After ERM

HARD TERMS

The government has joined ERM in order to save itself. **John Grahl**, co-author of a new book on 1992, discusses the longer-term meaning of the decision

By taking the pound into the European exchange rate mechanism, John Major obtained some relief in a very nasty situation. The basic cause of this predicament was the general failure of Conservative economic policy over the past 10 years. Inflation has not been controlled, and the long-run decline in industrial competitiveness has not been reversed. As a result, Britain is running a very large balance-of-payments deficit, which is financed by borrowing abroad. This need to borrow was the reason for the high interest rates. The large deficit made it probable that sterling would fall on the foreign exchanges, and this made lending to Britain risky. The high interest rates were needed to compensate lenders for the risks of holding sterling.

As the deficit persisted, the predicament got worse. Confidence in sterling was so shaky that even 15% interest rates, maintained for the record period of a year, seemed unable to stop wealth-holders moving into other currencies. Any large-scale selling of sterling would tend to provoke a cumulative decline in the exchange rate by further undermining confidence.

Although the Treasury and the Bank of England were not committed to any particular exchange rate for the pound, they could not accept a large and precipitate fall in sterling's value because it would push up the prices of imported goods and add to inflation. On the other hand, it was also difficult to contemplate the alternative – a further rise in interest rates to compensate holders of sterling for a rise in perceived exchange-rate rise. An increase in interest rates beyond 15% would obviously be bad news politically. It would also be damaging economically at a time when production is stagnating and unemployment starting to rise. But the danger of having to accept either faster inflation or higher interest rates kept increasing as the trade deficit persisted.

Britain's participation in the exchange-rate mechanism eases these pressures because it underpins the exchange rate of sterling against the currencies of our partners in the European Monetary System (EMS) – most notably against the D-mark.

The ERM is not just an agreement to fix exchange rates, as was the case, for example, in the Bretton Woods system during the 50s and 60s. ERM involves a *collective* agreement to defend those rates. Thus, if sterling comes under pressure in the markets, the other central banks of the system, including the powerful German Bundesbank, are committed to defend it – by buying sterling themselves and by lending foreign exchange to the Bank of England.

ERM membership removes, at a stroke, the risk of a drastic decline in the value of sterling, which is now pegged to other currencies. Britain's credit rating is improved by the guarantee of exchange-rate stability and thus British policy-makers have gained an important degree of freedom. It was logical to announce both ERM entry and a cut in interest rates at the same time, because it was the first that made the second possible. Further reductions in interest rates are expected to follow as the government takes full advantage of sterling's new stability.

Lower interest rates have been obtained at the cost of increased dependence on our partners in the EMS. The full consequences of this dependence may take some time to appear. Although the immediate threat to sterling has been removed, participation in ERM does nothing to correct our fundamental economic problems. It makes Britain's balance-of-payments deficit easier to *finance*, but it does nothing to reduce the deficit. Indeed, participation may well have a perverse effect because cheaper credit, as a result of lower interest rates, will allow consumers to buy more imported goods, and lower mortgage rates may rekindle inflation in the housing market.

'Continuing competitive decline of British industry makes an eventual devaluation of sterling inevitable'

The continuing competitive decline of British industry, exacerbated by the policies of the last 10 years, makes an eventual devaluation of sterling inevitable in spite of ERM. The rules of the system require our partners to defend sterling against speculative attacks – and they are obliged to provide unlimited credit to the Bank of England to do so. But this is short-term. Our partners do not have to finance, for any length of time, a deficit which represents levels of spending in Britain completely out of line with British production.

The same point has been made by several finance ministers and central bankers in the EC, including Karl-Otto Pöhl, head of the Bundesbank. Our partners feel that Britain should have taken more strenuous measures – including devaluation – to improve the balance of payments, before seeking help to prop up the pound. Such statements are unusual from finance officials whose code of conduct normally forbids any comment which could undermine confidence in another currency. Their explicitness on this occasion expresses a rather cynical view of British policy.

When it becomes too difficult to finance the payments deficit by the measures outlined earlier, it will have to be adjusted – either by increasing the production of exports or by squeezing expenditure on imports or by a combination of the two. The process will be painful and protracted because British companies are not sufficiently competitive to deliver a rapid increase in exports and because high levels of inflation continue to increase their costs. If the pattern established over more than 60 years is repeated, a devaluation will be necessary to make exports more profitable and to discourage imports.

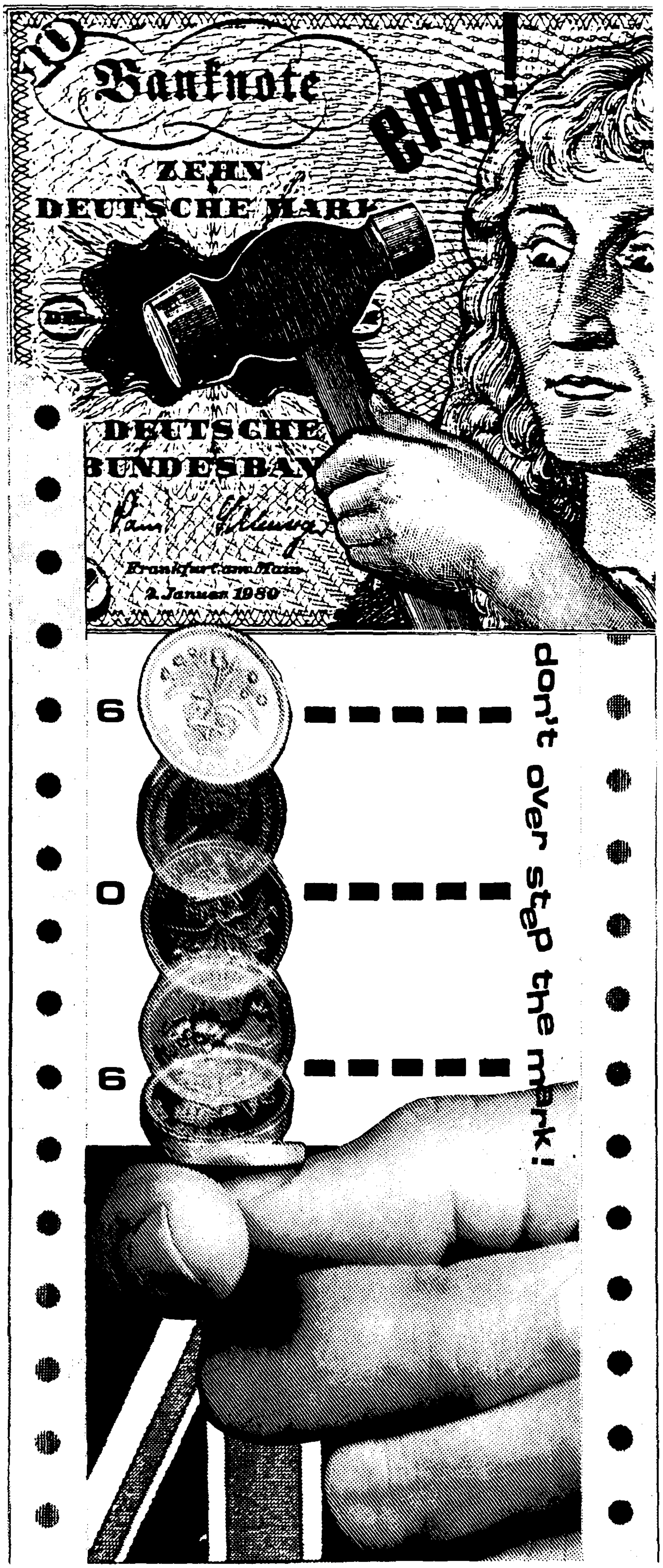


Illustration: Paul Bateman

'Loss of autonomy is like a penalty for the mismanagement of economic policy'

The possibility of devaluation is an open secret, although every effort will be made to avoid it before the next election, since it will erode consumer spending power and accelerate inflation. The rules of ERM, moreover, restrict and complicate devaluation. Exchange-rate changes within the ERM cannot be decided unilaterally by individual member states – they require agreement by all participating countries. Recently, the members of the system have been trying to delay currency realignments and limit their size. They have avoided exchange-rate adjustments which fully compensate for inflation in order to tighten constraints on high-inflation countries. This is a logical way of increasing confidence in the system by showing that exchange rates will only change slowly and deliberately. It also prepares the way for full monetary union in the Community, which would mean fixing exchange rates irrevocably and thus, in effect, moving to a single currency.

The rules of the ERM, however, will produce serious difficulties for Britain if it has to devalue the pound. Only limited devaluation will be accepted, and even that will be conditional on other policies such as restraints on public spending. The result is likely to be even more dependence on the EC. It will no longer be possible to pursue, independently, an expansionist programme of modernisation and investment. Britain will increasingly have to bargain with other EC countries for investment resources, public and private.

Thus, in future, Britain will have to accept tight constraints on its monetary policy. In a way, it will be like an economically backward region of a larger economy – it will be unable to influence the interest rates and inflation rates that prevail in the larger unit, but will instead have to negotiate for any increase in its share of resources.

Some attempt has been made, by Conservatives, to present ERM membership as a relaunch of the original drive against inflation in the early years of Thatcherism. The pound is now tied, permanently so it is asserted, to the D-mark with its world reputation for stability. We are on a 'D-mark standard' which will prevent inflationary increases in costs and prices and will re-establish tight economic discipline. In principle these claims could be true. In practice they inspire little credence – especially in view of the impending election with all its inflationary temptations. Over the last 10 years, the Netherlands has fought inflation by linking the guilder to the D-mark at a fixed rate. Only one small devaluation of the guilder has taken place and every change in German monetary policy is now matched by the Netherlands, so that the Dutch central bank is now almost a branch of the Bundesbank. This record has gradually convinced investors that the Dutch and German currencies are virtually the same thing. The pound has a long way to go before it has a similar reputation.

The attitude of British ministers, especially Margaret Thatcher, to the ERM suggests a different interpretation. They do not display satisfaction with a triumphantly relaunched strategy. They seem more like the owners of a small company, once proudly independent, who have accepted takeover by a European conglomerate rather than go bust.

The most important economic decisions of the Thatcher period have been exercises of monetary policy and have depended on Britain possessing full monetary sovereignty. The recession of 1980-81, which profoundly altered the economic landscape, was the result of a sharp shift towards monetary restriction. The resulting high exchange rate squeezed industry while high interest rates encouraged the expansion of the banking sector. The Lawson boom of 1983-88 was based on a gradual shift to much easier money, reducing interest rates and letting sterling depreciate. According to most economic opinion, these dramatic swings in policy were ill-judged, but they certainly had potent effects. They are now a thing of the past because the instruments of national monetary policy have to be set according to the disciplines of the ERM.

This loss of autonomy is like a penalty for the mismanagement of national economic policy. Perhaps Britain would eventually have joined ERM, even if Margaret Thatcher's economic experiment had been a brilliant success, but the circumstances of our participation make it like being rescued from the immediate consequences of failure. Although there was a brief period in the mid-80s when the British government enjoyed enormous prestige on the continent and started to set the policy agenda for the EC as a whole, Thatcherism was never fully accepted by conservative forces in other member countries. Thatcherism is basically a British project – it aims at national economic renewal by a radical strategy within Britain, and monetary policy has been at the heart of the strategy.

In this sense ERM membership symbolises a decline in Thatcherism, even if Thatcher remains in office. There is even an analogy with the introduction of west German marks into east Germany. Like the east Germans, Britain obtained a measure of stability in a critical situation by accepting an external monetary discipline, but, like east Germany, this acceptance saddled British companies with uncompetitive cost and price structures which can no longer be corrected by a unilateral change in the exchange rate. The loss of autonomy in Britain is of course much less extreme, but it is significant and the obvious disappointment of Thatcher and her closest supporters is understandable.

There will probably be further shifts of economic control from Britain to the Community, because the EMS itself will change. The Commission and its president Jacques Delors are promoting the goal of monetary union. This would mean replacing the present system, which stabilises exchange rates among different national currencies, by a single European monetary unit, issued by a European central banking system which would absorb national central banks such as the Bank of England.

It is not clear whether this drive for monetary union will succeed. Rapid monetary integration would present serious difficulties not just for Britain but for all the weak economies in the EC. They would no longer be able to expand credit to accelerate economic development, nor could they devalue their currencies to encourage exports or to compensate for inflation. In September, a meeting of EC finance ministers expressed doubts on rapid monetary unification, with the Spanish minister in particular pointing to the difficulties involved.

More generally, there are now uncertainties about the future of the Community as a whole. In recent years, the two most important EC initiatives have been the single European Act, passed by member parliaments in 1986, which strengthened Community institutions, and its subsequent 1992 programme for a single market, which pushed forward economic integration (although to nothing like the extent promised by the accompanying publicity). Both these measures were relatively successful, but they have now exhausted most of their initial impetus. Meanwhile, the collapse of socialism in eastern Europe and the USSR has completely transformed the context of the integration project. It no longer makes sense, for example, to regard the Community as the 'second pillar' of the Western alliance.

There is no single agreed perspective for the EC in these changed circumstances. French strategy is for a new and ambitious phase of institutional construction within the existing Community. A powerful European central bank is one aspect of this approach; another is a new drive for political unification. Both issues will be discussed at intergovernmental conferences, on EMU and political union in December. The French aim to build a powerful supranational entity, which can play a big role on the world stage. They envisage important interventions by the EC on Third World debt, world monetary reform, and the reconstruction of the ex-socialist countries. The EC would become, if not a rival to the US, at least an equal partner to it, with comparable weight in world affairs.

The German government, on the other hand, is much less enthusiastic about radical institutional change. It is strong enough not to feel the need for the EC as a way of playing an active world role and, as a successful exporter, it is less interested in a reconstruction of the world economic order. For historical, geographic and economic reasons, Germany seems uniquely well-placed to benefit from the emerging capitalist economies of the East. In the monetary sphere, Germany already has predominance as the only member of the EMS able to influence exchange rates between the US dollar and European currencies. Monetary union would deprive Germany of important policy instruments. It has resisted institutional change in this area for the last 10 years.

'Like the east Germans, Britain obtained a measure of stability by accepting external monetary discipline'

Nevertheless, neither France nor Germany will insist on its own national position to the point of endangering the close relations between the two countries. France will moderate its ambitions, while Germany will accept further institutional change including a European central bank, if it is given guarantees against a return to inflationary policies. Other EC members have varied interests but remain basically committed to the integration project. Smaller north European countries such as Belgium or Holland already have very close economic relations with France and Germany. The EC gives them some influence over economic forces which would otherwise be beyond their control. The low-income Mediterranean members of the Community are relying on integration with the north to stimulate economic growth. Inside the EC they benefit from regional and industrial support rather than being completely dependent on private investment flows.

Thus, most members of the Community remain committed to its further development, although the pattern of that development is not clear. Specific initiatives may well fail. For example, attempts by the EC to regulate labour market behaviour have failed in the past. On two occasions the community has failed in efforts to construct strong monetary institutions and this could happen again, even though all members except Britain accept monetary union in principle. Nonetheless, the EC has displayed an impressive ability to adapt to major economic and political changes and to redefine the integration project in ways which preserve its relevance to member countries. For example, there are already efforts to map out a role for the Community, as a unit, in east European recovery.

Britain faces difficult political choices, both in its general relations with the EC and on the specific question of monetary union. Thatcher herself, and those closest to her, are inclined to press for much looser, all-European structures which would embrace the re-emerging market economies of the East. The perspective would be a much larger, but centralised, Community acting essentially as a free-trade zone and without extensive supranational powers. It is ironic that it used to be the Left which advocated pan-European structures as an alternative to the EC, but such an approach is unlikely to be any more successful in the hands of the Right. Other member states are unlikely to accept this kind of dilution of the Community. They will accept east European countries into the EC, but not until they are much stronger economically.

An alternative, opposing strategy would be to align British policies much more closely with those of France and to press for a stronger, more centralised Community. Many Conservatives take this position on the view that Britain has no long-term future as a sovereign state and that it is better to share power within the EC than to accept a de facto German hegemony. Thus, monetary union may seem preferable to the existing ERM which is so dominated by Germany as to constitute, in practice, a D-mark zone.

These are difficult strategic issues and they are made all the more difficult by the Britain's frequent refusal – under Thatcher but also under previous prime ministers – to accept existing Community rules and structures. The fact that Britain refused to accept the ERM for 10 years and only joined in an emergency will not enhance our influence when the future of the monetary system is being discussed. Official British contributions to the debate on monetary union have been unconvincing. To deflect the drive for a European central bank and a common currency the Treasury has come up with two different, and quite inconsistent, alternatives. First, unrestricted competition between national currencies and then, when this scheme received no support, the issue of a new parallel currency, the 'hard ecu', alongside national currencies. These schemes were ad hoc responses to proposals for monetary union and did not express a well-thought-out strategic position.

For Britain, the best outcome of the debate would probably be to delay the introduction of a single currency but to accept a supranational system of central banks with control over monetary policy in member states. This would avoid a sudden and disruptive shift from entrenched high rates of inflation to much lower rates with a common currency. Even before the common currency was introduced, the European central bank system could take over responsibility for the overall direction of monetary policy on the EC – by setting the general level of interest rates or the average value of European currencies against the dollar. At present these policy choices are made, in practice, in Germany, and without too much concern for the interest of other members. A supranational monetary authority would have to balance the interests of different member states and would be preferable to German hegemony.

Britain today, however, is not well placed to assert its own positions within the Community. There is an often-repeated cycle. We begin by dismissing some EC initiative; polemics continue while the costs of our exclusion increase and become more obvious; in the end there is a humiliating acceptance of new structures when it is too late to have any influence on the way they work. A good example is Britain's refusal last December to sign the Social Charter of employment rights which were accepted by the other 11 members. At the time, this may have seemed an easy gesture, since the Charter was only a declaration with no legal force. The Commission, however, has followed up the Charter with an extensive action programme of new labour-market and employment policies, including legislation. How much credibility will British representatives now have in the negotiations around the action programme? It will be difficult to press for detailed revisions to measures which have already been rejected in principle. On the other hand, Britain is bound to be affected by the resulting changes in European labour markets.

'Difficulties in our European relations reflect a more general failure to address Britain's long term economic problems'

These difficulties in our European relations have been particularly marked under Thatcher, but they certainly did not begin with her. Basically they reflect a more general failure to address Britain's long-term economic problems. Lack of commitment to the EC is of a piece with the failure to make other necessary long-term investments, in industrial modernisation or in better education. The case of ERM entry seems typical. Once again short-term considerations have prevailed and there is no coherent long-run strategy for our monetary relations with the EC.●

After ERM

Pragmatism Rules, OK?

Entry into the ERM could just deliver a fourth term for the Tories. But **Charlie Leadbeater** anticipates more profound changes

If the politics of conviction were the mark of the 1980s, the symbol of politics in the 1990s will be Euro-pragmatism. Politics in the 1980s unleashed passion, imagination and ideas, mainly from the Right, to change society. In the 1990s politics will be about technocratic, gradual, unambitious adjustments to circumstances. Party politics in the 1980s was organised around Thatcherism's ideological dominance of the political agenda. In the 1990s it will be much more closely fought between two more equally matched, managerial parties.

The dominant Tory politics of the 1980s was of a resurgent British spirit, the Falklands and the rediscovery of great Victorian virtues. The spirit of the 1990s will be of Britain dependent upon others in Europe, pooling sovereignty and reluctantly acknowledging that economically it trails in Germany's wake.

British politics is in the midst of a slow evolution. Beneath the battle in the polls, with Labour resurgent and the Tories fighting back, a more subtle but no less important shift is taking place. Regardless of who happens to be leading in the polls, the terms of political debate, the parameters of political possibility are changing. Politics has become progressively less ideological and less ambitious, more pragmatic and careful, with the only excitement provided by spectacle and scandal rather than ideas and imagination.

The television evening news on Friday October 5 was emblematic of this quiet transformation. From Blackpool we had the Labour Party rounding off a successful – that is to say tame and energy-less – conference with a song foisted upon it by its marketing advisers. It capped a week of controlled, neatly-dressed, spectacle: something to window shop rather than feel stirred by. But just as Peter Mandelson was packing away his mannequins for the last time, so the Tories were planning to upstage him.

With exquisite timing at 4.00pm that afternoon, John Major, the chancellor, announced Britain would be entering the exchange rate mechanism of the European Monetary System. There was just enough time for the financial markets to rally and for tv news producers to elbow Labour into the dying minutes of the bulletins.

As a political gesture the ERM announcement could not be faulted and not surprisingly most attention has focused on its short-term political ramifications. After months of division, defensiveness and evasion over Europe and the ERM the Tories are back in the driving seat. They may yet crash. But they are back on the move again after the intense self-doubt of the spring. Major's move has given the Tories the same sense of momentum they got from their 1986 conference, when a battery of ministers rolled out the agenda for the next few years.

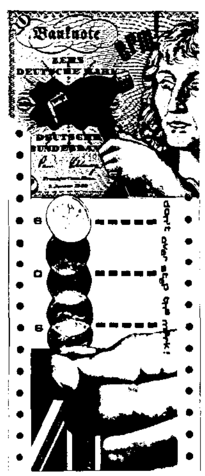
It has pulled at least part of the rug from beneath the Labour Party. It struck at the heart of Labour's economic policy. For months Labour had benefited from Tory division over Europe, Thatcher's distaste for European integration, and proclaimed it's economic policy distinctive because it revolved around ERM membership. By 4.05pm that day much of what had sustained Labour's attack on the Tories had been repossessed by the bailiffs.

Most significantly, Britain's entry sounded the starting gun for the race for the next general election, with a great deal riding on how the economy responds to the discipline of ERM membership and developments in the Gulf. ERM entry could allow a sustained cut in interest rates. Combined with falling inflation and give-aways with electricity privatisation, the electorate could take Major to its heart after letting him replenish their pockets. Labour's poll lead could erode rapidly.

But the decision to go into the ERM is not just significant for its effect on the parties' standing in the polls. The ERM mini-series will tell us something very important about how the character of British politics has changed since the mid-1980s. It could also be a defining moment, laying the foundations for what politics could be about, how it could be conducted, for the next decade. The character of British politics is evolving. ERM entry will be central to its evolution.

In assessing the significance of the ERM decision it is worth recalling the political changes which were unleashed by the economic upheaval of the recession a decade ago. How politics changed in that period will help us piece together how the character of British politics is likely to develop in the early 1990s. For the recession of 1979-81 was just such a defining moment, when a savage economic downturn combined with an abrupt change in economic policy and a new set of political priorities. Those years laid the foundations for much of the politics in the remainder of the decade.

'Entry into ERM marks the end of the experiment with monetarism in one country'



First, it was the political equivalent of the Torrey Canyon disaster for social democratic politics. The badly holed, political super tanker was finally pushed onto the rocks to break up. Social democracy plunged into the waves. It has only surfaced in the last couple of years. Second, the break with the past changed the terms of what was politically possible in dealing with the British malaise. The economic and political shock of the early 1980s was the breach through which flowed trade-union reform and privatisation. It ushered in a deeply ideological period of politics dominated by the Tories. Could ERM entry, combined with the mini-recession which will probably come next year, provide just such a catalyst to transform politics into the 1990s? In a way it will, but it will be far less dramatic than the early 1980s.

A decade has made an enormous difference to politics. The recession of 1979-81 was marked by an intense ideological debate between monetarists and Keynesians. It was because the recession was accompanied by this debate that the political and economic consequences in later years were so radical. Thatcherism emerged as the driving force around which the rest of British politics had to reorganise.

In contrast the downturn of 1990 and the abrupt shift in economic policy with ERM entry, has been accompanied by hardly any grand economic debate at all. There has been great drama with the row over Professor Walters and the Lawson resignation. There has been a slanging match over whether and when Britain was going to enter the ERM. But no great debate about why the economy is in a mess, the alternative cures and the aims of economic policy.

The debate which accompanied the recession of 1979-81 was a grand clash of economic ideologies. The debate of