

BRITAIN AND THE EXCHANGE RATE MECHANISM – CHANCELLOR'S SPEECH TO THE EUROPEAN POLICY FORUM

29 July 1993

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Issue

It is widely asserted that Mr Lamont's speech to the European Policy Forum on 10 July 1992 was wrong in its warnings about the consequences of leaving the ERM. In fact (it is said) we have left the ERM and are now enjoying low interest rates, improved competitiveness, low inflation and an economic recovery. Therefore his analysis was incorrect. This note examines the arguments and the evidence.

Timing

Routine, for holiday (or post-holiday) reading. However you have already been asked about these matters and may be asked more about them in future. This note may provide relevant background briefing.

Summary

Mr Lamont considered five alternatives to continued ERM membership at the original parities. His arguments for rejecting the first four remain sound. We have adopted a version of the fifth alternative, namely leaving the ERM and setting interest rates according to domestic monetary targets. The results (so far) seem

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quite favourable. We can probably admit that they have turned out slightly better than we expected. In particular, contrary to what was asserted in the speech, we have been able to combine a lower exchange rate with lower interest rates. However that does not imply that the analysis was wrong or that, in the circumstances, the warnings in the speech were mistaken. Mr Lamont's main conclusion was that the ERM was most likely to deliver price stability in Britain. It is too early to say how successful we shall be outside it.

THE SPEECH

The core of the speech can be summarised as follows:

- (i) low inflation is essential for sustained economic success;
- (ii) membership of the ERM is the best way for the UK to achieve low inflation;
- (iii) it has already brought benefits that would not have been achieved outside the ERM;
- (iv) alternative policies are either illusory or will fail;
- ∴ (v) we must maintain our current policies and stay in the ERM.

The effects of ERM membership

2. The parts of the speech that can be reconsidered are contained in items (iii) and (iv) of the Summary. I start by considering the benefits of membership. The claimed benefits were as follows:

- retail price inflation had fallen from nearly 11 per cent to less than 4 per cent;

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- interest rates had been cut from 15 per cent to 10 per cent;
- the interest rate differential with Germany had been reduced from 6.5 per cent in 1990 to about $\frac{1}{4}$ per cent;
- the differential between UK and German bond rates had fallen from 4 per cent in April 1990 to little more than 1 per cent;
- average earnings were at their lowest level since 1967. Pay settlements were around 4 per cent;
- unit wage costs in manufacturing were falling and productivity was rising;
- exports were at a record level and the trade deficit with the EC had fallen from £11 billion in 1990 to £2 billion in 1991.

3. Mr Lamont said "I cannot believe we could have achieved all this outside the ERM". The achievements are not in dispute. The difficult question is what part was played by ERM membership. The problem is to find the counter-factual (ie what would have happened outside the ERM). There are two slightly different versions of the ERM case. The first is that ERM membership forced us to maintain counter-inflationary measures that we would otherwise have abandoned. (The Ulysses-tied-to-the-mast argument.) The second is that ERM membership reduced the cost of bringing down inflation because it increased the credibility of the Government's actions.

4. The mast argument must be partly true since we eventually cut the bindings and have subsequently argued that policy was unnecessarily tight. But that was fairly late in the day.

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5. From about April or May of 1992 our policy was constrained by German interest rates. Domestic conditions (including prospects for inflation) would probably have justified further interest rates cuts but UK rates had hit a floor set by German rates. Thus there was a period of about five months when ERM membership probably imposed tighter policies than we might have chosen for ourselves. It is extremely difficult to know whether before that period ERM membership caused us to have tighter policies than we would have chosen otherwise.

6. It is even more difficult to decide whether ERM membership increased the credibility of Government policy. The behaviour of short-term and long-term interest rates suggests that it did so, at least for financial markets. Ideally it would also have done so for labour markets, thereby reducing the level of unemployment required to bring down wage increases. We have been fairly cautious about claiming such an effect. However even those who are hostile to the ERM do accept that, by one route or another, our period of membership, and the policies that accompanied it, were powerful forces in bringing inflation down.

The alternatives

7. The first alternative was to cut interest rates by 2 or 3 per cent while maintaining our parity. The argument against such a move was fairly straightforward. One currency can only have lower interest rates than others if it is expected to appreciate within the relevant period. Currencies can move - within limits - inside the ERM and can leave it completely. After years of policy and inflation convergence the Benelux countries can sometimes have slightly lower interest rates than Germany. France has tried to do so twice and failed to maintain the differential. (Chart 1) (No more singing of the Marseillaise.)

8. That alternative was not feasible. We could not possibly have cut interest rates by 2 or 3 per cent relative to other ERM rates and maintained our parity, even though our wide band gave us slightly more scope to do so than the narrow band members.

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9. The second alternative was a general German realignment. In this context it had to include an effective devaluation of the French franc. The French have still not (28 July) accepted a German revaluation as a policy option. Alternative (ii) was not feasible.

10. The third alternative was a devaluation within the ERM. Mr Lamont said "A realignment could only put interest rates up, not down". The argument was that a devaluation would increase the market's fear of a further devaluation. Thus a higher risk premium would be needed against the DM.

11. It was always recognised that there might be special conditions in which this proposition would be wrong. For example a currency that was expected to devalue might face high interest rates until it actually did devalue, whereupon interest rates would fall. (This is explained in ~~the~~ article on UK interest rates and the level of sterling in the Treasury Bulletin of Winter 1991-92.) In fact the experience of those that have devalued within the ERM shows that Mr Lamont's analysis was correct. Chart 2 shows how the experience of the escudo, peseta and punt. If we start the story from August 1992 and leave out the exceptional periods in which interest rates were raised (eg by the Irish) in an attempt to prevent a devaluation, countries have not been able to combine a devaluation with a cut in interest rates. After 10 months, differentials are back to where they started (the Irish differential has fallen slightly). But these recent developments can partly be explained by the difficulties of the DM (Soros etc). In the case of sterling, where the sterling/DM interest rate differential had fallen to exceptionally low levels, it seems certain that a devaluation within the ERM would have meant higher interest rates in the short term.

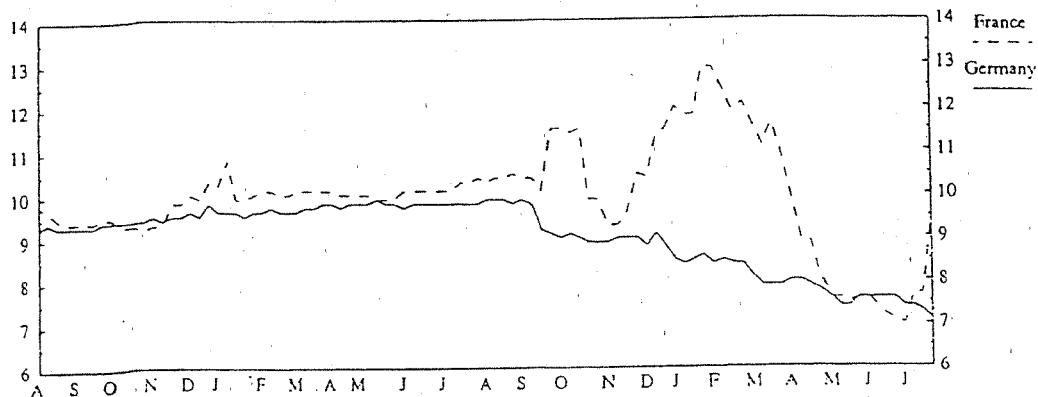
12. The fourth alternative was to leave the ERM and "slash" interest rates. This was defined as involving "large" cuts in interest rates. We did not adopt that alternative and nor did anyone else who has either left the ERM or severed its links with it. Chart 3 shows what happened to Italy. Chart 4 shows the Scandinavian experience. In each case there was a clear

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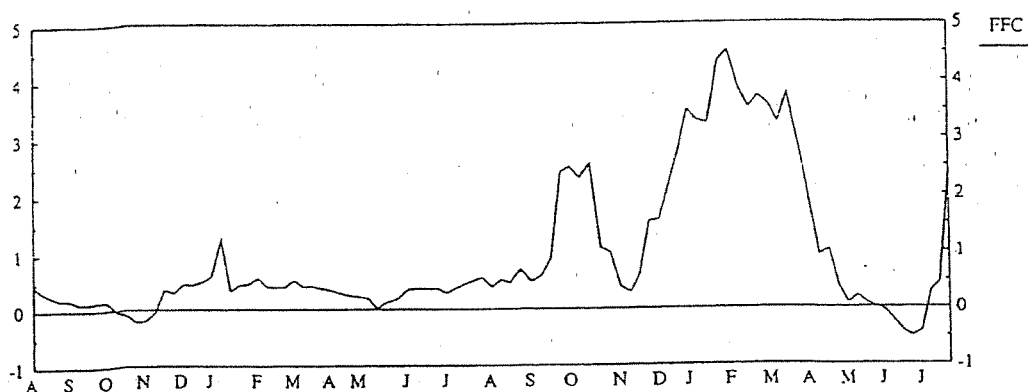
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Chart 1

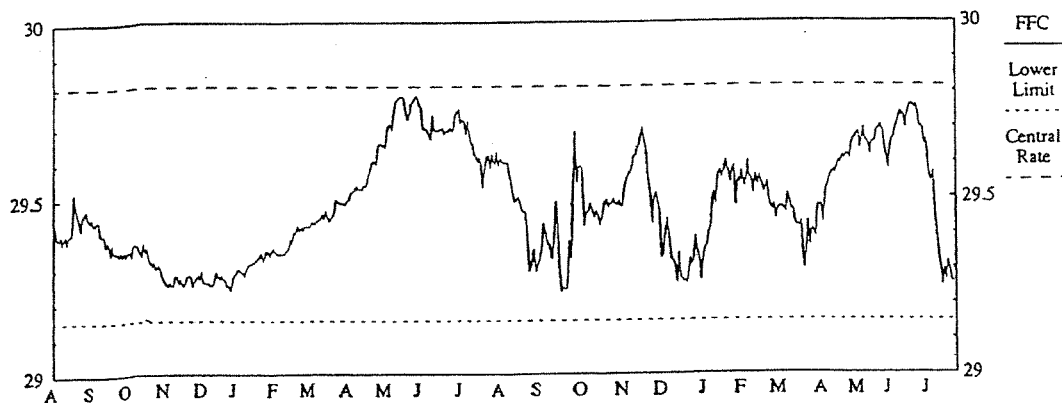
France
August 1991 - July 1993
Short Term Interest Rates



Differential with Germany



DM Exchange Rate

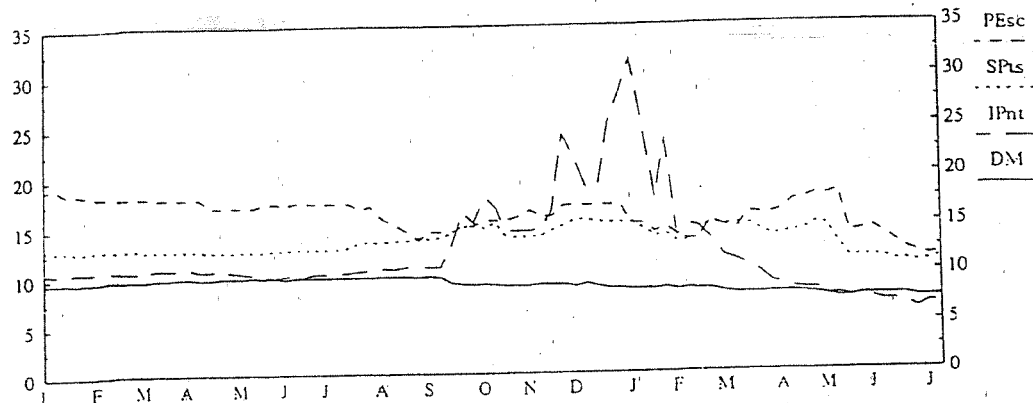


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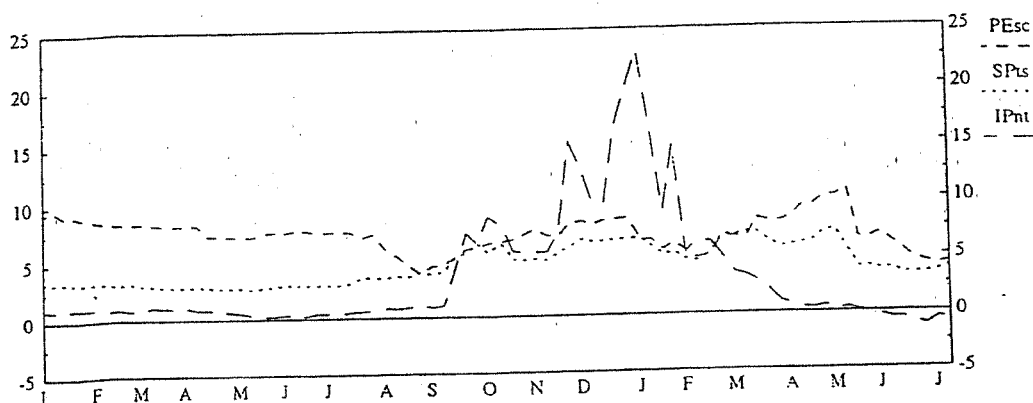
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Chart 2

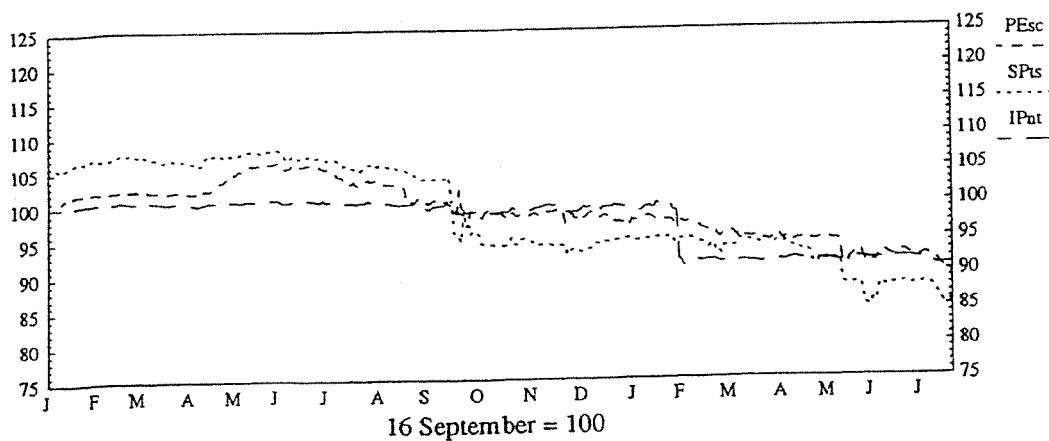
ERM Devaluers
January 1992 - July 1993
Short Term Interest Rates



Differential with Germany



DM Exchange Rate Indices

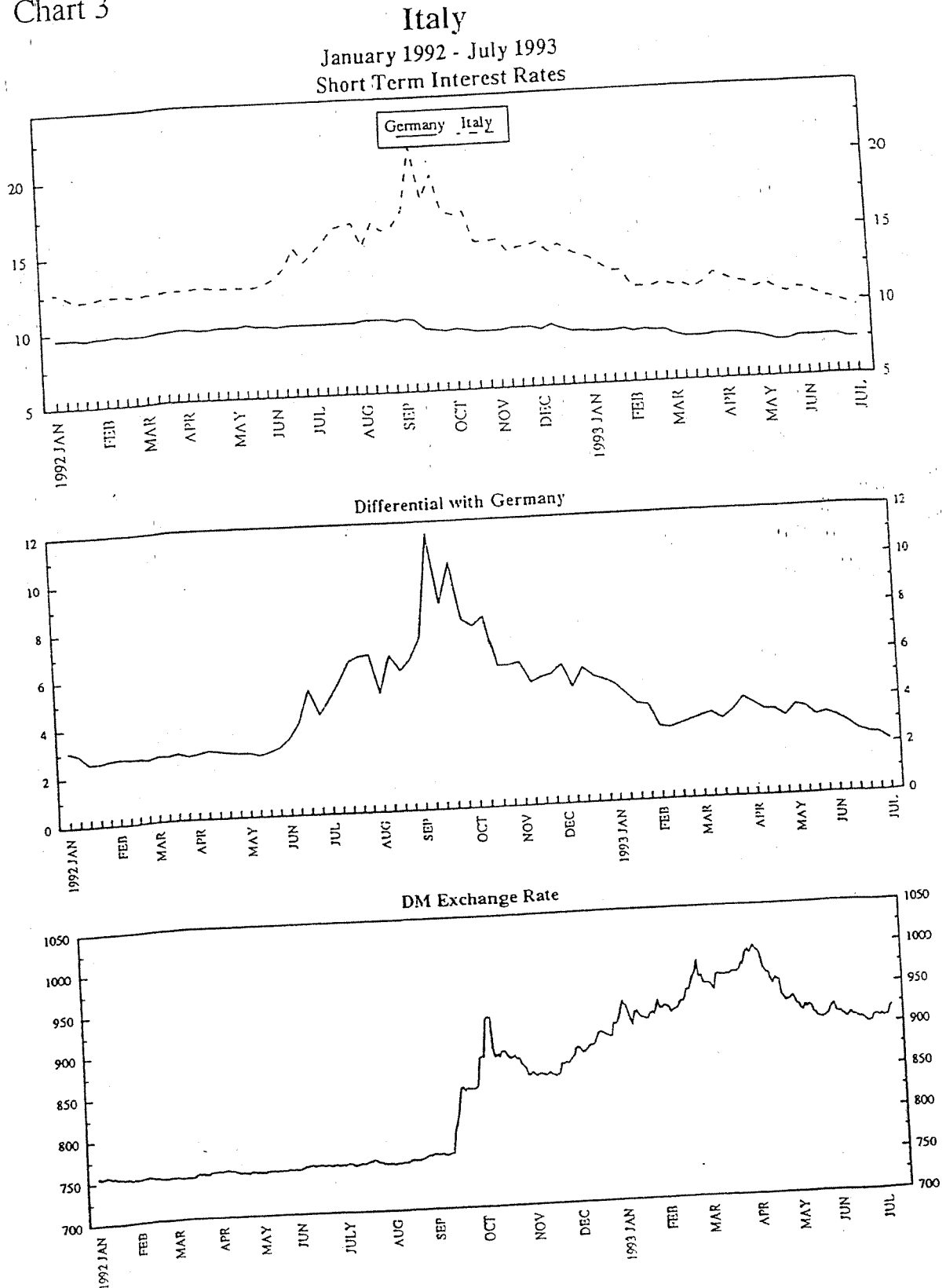


16 September = 100

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Chart 3



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pre-devaluation rise in interest rates. Over the longer period these currencies have been able to reduce their interest rate differentials against the DM but the changes have generally been less than 2 per cent.

13. There is no reason to doubt the analysis we provided then. We could only have cut interest rates savagely if we created the expectation that Sterling would consequently appreciate strongly. That would have required a large fall in the exchange rate. It is not even clear that there was a stable alternative since a large fall in the rate might have increased the risk of a further depreciation. And if such a fall could have been engineered, there would inevitably have been higher inflation.

The fifth alternative

14. The fifth alternative was to leave the ERM and set interest rates according to domestic monetary targets. The main objection to this alternative was that the UK did not have a reliable domestic monetary indicator.

"We have been here before. In the 1980s we fixed domestic monetary targets, and we attempted to meet them by setting interest rates accordingly. But in practice the money supply figures often provided a poor guide to interest rate policy, particularly in the wake of financial deregulation."

Thus the Government had to take the exchange rate into account. But if that was the case, we would have had all the problems of trying to conduct some kind of exchange rate policy without the help of the ERM. "Inside or outside the ERM, we could not ignore the level of interest rates in continental Europe." Mr Lamont concluded, "So in practice there is no reason to believe that a floating exchange rate regime would lead to lower interest rates."

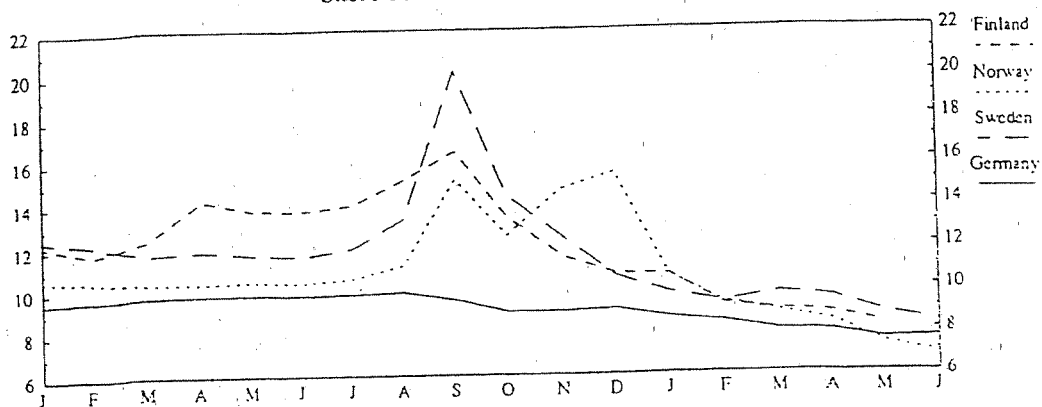
15. It is that last point which seems to have been falsified by events. We do have a floating exchange rate regime and we do have lower interest rates. We need to explain why that has been possible. We can go further and admit that events, so far, have

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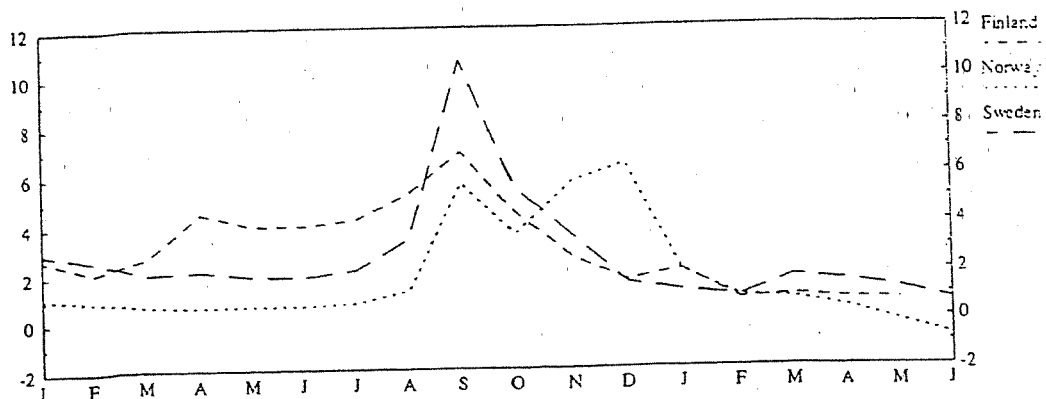
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Chart 4

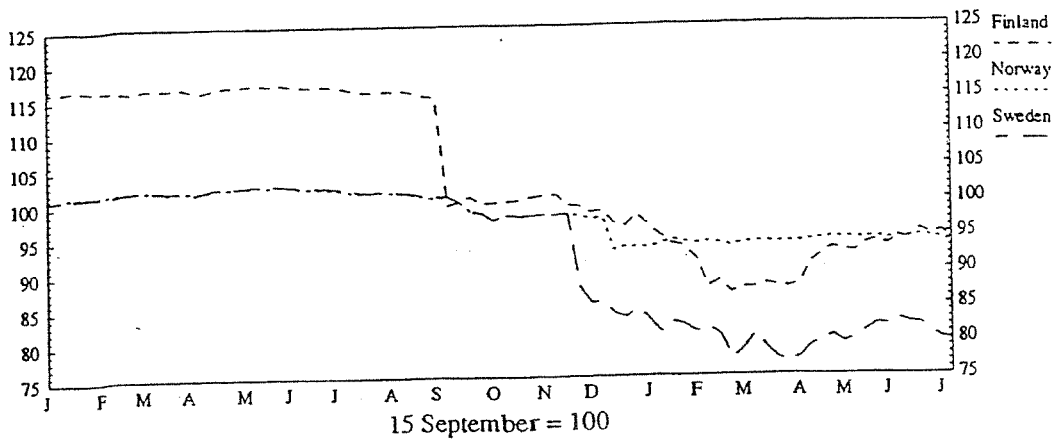
De-Linkers
January 1992 - June 1993
Short Term Interest Rates



Differential with Germany



DM Exchange Rate Indices



15 September = 100

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we have been able to do so without a sharper fall in the currency. That can be partly explained by the conduct of policy since 16 September.

Events since September 16

18. The first point is that the change in interest rates has been restrained. As Charts 5 and 6 show, German short-term rates have fallen by about 2½ percentage points since September 16 while UK rates have fallen by about 4½ percentage points. Thus the interest differential has changed by less than two percentage points. Also UK rates were reduced in steps. The latest move, to 6 per cent base rates, did not take place for more than four months after September 16. Thus there has been a gradual, rather than a dramatic easing of monetary policy.

19. The easing of monetary policy has been accompanied by depreciation of the currency. It is important to distinguish between the depreciation against the ERM currencies and the depreciation against the dollar and the yen. At today's rates (29 July) the DM has depreciated by 27 per cent, against the yen and by 15 per cent against the dollar. Had sterling stayed in the ERM it would, presumably, have experienced the same depreciation against the other major currencies (subject to any moves within the ERM ranges). The depreciation of the sterling index has been about 10 per cent, of which about 4/5ths can be explained by our departure from the ERM. (This is another example of the problem of counter-factuals, since we do not know what would have happened to the other ERM currencies if we had stayed in the system.)

20. In the event we have been able to cut interest rates and sterling has not collapsed. (The immediate fall against the DM was 15 per cent. The maximum fall - shortly before the Budget - was 17½ per cent.) To emphasise the earlier point, the reduction in interest rates relative to the DM has been less than 2 percentage points. But I think we can admit that the combination of the exchange rate and interest rate changes is

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generally turned out better than we expected. But we need not be too defensive. Mr Lamont's speech did not suggest that the results of adopting the fifth alternative would be disastrous. His main argument was that in practice ERM membership was the most likely means of delivering price stability in the UK.

16. The fact that we have been able to keep interest rates lower than those in Germany can be partly explained by the exceptional conditions in Germany itself. Table 1 shows the implied future rates for 3-month money for Germany and the UK. Markets recognise that German rates are exceptionally high and are expected to fall. They also expect UK rates to fall further in the short term but they expect UK rates to rise and move ahead of Germany rates by September of next year.

TABLE 1

Implied 3 month interest rates (28 July)

	Sterling	DM
1993		
September	5.65	5.58
December	5.43	6.01
1994		
March	5.52	5.59
June	5.68	5.3
September	6	5.36
December	6.3	5.5
1995		
March	6.61	5.65
June	6.9	5.76
September	7.21	5.88
December	7.49	6.01

17. In present conditions, with German short term rates so much higher than those in the USA and Japan it is not surprising that we have been able to hold our rates somewhere between the two groups. The encouraging - and perhaps surprising - fact is that

Chart 5

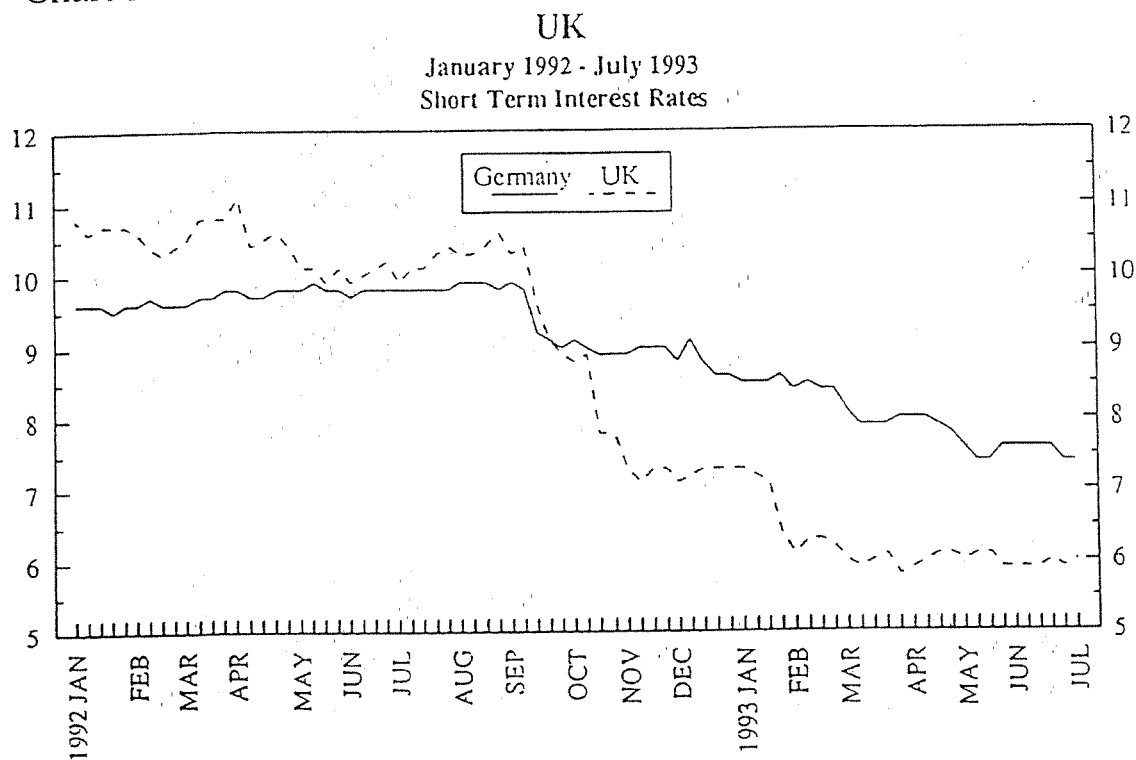
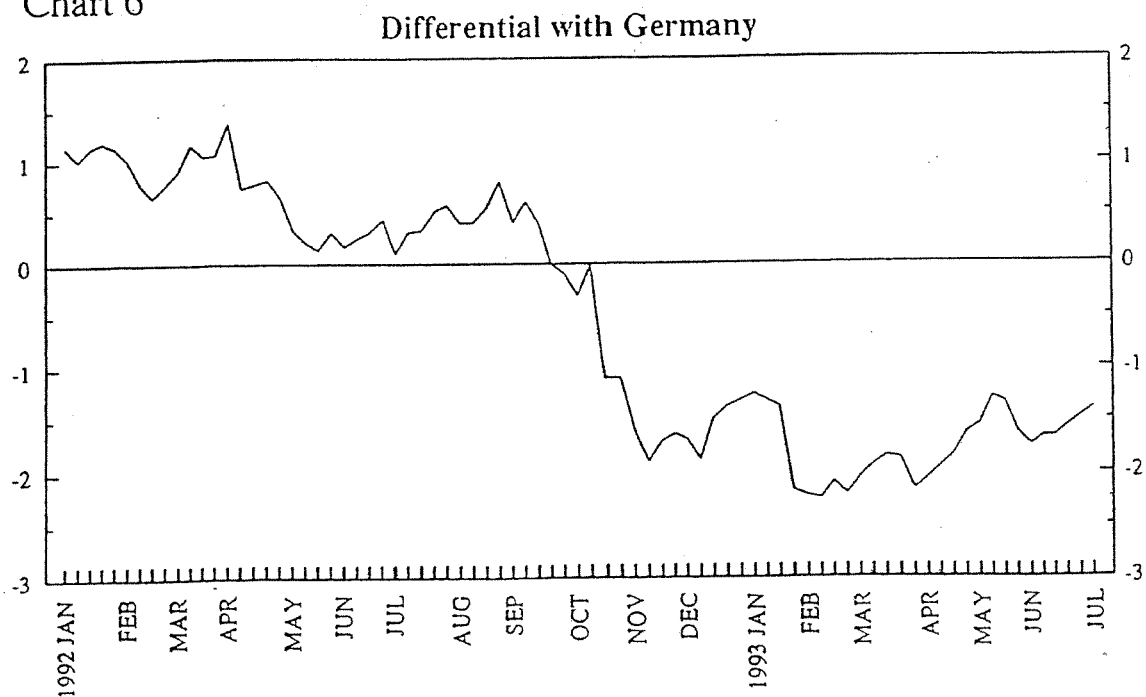


Chart 6



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slightly more favourable than we might have expected. Also fears that leaving the ERM would destroy our counter-inflationary credibility have not been realised.

21. Charts 7 to 9 provide some guide to how markets have reacted. Chart 7 shows UK and German long-term interest rates. Chart 8 shows the implied forward interest rates before and after September 16 and currently. Chart 9 shows the implied inflation rates from the comparison between nominal and index-linked gilts. Chart 7 shows that the longer term interest rates did rise when we left the ERM and have fallen subsequently. Chart 8 provides a rather better guide to expectations since it shows what future short-term interest rates are implied by current market rates. Forward rates from about six years onwards did rise sharply when we left the ERM suggesting some loss of credibility. Rates have fallen back but remain slightly higher than before we left the ERM.

22. These developments suggest that the immediate effect of leaving the ERM was the kind of loss of credibility that we feared. However credibility has been largely restored by:

- the announcement of the new framework for monetary policy (including the 1-4 per cent inflation target);
- the conduct of monetary policy since September 16;
- the medium-term fiscal tightening announced in the Budget;
- the better-than-expected inflation figures.

CONCLUSIONS

23. We should recall the context in which the speech was given. There was mounting criticism of the UK's ERM policy and it was important to emphasise the Government's commitment to membership. Given the theoretical liberties to be expected of such a speech it has stood up remarkably well. Mr Lamont examined five alternative

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Chart 7

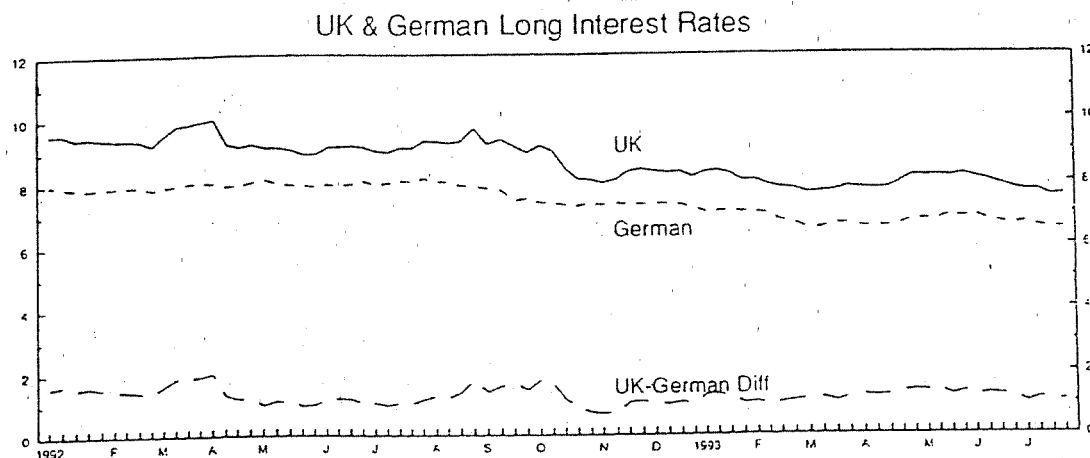


Chart 8

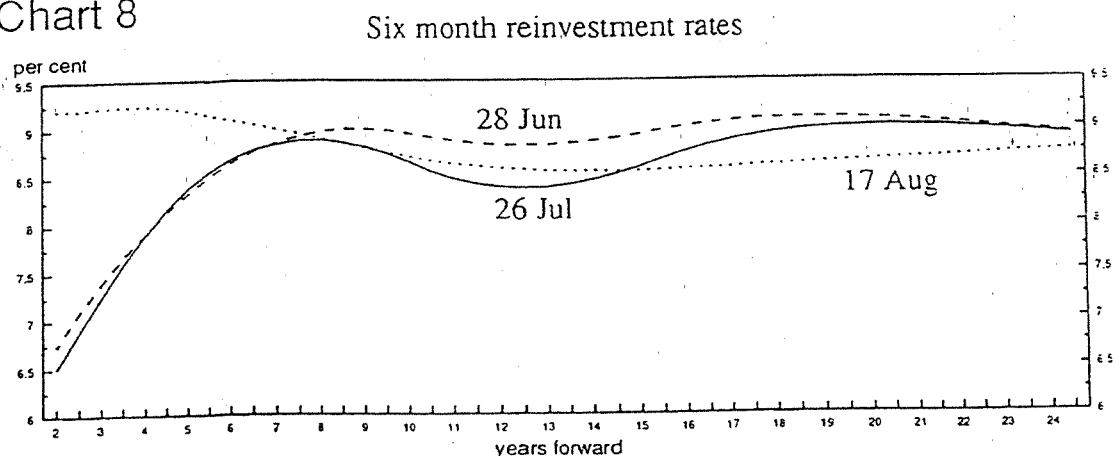
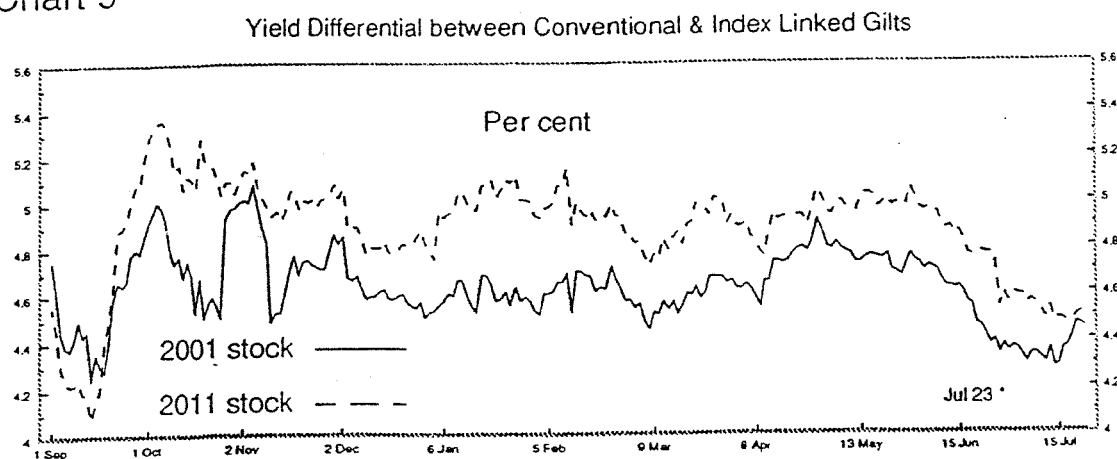


Chart 9



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policies which were being widely canvassed. Subsequent experience has confirmed his arguments that four of them – cutting UK interest rates without changing the parity, devaluation within the ERM, a German realignment and leaving the ERM and slashing UK interest rates were either impractical or would not have brought the benefits claimed for them.

24. We have adopted the fifth, leaving the ERM and setting interest rates according to domestic monetary targets. Mr Lamont did not say that the fifth alternative would be a disaster; he drew attention to the practical difficulties of conducting an independent monetary policy and concluded that ERM membership was the best way of defeating inflation. He also argued that it would not necessarily be possible to cut interest rates outside the ERM.

25. So far we seem to be doing fairly well outside the ERM. Inflation is still falling and the economy is recovering. We have been able to cut interest rates (by between 1 and 2 per cent relative to the DM). But these are early days. If the exchange rate stays at its current level, inflation – at least for a time – will be higher than it would otherwise have been. The full effects of the exchange rate fall have not yet been felt and we have not yet convinced the financial markets that our counter-inflationary policy will succeed. Although we have brought our short-term interest rates below those of Germany our long-term rates are still higher than theirs and markets expect our short-term rates to move above theirs in the course of next year.

26. Finally we must not confuse ex ante and ex post judgements. The purpose of the speech was to warn against the risks of a change in policy. Leaving the ERM has turned out better than we expected but that does not make the warnings wrong. To use a simple analogy it is risky to cross a busy road with your eyes shut. That view is not falsified by the fact that people may occasionally try the experiment and survive.