SATURDAY 21st October 1989

The Guardian

# 'Simple truths' that won PM's heart

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Christopher Huhne
Economics Editor

SIR Alan Walters' appeal to the Prime Minister lies in the fact that he deals in simple truths.

For him, economics boils down to the verities of the market place. The way to control inflation is to stop printing money. The way to run a successful economy is to free the market. Everything else is just gloss.

Sir Alan, a remarkably fit 63-year-old, is a charming and considerate man. He commutes between his Virginia home and a flat in north London, because it would not be fair to uproot his young wife Paddie from her career in the United States.

A Leicestershire working-class boy who left school to join the army before going into higher education, he has an east Midlands bluntness which woos Mrs Thatcher but which can also land him in hot water. He is a political innocent who will tell anyone who asks exactly what his views are. He is also an outsider with as much distrust of the British establishment as his leader.

Sir Alan is not so much a Tory as an old-fashioned Manchester Liberal. He believes, for example, that we should have free imports of goods even if others impose tariffs on our exports.

Mr Lawson, the Chancellor, used to have a similar faith in the free market, but he is now a convert to fixed exchange rates, ideally in the framework of the European Monetary System, because he believes foreign exchange markets can push currencies outside sensible ranges.

Sir Alan says that there are two types of people: those (like Mr Lawson) who do not know where an exchange rate should be and want to fix it; and those (like him) who do not know where an exchange rate ought to be and want the market to make the decision.

They both agreed on the need to put up interest rates to 15 per cent — but for different reasons. Mr Lawson wanted to stop the pound slipping, which would raise import prices and boost domestic inflation. Sir Alan felt the growth of the money supply is still too high.

Sir Alan is thus a straightforward monetarist who believes that if you set sensible targets for the growth of the money supply, inflation will be held in check and the economy will be able to perform well.

While he has the ear of the Prime Minister, and there is little sign that she will abandon him despite his indiscretions, there is going to be a nagging uncertainty at the heart of British monetary policy.

At some point, perhaps quite soon, there is going to be an almighty row because narrow money is under control and Sir Alan wants to cut interest rates, but the pound is still weak and the Chancellor wants rates to stay high.

The Guardian

# Sir Alan explains his EMS position

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THE following is an extract from A Life Philosophy, by Sir Alan Walters, which will appear in the autumn edition of The American Economist.

'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) 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 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. 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.) It would not be in Britain's or, I believe, Europe's interest to join the present half-baked system.'

Daily Mail

# Tory Euro MPs set for new cash clash with Maggie

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By JOHN FISHER, Political Reporter

A NEW clash looms between Mrs Thatcher and Tory Euro-MPs over European monetary union.

The 32 MEPs, already at odds with her over her opposition to the Social Charter, are set to back a plan for an independent central European Bank and a compromise over a common currency.

Mrs Thatcher and the Chancellor are bitterly resisting both proposals being pushed by Commission chief Jacques Delors, and to be debated in Strasbourg next week.

The MEPs support amendments which avoid outright endorsement of the Delors plan, but go further than she has accepted. They feel the City will suffer unless Britain backs the bank but they want it to be independent of national governments.

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FINANCIAL TIMES
NUMBER ONE SOUTHWARK BRIDGE, LONDON SE1 9HL
Telephone: 01-873 3000 Telex: 922186 Fax: 01-407 5700
Saturday October 21 1989

# The limits of co-operation 6

WHAT IS THE connection between Sir Alan Walters' view of the European Monetary System, Mr Alan Greenspan's now notorious speech in Moscow and the stock market crash? Surprisingly perhaps, there is a clear answer to what looks like a trick question. What they share are the problems of international economic cooperation.

Sir Alan Walters believes the EMS is "half-baked." The public comment was unwise, but he is not unique in holding this view, as can be seen from a reading of this year's Wincott Lecture by Professor Deepak Lal. For the liberal economist there are only two fully-baked systems: floating rates, on the one hand and irrevocably fixed rates, on the other. Sir Alan's view that a fully fledged economic and monetary union is far more defensible and, in the right circumstances, workable than the current EMS is not surprising.

No more surprising is the reaction of ministers like Mr Nigel Lawson. They are, quite understandably, piqued by Sir Alan's remarks because they believe he is the court jester, licensed to utter what his mistress thinks, but does not wish to say. But there is substance to their objections as well. At the Mansion House Mr Lawson reiterated his liking for the EMS and his deep suspicion of EMU. As a politician, what he likes about the EMS is precisely that it is half-baked. The EMS provides an opportunity for cooperation, which is good, but it provides an escape as well, which is better.

## Back-biting

If the EMS is half-baked then cooperation among the group of seven industrial countries is quarter baked at best. It is built around a limited number of loose commitments, the most important being to exchange rate management. These commitments are made by policy-makers who have conflicting values, objectives, powers and opportunities. It is a process with limitless potential for back-biting among participants and confusion among onlookers.

This provides the best rational explanation – or at least excuse – for the crash on the world's stock markets in October 1987 and the mini-crash of 1989. Interpreting the G-7's objectives requires Kremlinological arts. It is entirely appropriate, therefore, that a comprehensively misinterpreted speech by Mr Greenspan in Moscow should have been a part of the background to Wall Street's collapse.

Mr Greenspan suggested that it was a mistake to uphold inappropriate currency values. *Ergo* he was offering a coded complaint about the finance ministers' agreement to drive down the dollar. The Japanese banks refuse to participate in the buy-out of United Air Lines. *Ergo* Tokyo was complaining about the failure of the US to play its part in exchange rate management.

It can be no accident that the proximate cause of the two crashes was the appearance of such conflicts within the G-7. The considerable confusion about what policy makers are up to adds an important additional element to the uncertainty already inherent in the ebb and flow of economic life.

The answer, it would appear, is to eliminate conflicts among policy-makers. Unfortunately, they are inescapable. Sometimes the differing interests and objectives of the G-7 countries coincide both with one another and with the underlying economic pressures. At other times, they do not. This is not surprising when one remembers, for example, that what is regarded as reasonable price stability in the US is viewed as the first step to hyperinflation in West Germany.

## Predictable structure

Partisans of the EMS would argue that it provides just the sort of articulated, and so more predictable, structure that the looser G-7 process lacks. This is correct as far as it goes, but it does not go all that far. Serious problems remain, problems that the move to Emu is intended to solve. To take the main current example: there is a growing conflict between the Bundesbank's desire for an appreciation of the D-mark and the desire of almost everyone else to avoid one.

The radical critique of current forms of international economic cooperation carries with it a few central lessons: first, the process of cooperation can have long term effects only to the extent that it changes domestic policies. Secondly, one cannot achieve through international sleight of hand what one will not contemplate at home. No magic wand will eliminate the US current account deficit. It will almost certainly require a change in fiscal policy, instead.

Finally, a short term tactical agreement will not allow an escape from strategic conflicts. France may now be able to maintain the value of the franc against the D-mark, but not because of a desire for exchange rate stability alone but because she seeks German levels of inflation. In short, cooperation is not the sort of magic pill that will allow policy-makers suffering from domestic headaches to wake up feeling better in the morning.

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FINANCIAL TIMES

# Lawson looks to 158-year-old guru for economic initiative

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By Simon Holberton, Economics Staff

IT SEEMS that every one needs a guru. The Prime Minister has Sir Alan Walters, but what of Mr Nigel Lawson, the Chancellor?

Surrounded by the Treasury mandarins, the stormtroopers of Whitehall, Mr Lawson may not feel he needs one. But in his speeches, the name of Goschen has begun to appear.

The most recent citation was on Thursday night at the Mansion House when the Chancellor announced what might be the beginning of the Government's attempt to restructure the national debt.

Viscount George Goschen (1831-1907) was a distinguished Chancellor of the Exchequer in Lord Salisbury's Government.

His political career is remembered chiefly for his conversion and consolidation of the greater part of the national debt in 1888.

He converted £591m of debt, then yielding 3 per cent. He offered 2.75 per cent for the first 14 years and 2.5 per cent thereafter.

Mr Lawson's initiative is more tentative. Couched in terms which appear to provide a ready-made escape if it fails – it is a "modest" and "experimental" venture, the Chancellor said – the Bank of England is offering to convert one UK Government bond, of which there is only £399m in market hands, into another much larger issue, of which there is £1.6bn in market hands. If it works the market can expect more such experiments, the cumulative effect of which might be to reorganise the gilt-edged securities market into one of fewer but larger issues.

Goschen: as portrayed in Vanity Fair, 1869

Mr Lawson also shares another interest with Goschen – exchange rates. Goschen's The Theory of Foreign Exchanges (1861) was a standard text on the subject in the latter half of the 19th century.

Goschen had a strong desire to avoid interference in what he called the "natural" workings of the price system. For him the exchange rate was self-adjusting and he believed that in altering its interest rates the Bank should follow the market.

Mr Lawson's attitude to the exchange rate is, however, a little less permissive. He is a believer in exchange rate stability and, on Thursday, reminded the City that the exchange rate is one of the two most important monetary indicators. Goschen's views on the exchange rate were controversial when he made them – the Bank was then, as now, an enthusiastic manipulator of interest rates – and it is unlikely that Mr Lawson would derive much succour from them now.

In a barely guarded refutation of Sir Alan Walters' known views on the exchange rate, the Chancellor said it was a most important part of the transmission mechanism through which monetary policy affects inflation.

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Evening Standard



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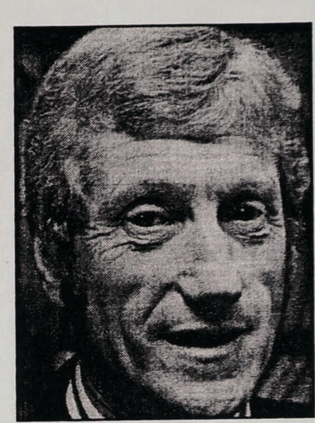
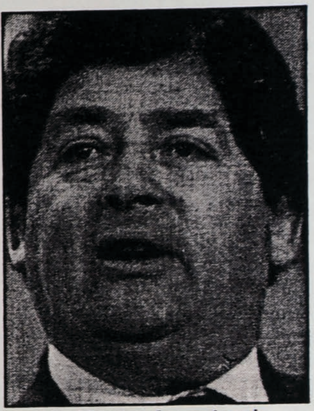
# Keeping out of ERM's way



Alan Walters: the EMS is "half-baked"



Nigel Lawson: he wants us in

To join or not to join? With opinions divided at the top, CHRISTOPHER MONCKTON investigates the Exchange Rate Mechanism

THE POUND is falling against other European currencies, while they remain stable in relation to each other. British inflation and interest rates are around twice the European average. Mortgage costs, as a proportion of your income and mine, are the highest in Europe.

So should the Government allow sterling to join the Exchange Rate Mechanism by which the currencies of almost all the other member-states of the EC are linked together in the European Monetary System?

Both Nigel Lawson and Margaret Thatcher were silent on the point during their Party Conference speeches. Their silence was coded. Nigel Lawson wants us in, though he is delicately not saying so at present. The Prime Minister doesn't, though her plain-speaking, shoot-from-the-hip economic adviser, Sir Alan Walters, continues to make public his view that the EMS is "half-baked".

Those in favour of joining the ERM include the Treasury, the Bank of England, Sir Geoffrey Howe, Lord Plumb, Leon Brittan, David Howell, Edward Heath, Michael Heseltine, the Tory Wets, Labour (this year), the Democrats, the Social Democrats, the CBI and the NIESR.

Those against include Downing Street, Nicholas Ridley, John Biffen, David Young, Teddy Taylor, the No Turning Back Group, the Tory Dries, Labour (last year), the IoD and the Institute of Economic Affairs.

Here are 10 questions on British membership of ERM, with answers from both the pros and the antis:

**1. Is British membership of the Exchange Rate Mechanism one of the most important economic decisions which the Government must take?**

PRO-ERM: Yes. Tying the value of the pound to that of the other major European currencies, especially the German Mark, would bring badly-needed stability to the volatile £.

*ANTI-ERM: No. The pound is an internationally-traded petro-currency subject to pressures unconnected with Europe: so it is too big and too volatile to be confined within the ERM.*

**2. Would Britain's willingness to join the ERM be a vital sign of our commitment to the European ideal?**

PRO-ERM: Yes. All the other European countries have declared their support for ERM, and all our major competitors in Europe have joined it. At the Madrid Summit Britain was isolated because Mrs Thatcher remained adamant in her refusal to bring Britain into the ERM, and the £ fell as a direct result.

*ANTI-ERM: No. Our commitment to Europe is better expressed in our abolition of exchange controls and in our liberalisation of the financial markets. In this area, we are ahead of Europe and our partners have a lot of catching-up to do. ERM is unnecessary to greater economic integration in Europe.*

**3. Would British membership of the ERM represent a loss of British sovereignty?**

PRO-ERM: No. It would be a pooling of sovereignty, under which the member-States clubbed together to run a stable and powerful super-economy big enough to take on the US and Japan in world markets. What we lose in individual sovereignty would be matched by gains in collective sovereignty.

*ANTI-ERM: Yes. It would take away our freedom to decide our own monetary policy. Look at Spain. It recently joined ERM. Foreigners piled into the peseta to take advantage of high interest rates backed by a fixed exchange rate and Spanish monetary policy was screwed up.*

**4. Would British ERM membership tend to stop the slide of sterling and stabilise its international value?**

PRO-ERM: Yes. Inside the ERM, sterling would not be permitted to move by more than a very small amount against other European currencies, so its international value would remain stable. What has worked for other European currencies would also work for the British currency.

*ANTI-ERM: No. The £ would have pulled the ERM apart if it had been in the system recently. After all, last year Nigel Lawson was desperately trying to keep the £'s value down to three marks: this year he is just as desperate to keep it up to three marks. The ERM would work no better than the Chancellor.*

**5. Would British ERM membership help to bring Britain's inflation and interest rates down to European levels, making mortgages and other personal borrowing cheaper?**

PRO-ERM: Yes. The average inflation rate in Europe is half that of Britain. Interest rates, too, are generally lower. By staying out of line we are putting our economic recovery gravely at risk and forcing up the cost of home ownership through high interest rates.

*ANTI-ERM: No. The average inflation rate of countries inside the ERM is noticeably higher than the average rate for major industrial countries outside the ERM, Britain being the exception. Non-ERM interest rates, too, tend to be lower than those inside the ERM.*

**6. Would British ERM membership help our firms to do business in Europe?**

PRO-ERM: Yes. The CBI has long argued for stable exchange rates and low interest rates. Inside the ERM exchange rates are stabler than ours and interest rates are lower than ours, so that European firms can make long-term investment plans with confidence. In Britain, firms are scrapping their long-term plans, suggesting that a long and deep recession is on the way.

*ANTI-ERM: No. The chief reason for high interest rates in Britain is high taxation, which makes British firms uncompetitive. High taxes are caused by high public spending, which also causes most of Britain's inflation. Cutting public spending, not joining ERM, would be the best way to help businesses.*

**7. Would British ERM membership improve our balance of payments?** PRO-ERM: Yes. Gradually the idea of a British trade deficit would disappear as Europe came to be regarded as a single trading entity. That is one of the consequences of having a single European market.

*ANTI-ERM: No. Britain will still keep national accounts and, unless public spending is cut, our balance of payments will remain poor as Government spending sucks in imports and over-taxes British firms.*

**8. When should Britain join the ERM?**

PRO-ERM: Now. The sooner we join, the sooner we get the benefits of membership. We cannot afford to wait any longer. The best way to avoid a recession is to join the ERM before the European summit later this year.

*ANTI-ERM: Not now. We cannot belong to ERM until our inflation rate is as low as Europe's and Europe has followed us in scrapping exchange controls. If those two conditions are satisfied, there will be no need for an ERM anyway.*

‘Those in favour of ERM include the Treasury and the Tory Wets—those against include Downing Street and the Tory Dries’

SATURDAY 21st October 1989

THE INDEPENDENT

# Differences on ERM exploited by Labour

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LABOUR continued to make capital yesterday out of the internal Whitehall split disclosed by Sir Alan Walters this week; that the Prime Minister shared his scornful attitude towards the European exchange rate mechanism.

The Prime Minister's personal adviser said in an autobiographical essay for *The American Economist* yesterday that the mechanism was "half-baked", and that Mrs Thatcher "concurred" with his view.

That is not the line taken this week by Nigel Lawson, the Chancellor of the Exchequer — or Mrs Thatcher at the EC summit at Madrid in June, when she reaffirmed eventual British intentions to become a full member of the European Monetary System.

John Smith, Labour's shadow chancellor, said in Bonn yesterday: "What we've got once again, right at the heart of economic policy, are two voices of government; one, the official Chancellor of the Exchequer and his position, and also the Prime Minister's personal economic adviser, giving a quite different view."

He said in a BBC *World at One* radio interview: "It's a recipe for confusion and muddle. No wonder the markets can't understand what the Government's economic policy is; no wonder the political community is confused. I find in western Europe some puzzlement that a government should be conducted in this way. I think it is surprising in domestic terms. It is even more surprising in international terms."

The matter is bound to be raised again in next Tuesday's Commons debate on the economy and, again, when Mrs Thatcher returns from the Commonwealth heads of government meeting in Kuala Lumpur for Prime Minister's question time on Thursday.

Alan Beith, the Liberal Democrat spokesman, said that the Chancellor's Mansion House speech on Thursday, suggesting indefinitely high interest rates, had been "devastating news" for home-buyers and small business.

"How much higher will they have to go next time sterling slides?" he asked. "And he was obviously under strict instructions from Mrs Thatcher to repeat her conditions for EMS membership — instead of going in now when it would help the pound, we will be waiting for at least a year and probably longer if Sir Alan Walters is to be believed."

ANTHONY BEVINS
*Political Editor*

THE GUARDIAN
Saturday October 21 1989

**Lawson allies chide adviser's 'American habits**

# Thatcher expected to back guru Walters

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**Michael White**

MRS Thatcher is expected to express full confidence in Sir Alan Walters when she returns from the Commonwealth conference, despite growing concern among Conservative MPs that her personal economic guru's weakness for public candour is enabling a revitalised Opposition to present the Government as irresponsibly divided on fundamental policy questions.

"It really is a problem for the Prime Minister, not a problem for other members of the Government," a well-placed Whitehall source said last night, but the assumption remains that Mrs Thatcher's instinct will be against dispensing with a respected adviser whom she regards as having been right in the testing years of the 1980-81 recession, and since.

She will not return from Kuala Lumpur in time for Tuesday's Labour-initiated debate on "the failure of the Government's economic strategy", but ministers got a taste yesterday of what they can expect as the shadow Chancellor, Mr John Smith, and his team, denounced the "confusion and muddle" at the heart of economic policy.

"No wonder the markets cannot understand what the Chancellor's economic policy is. No wonder the political community is confused," Mr Smith said on BBC radio.

Weekend ministerial speeches offered no defence of Sir Alan, though Mr John Biffen, the dismissed monetarist, told the Guardian he was "one of the best things floating around Whitehall. I would not like to see him hounded out by ersatz socialists who would pick up any revisionism which suits their book."

The tension between No 10 and No 11 Downing Street, of which the shadow chief secretary to the Treasury, Mr Gordon Brown, also spoke, has arisen again because of the widely-reported essay Sir Alan has written for the American Economist magazine. In it he claims that "so far Mrs Thatcher concurs" with his distaste for a "half-baked" European Monetary System (EMS)in which the existing exchange rate mechanism (ERM) is a cover for "pseudo-fixed exchange rates" which would be damaging for Britain.

Though the essay was written almost a year ago — before Mr Nigel Lawson and Sir Geoffrey Howe persuaded Mrs Thatcher to commit herself to eventual stage one membership of EMS — and has yet to appear, irate Treasury colleagues have been knocked off balance by the renewed clamour as the City, Opposition, and industry have made ERM the consensus answer to inflation and devaluation.

The Chancellor's allies have accused Sir Alan of picking up American habits of open policy debate and of being vain about his achievements in what he calls "one of the most influential jobs any economist could wish". Both Mr Lawson and Sir Geoffrey this week distanced themselves from Sir Alan as a mere adviser, whose words were not policy.

With some Tories regarding the Lawson-Walters relationship as the political equivalent of tectonic plates "rubbing together along the San Andreas fault", the Liberal Democrats' economic spokesman, Mr Alan Beith, joined complaints that the Chancellor's Mansion House speech on Thursday night "failed to provide any framework or discipline under which inflation can be tackled without penalising the weak."

Labour's trade and industry spokesman, Mr Bryan Gould, will today warn party activists that Mrs Thatcher may resign as defeat looms. Mr Paddy Ashdown, the Democrat leader, asked party activists in Hampshire last night: "Are we witnessing the last throes of Thatcherism ?"

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