

SHOULD STERLING REJOIN AND IF SO WHEN?

18 September 1992

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The stated position of the Government is that sterling will resume its membership of the ERM "as soon as conditions permit". The timing is subject to varying interpretation e.g.

- as soon as the dust settles after the French referendum if there is a Yes i.e. within a week or two.
- as soon as the fundamental conditions which caused the system to break down are corrected i.e. a number of months.

To answer the question we need to consider why we failed to sustain our membership and thus identify what needs to change before we return. The main factors were:

- (i) German policy encountered an external shock which took both its economic cycle, its desired monetary policy and an equilibrium exchange rate out of line with the requirements of its EMS partners. It can be argued that at the time of reunification there should have been a DM revaluation to help provide the extra anti-inflationary pressure and to reflect the fact that its external surplus would be substantially reduced.

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- (ii) The US suffered a serious recession in which high personal and corporate debt was a major factor. They therefore sought interest rates which were exceptionally low.
- (iii) The UK cycle was different from that of the rest of the EMS. It started earlier and we had much more of a debt problem than the rest of Europe. Although we shared the debt problem with US, Japan and Australia we were precluded from adopting their monetary response.
- (iv) ERM changed its character from a fiscal but adjustable system to the transition to EMU. The (forlorn) hope was that we had seen the last devaluation.
- (v) Our entry rate into the ERM reflected the position in 1990 and the priorities of the time i.e. to get inflation down. In retrospect that rate may have been too high to be sustainable and too high once the depth and length of the recession emerged.
- (vi) Policy co-operation failed. It was one thing for the German authorities to cling to the monetary policy they thought was necessary, with minimal concessions to others, but quite another publicly to oppose the stated policy objectives of their partners.

This analysis suggests that while the uncertainties of the French referendum which gave speculative forces a uniquely favourable situation in which to operate, were the trigger for the collapse, they were not its fundamental cause. Before returning to the ERM we need to see changes to the fundamental factors listed above. The following conditions would need to be satisfied:

- (i) The German economy needs to develop in a way so that the requirements of its monetary policy are more compatible with those of EMS partners. Inflation needs to fall to

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levels the Germans find acceptable; and real interest rates ~~return to more normal levels~~. This will require action by the Germans to reduce their fiscal deficit. All this is likely to take several months.

- (ii) The US recovery needs to establish itself so that there is no fear of reductions. This condition is unlikely to be satisfied before the Presidential election.
- (iii) The combination of (i) and (ii) indicate that the German/US internal rate differential, currently 6½ per cent, needs to narrow substantially.
- (iv) The UK recovery needs to be seen to be underway. While we are bumping along the bottom or are in fear of worse, it will not be plausible to expect Ministers to raise interest rates. We cannot enter ERM without the scope on interest rates to make it work.
- (v) Our net reserves are negative. At present we can only intervene by undertaking more borrowing much of which may have to be repaid in a few months. We need to replenish our usable reserves either by creaming off or a programme of longer-term borrowing.
- (vi) The nature of the ERM needs to be clarified. Is it a 'hard' system acting as a precursor to EMU, or the fixed but adjustable system of the 1980s? Is the former plausible? If the latter how does it cope with periodic realignments involving major currencies?
- (vii) The nature of policy co-operation needs to be re-examined. Is there some way that the burden of adjustment can be shared between weaker and stronger currencies?

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(viii) This was the first post exchange control crisis. We need to examine the implications of this for the size of reserves required and the arrangements for mutual support. Do we need something like the "limit down" arrangements of commodity markets which allow suspension to take place once movement of a certain size has taken place. Should we have been entitled to call a halt at 2.15 pm as soon as the second interest rate rise failed to work.

2. It is clear that it will take several months at least before these conditions are satisfied. If such a combination of favourable circumstances arose we would need to consider the right rate at which to re-enter. Among the criteria we should examine are:

- (a) Is our inflation still reasonably close to the ERM average? If it is not it indicates that we will need to hold interest rates relatively high which in turn means we are likely to have an exchange rate which is high relative to long run trends.
- (b) Is output close to trend? If it is above we have the problem above. If below, we could find ourselves in the same position as recent months with a serious conflict between the interest rates justified on domestic grounds and those required to maintain the exchange rate.
- (c) We need to look carefully at the level of competitiveness. DM2.95 was not outside the range of past trends for the various indicators of competitiveness but it was recognised to be at the top end. This was justified when the priority was to bring inflation down from 11 per cent.

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- (d) We should be less concerned about choosing a rate which is too low for fear that we would hit the top of the band. In present circumstances acquiring more reserves is desirable.

3. The conclusions to emerge are:

- (i) there can be no question of re-entering in a matter of weeks
- (ii) there needs to be more convergence between the interest rates required to meet UK objectives and those Germany requires
- (iii) there needs to be a re-examination of the purpose of the ERM and its modus operandi
- (iv) when we join we need to be closer to an equilibrium position and put less reliance on the ERM to bring us into line as opposed to keeping us in line with the rest of the system.

All the above accepts the premise that we will rejoin eventually. In the meantime, however, we will need to consider how we do conduct policy e.g. the objectives, the role of monetary aggregates, the weight given to various indicators. We know from experience that it is not easy to read the signals, but still less so to explain to the outside world that there is a coherent set of objectives and a set of policy instruments to deliver them. We should not, however, exclude the possibility that we conclude that floating has a better chance of success than a return to fixed rates.

4. I would welcome the chance to discuss this before a note is put to the Chancellor this evening.



