

## REFLECTIONS ON THE UK'S MEMBERSHIP OF THE ERM

10 JANUARY 1994

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[REDACTED] paper, attached to [REDACTED] minute of 5 January, makes fascinating reading. It is, as [REDACTED] says, a thorough and thoughtful analysis, and I do not really disagree with either his or [REDACTED]'s main conclusions. What follows in this minute are some particular points regarding the analysis as well as some personal observations.

2. i. Personal recollection, as well as [REDACTED] record makes clear, that pre-entry preparations in 1989 and 1990 focused heavily on the domestic political handling of the entry decision, notably the persuasion of the Prime Minister herself. That Ministerial and senior official energies were focused on that aspect provided an unhelpful and distracting backcloth for our preparations. There is a wider issue here. The political consensus in favour of the ERM was fairly superficial. To some extent it was regarded as a useful instrument for reducing interest rates. Indeed, from [REDACTED] account and from personal recollection, the Prime Minister seems to have accepted entry as a quid pro quo for a 1 per cent cut in interest rates, a cut which many of us in the Treasury were intensely unhappy to see implemented before entry.

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ii. [REDACTED] paper give insufficient weight to the change in the international environment during our period of membership. We certainly underestimated the trauma of German reunification - but so did everyone else, including the Germans. Nor did we foresee the decline in the dollar viz a viz the European currencies as the American recession took hold. Again we were not alone there. The reunification trauma meant that the mismatch between the requirements of German and UK policy would be especially pronounced while it was the fall of the dollar, rather than Sterling's relationship with the Deutschmark which caused "competitiveness" problems, to the extent they existed. I very much agree here with [REDACTED] judgement, in paragraph 8 of his minute, that our entry rate against the Deutschmark was not way off course. As I recall, there were few complaints from exporters about Sterling's relationship with other ERM currencies - indeed the UK was the only major country to increase its share of German imports in 1992. [REDACTED]

[REDACTED] see much better [REDACTED]  
 during the [REDACTED] [REDACTED] enough [REDACTED]  
 [REDACTED] expressed the view that it was a [REDACTED]  
 [REDACTED] [REDACTED] the [REDACTED] [REDACTED]

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iii. The paper provides good evidence that a necessary condition for a successful monetary policy is to take monetary policy decisions on the basis of monetary criteria, not political criteria or on the deemed consequences for particular financial institutions.

3. As regards the possible further study, I agree with [redacted] terms of reference, except his subhead (iv) namely:

"In the light of these points, to make proposals for any adjustments to current techniques or establish tactics for market operations".

Surely the techniques used in the period in question were too a high degree conditioned by our membership of the ERM. I therefore rather doubt whether such a specific reference "to adjusting current techniques or established tactics for market operations is altogether appropriate. Could we not have something more general like:

"In the light of these points to make proposals, as appropriate."

I think it important that the author of the study should be someone who has a first hand knowledge of markets.

4. As regards [redacted] 4 conditions for re-entry, I believe that we are too far away from any re-entry date to be too specific regarding conditions. Even so, I agree with the philosophy behind [redacted] 4 points. In particular, we should explore what can be done to capitalise on our newly achieved long term interest rate further to encourage the process of fixed rate lending - and the answer here may be no more than to run monetary policy in a way

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which maintains long term interest rates at low levels. I also agree with his point that the Bank should not be constrained by having responsibilities for other functions like debt management or by the nature of its links to counterparties in the markets. But that is another way of making the point at iii. above.