Senior adviser says Thatcher shares his v

THE CONTROVERSIAL claim that the Prime Minister shares the hostility of her economic adviser, Professor Sir Alan Walters, to participation in the European exchange rate mechanism, is made in an article published in *The American Economist* today.

In an autobiographical essay, Sir Alan writes of his battles with the economic establishment of London.

He then says: "In my role as adviser, there was one other major controversy where I found myself in a beleaguered but rather select minority.

"The issue was exchange rate intervention and in particular the advisability of Britain joining the exchange rate mechanism (ERM)

## Exchange rate mechanism: Walters' position

of the European Monetary System.

"For more than 35 years I have been convinced that the various forms of pseudo-fixed exchange rates, dignified by various names such as crawling pegs, reference zones, etc, had only deleterious consequences — especially encouraging overvaluation and depression (on the part of dependent currencies such as sterling, the French franc, etc) and massive capital flight or inflow when the 'realignment' was imminent, which would in turn give rise to proposals for more exchange con-

trols and trade barriers. The pressure from Europe and the British establishment to conform and join the ERM has been enormous. But the arguments have never attained even a minimum level of plausibility.

"My advice has been for Britain to retain its system of flexible exchange rates and to stay out of the present arrangements of the ERM. So far, Mrs Thatcher has concurred."

The Prime Minister's outspoken adviser is no stranger to controversy. Just before his renewed appointment to a part-time role

one of the factors taken into account by the Prime Minister and the rest of the Government. The policy of the Government is as stated by people speaking on behalf of the Government."

The Prime Minister, Mr Lawson and himself had all articulated the policy on joining the ERM in precisely the same terms and would continue to do so, Sir Geoffrey said.

Mr Kinnock pressed the point again: "Sir Alan says that the Prime Minister concurs with his view on British participation in the ERM. Are you saying that Sir Alan is not telling the truth about the Prime Minister's view?"

Sir Geoffrey retorted: "I am not required to answer for every nuance. I think it would be astonishing if I was."

The Prime Minister's view was the one he had reiterated to the House on Tuesday and which Mr Lawson had reiterated.

Mrs Thatcher's principal conditions for entry to the ERM were that Britain's inflation should be down to the European Community average and that exchange controls should be abolished by France and Italy.

Tory unease at high interest rates was voiced by Sir Anthony Grant (Cambridgeshire SW) who told the Chancellor he should not give up the quest for inflation control by methods other than "the crude one of interest rates".

"Interest rates are all very well for the 'haves', but they bear very cruelly on the 'have nots', in particular small businesses and home owners," Sir Anthony said.

Mr Lawson, however, said it would delude the House to suggest there was an alternative to high interest if they were serious about getting inflation down.

ANTHONY BEVINS  
Political Editor

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