REFLECTIONS ON THE UK'S MEMBERSHIP OF THE ERM

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Summary

I attach to this minute the paper [redacted] prepared during his 2½ month project between mid-October and December. I also include in this minute my own reflections on our membership of the ERM and some suggested terms of reference for a study of market management techniques. (Both of these were requested in [redacted]' minute of 17 September following our discussion earlier that day.)

The [redacted] Report

2. [redacted] discussed with [redacted] and me in broad terms the planned scope of his study, but we agreed he should set his own detailed terms of reference within the broad framework of the issues set out in [redacted] minute of 20 July last. The analysis is in 2 parts:

- the run-up to our ERM membership.
- experience within the mechanism (but with deliberately little focus on the final events).

3. As expected, [redacted] has provided a thorough and thoughtful analysis. It points to some aspects and issues where - certainly with the benefit of hindsight - we might have handled things differently. But his analysis also highlights that we faced some dilemmas from which there was no easy alternative way out. And the period of our membership did yield some substantial

successes, notably a much more rapid narrowing of the differential against ~~German interest rates than~~ expected.

4. I will not attempt to summarise [redacted]s report. It should be read as it is. Having done so, you will want to consider whether to extend or elaborate the analysis.

<u>Some personal observations</u>

5. I will not attempt my own full-scale post mortem. But here are a few reflections which, like [redacted], I find convenient broadly to divide between the position pre-entry and during our membership.

(i) <u>Pre-Entry</u>

6. In the run-up to our entry most of us comprehensively mis-read the likely state of the UK economy in the early 1990s; a point which emerges graphically from [redacted]'s report. We were still heavily focused on the fighting the battles of the late 1980s, convinced that, following earlier failures, we needed a credible external discipline to get inflation down. We under-estimated both the scale and duration of the process of adjustment to the excesses of the 1980s, and did not realise just how tight policy was. In this respect, if no others, the Walters/ Minford critique was closer to the mark.

7. As a result our main worry - before membership and for a significant period afterwards - was about rates falling too fast, not that they wouldn't fall by enough. That is, I think, part of the explanation why we didn't reflect more deeply on the possible implications of German reunification. But clearly we ought to have done more in this area, if only as part of "what if?" planning. It probably is fair to say that we were so dead set on getting into the mechanism - after the frustrations of the previous 5 years - that we were more blinkered than we should have been about some of the risks.

8. As part of this, were we wrong about the entry rate of DM2.95? Maybe with the benefit of hindsight it was a bit too high, but I still don't think there was much in it. Our key consideration was the desire for a challenging dis-inflationary rate. And we all thought there would be the possibility of a realignment if it proved too challenging to sustain.

9. What we failed to recognise - and perhaps by late 1990 we ought to have had some inkling of this - was that the whole nature of the ERM was changing to a quasi-fixed rate system. Against that background, we also underestimated how quickly we would talk ourselves into a corner by ruling out any sort of depreciation, even the Italian solution.

10. For the most part this process of nailing ourselves ever more firmly to the DM2.95 mast was unplanned. But once in the mechanism as it proved to be we were trapped; to have done other than pledge our loyalty to DM2.95 would probably have led to a lower exchange rate and higher interest rates.

11. So should we still have gone in had we been able to foresee these developments more clearly? It is difficult to disentangle the underlying economic desirability from the politics of Europe and the Conservative Party. But in economic and market terms the need was for a credible policy framework which would allow us to make significant reductions in interest rates (albeit more than we realised at the time). That objective was achieved during 1991. And, given where we started from I still find it difficult to see what other scenario policy approach would have delivered this outcome on acceptable terms.

(ii) Management in the system

12. As already noted, the first year or so of our membership delivered substantial success; more than most of us expected. The issue for debate is whether we could have managed things better in the second year of membership. What is clear now is that during this period we were uncomfortably - and increasingly unconvincingly - caught between 2 stools:

- having so convinced ourselves that ERM membership was a good thing, we found it difficult to contemplate (or ~~plan for~~) the possibility of once again being outside it. All this was strongly underpinned by the politics of Maastricht.

- but, as time went on, we increasingly convinced ourselves that, because of domestic conditions, the interest rate weapon was not appropriate and/or necessary. Our very success in 1991 in narrowing the differential against German rates may have lulled us into a false sense of security - and maybe a feeling that we could survive through a combination of words, intervention, and clever wheezes like the September 1992 foreign currency borrowing.

13. In considering our strategy at this stage, I still believe we were right to have persuaded ourselves that formal devaluation would be wrong, unless the French would join in. (And subsequent Spanish experience confirmed the view that, when you devalue once, the market watch ever more eagerly for the next one).

14. But I think it is fair to conclude that we should have recognised earlier and more clearly the possibility of facing a clear choice between raising interest rates or leaving the mechanism. Although we did some contingency planning during the summer of 1992 we didn't really address this brutal choice or ask ourselves what in the end was the crucial question; how much would we be prepared to "spend" via intervention before throwing in the towel?

15. That is where some of the Scandinavians - and maybe even the French - learned from our misfortune. They developed a much clearer idea than we had of how far they would go. I do not suggest any of this would have made much difference to the way things panned out up to the morning of 16 September. But it *might* - and, given the politics, I put it no stronger than that - have

could not have hoped to turn the game. [redacted]

- [redacted]

- [redacted]

A possible further study

17. It is this last point which underlines my desire for some kind of further study of market operations of the sort described in [redacted]' minute of 17 September 1993. My suggested terms of reference are:

(i) to review the conduct of foreign exchange and money market operations by the UK authorities in the first half of September 1992 and, in particular, the last 48 hours before the suspension of ERM membership.

(ii) to consider the extent to which techniques or tactics were affected by the attitude towards, and the position of, the authorities' counterparties in the markets.

(iii) to compare the techniques used in the UK with those in France [and other European countries] and to consider whether alternative techniques or tactics would have affected the UK's ability to remain within the ERM.

(iv) in the light of these points, to make proposals for any adjustments to current techniques or established tactics for market operations.

18. If you are still attracted to pursuing this, you would need to discuss it further with the Governor; [redacted]' minute of 28 September suggested he was (surprisingly) relaxed about it when you discussed it on 21 September.

19. Whether or not you decide to pursue this, you will need to decide whether to show the [redacted] report to the Bank. I would favour showing it to a selected small group on a personal basis.

<u>Lessons for the future</u>

20. Perhaps I can end with some valedictory thoughts about our attitude to the ERM in the future. Compared with our expectations in Autumn 1992 the conduct of monetary policy has been amazingly successful in the last 15 months. I for one did not believe we could possibly have got long term interest rates and inflationary expectations down to their present levels. And the de facto stability of sterling since the spring has also been fairly remarkable.

21. But I remain fearful this may have been a purple patch, which we'll look back to in the future with nostalgia and longing.

Managing the upturn in this cycle will be every bit as difficult as in the past. It would be very surprising if within, say, the next 2 years, we had not gone through another period of worrying exchange rate turbulence.

22. None of this suggests to me anything other than sticking with the now established policy framework, but trying to better than in the past. I certainly wouldn't be in a hurry to rush back to the ERM. Indeed I wouldn't rejoin unless 4 conditions were met:

(i) there is a political consensus that we wish to move forward to a European single currency area.

(ii) we (and others) are ready to make that move quickly, and almost certainly at unchanged parities. (A steady glide path approach to EMU broke down and can't be put back together again).

(iii) our monetary policy instruments and institutional structures should be much closer to those of our partners. As for policy instruments, it doesn't much matter whether others get more like us or vice versa; what is happening at the moment is a bit of both. But we must have lessened the importance of short term interest rates for personal and corporate borrowers. I don't see this as an issue for legislation. But whether or not we ever want to get back into the ERM/EMU I see strong grounds for aiming to capitalise on our newly achieved low long term interest rate further to encourage the process of fixed rate lending. (Exploring this area is one of the issues flagged up in possible MG work programming for 1994-95; although some aspects are much more for others like BG and would interact closely with current work on industrial finance.)

(iv) the UK monetary authority should have a clear cut mandate and the authority to implement it. The process would be further helped if the Bank was not constrained by having responsibility for other functions like debt management or by the nature of its links to counterparties in the markets.

23. All that said, I hope we don't downgrade too much the weight placed on the exchange rate. And it will be crucial to the success of the current framework for decision-takers to accept that interest rates can and must move in both directions.

[redacted]