JOINING THE ERM: CORE EXECUTIVE DECISION-MAKING IN THE UK 1979-1990

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Ph.D. Thesis

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ABSTRACT

Core executive decision-making in economic policy in the UK is dominated by a Prime Minister-Chancellor axis and a set of constraints defined by vast flows of capital around foreign exchange markets. This thesis examines policy-making during the Thatcher governments in relation to the debate about ERM membership from 1979 to 1990. The analysis reconstructs the choices which faced the Thatcher governments given their economic and European policy interests and capital accumulation priorities, and investigates core executive actors' activity against this background. From the first Thatcher administration onwards, the core executive was seriously divided on ERM membership and the government was unable to pursue a coherent policy on the issue. As a result of both a power struggle between the Prime Minister and successive Chancellors and the retention of empirically untenable policy positions by core executive actors, economic policy-making falied as a judgement about effective means to ends. In this sense, decision-making became non-rational. Having renounced the potential benefits of ERM membership for most of the 1980s, the Prime Minister and Chancellor decided to enter ERM in autumn 1990 at a central rate of DM2.95 which served neither their own interests nor those of UK producers. The failure of the Conservative government to pursue an effective policy on ERM membership represented a failure to cope with or understand the implications for successful economic management of vast capital flows around foreign exchange markets.

ACKNOWLEDGEMENTS

During the course of this thesis, I have accumulated so many debts as to make its completion far more than the result of my individual effort. My primary debt is to my supervisor Patrick Dunleavy who provided a foil to my sometimes less than coherent thinking and writing as well as generous encouragement and kindness. I am also deeply appreciative for his practical support over an assortment of difficulties. Whatever the inadequacies of this thesis, they would have been far greater without him.

In the LSE government department, I would like to thank Alan Beattie for his secondary supervision and his ongoing interest in and insight into the project. I am also grateful to George Jones for giving me the opportunity to present my ideas to the Institute of Historical Research and to my fellow students, Etain Tannam and Steven Griggs for their support and friendship. Last, but certainly, not least, I am incredibly grateful to Claire Wilkinson for her generous help in facilitating the interviews, unfailingly sorting out what no doubt seemed like an endless series of problems and enduring an awful lot of my less than amenable moods.

My sincere thanks to the various people who allowed me to interview them. For reasons of confidentiality, I cannot thank them personally but I am very grateful for their time, courtesy and quite often candour. For their advice and suggestions at different times, I would also like to thank William Keegan, Peter Hennessy and Jim Bulpitt.

Left to my own devices, the production of this thesis would have ceased long before its completion. To those who made it possible for me to continue, I am deeply grateful. My thanks to Brian Barry and Jenny Richards at LSE; to my parents who as always leapt to my problems with care and generosity; to Thanasis Sfikas whose late but divine intervention meant that I reached the end smiling; to Alice Thompson for unselfishly giving me so much of her time up and down the country when there were infinitely better things to do; and to Julian Reindorp who through the last year typed parts of the manuscript with the greatest interest and enthusiasm

and shared more of the pleasures and pains of this work than I thought it possible to share with anyone. I can only dedicate the thesis to Alice and Julian with my love as a small gesture of how much what they gave meant to me.

GLOSSARY

BL	British Leyland
CAP	Common Agricultural Policy
CBI	Confederation of British Industry
CEE	Council of Economic Experts
DHSS	Department of Health and Social Security
DTI	Department of Trade and Industry
EC	European Community
Ecofin	Economic and Financial Affairs Council of the EC
Ecu	European Currency Unit
ERM	Exchange Rate Mechanism
EMF	European Monetary Federation
EMI	European Monetary Institute
EMS	European Monetary System
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
FCO	Foreign and Commonwealth Office
FRN	Floating Rate Notes
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
G5	Group of 5
G6	Group of 6
G7	Group of 7
ICL	International Computers Limited
IGC	Inter-Governmental Conference
IoD	Institute of Directors
IMF	International Monetary Fund
MAFF	Ministry of Agriculture, Fisheries and Food
MTFS	Medium Term Financial Strategy
NATO	North Atlantic Treaty Organisation

NEC	National Executive Committee (of Labour Party)
NEDC	National Economic Development Council
OECD	Organisation for Economic Co-operation and Development
PSBR	Public Sector Borrowing Requirement
RPR	Rassemblement pour la République
SEA	Single European Act
TUC	Trade Union Congress

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CHAPTER 1
CORE EXECUTIVE DECISION-MAKING

Since states started to trade with each other, they have been forced to confront the question of how to organise payment for that trade. Their endeavours to deal with the problem have fallen into cycles in which currency values are fixed against each other in an international system for periods of time only for the system to break down as the national costs of maintaining them outweigh the national and collective benefits of their continued operation. When a system collapses, currencies move freely against each other until a time when the national and collective costs of pursuing unilateral state objectives outweigh their national benefits. Any particular method of facilitating trade has become not an end in itself, to be judged a failure or success by its longevity, but a means of minimising the problems posed to national growth by the necessity of exchange rates to be used and then discarded when its effectiveness wanes.

The collapse of the Bretton Woods system in 1972-1973 was particularly significant because in its aftermath, states began to face a new dilemma in currency management. Unprecedented sums of capital bearing no relation to trade flows were now moving around the world electronically. As a result, states faced fewer problems in maintaining adequate sums of foreign exchange to pay for trade. Instead, choices about exchange rate management were increasingly defined by the costs which rapidly falling and rising currencies imposed on countries in terms of inflation and competitiveness respectively. Overall, the foreign exchange markets became divorced from the demands of trade and became an independent structural constraint on states in making their economic policies.

To cope with the consequences of this phenomenon, different states at different times have sought collective currency arrangements, not simply to facilitate trade, but to defend their national interests against the exchange markets themselves and those countries which benefit most from exchange rate operations at any particular time. Between 1978 and 1993, the European

Exchange Rate Mechanism (ERM) represented the most systematic effort by any group of states to deal with the problems of currency management in the post-Bretton Woods world. Although in July 1993 the scale of the exchange market flows proved stronger than the EC's collective ability to maintain the original rules of the system, for most of its duration the ERM provided its participants with a package they found generally acceptable in terms of benefits over costs, given the prevailing international currency environment. The ERM's *de facto* abandonment in 1993 was not an admission that a decade and a half of currency management had failed. Rather, it was a recognition of the fact that the costs of participating in the system in the particular set of circumstances prevailing were too high for all but Holland and Germany. Indeed, for the ERM states, the questions which the system sought to address about the relationship between the economic objectives of nation-states remain as pertinent as ever

Alone among the ERM and former ERM states, the UK government chose to dance on the system's supposed grave. This thesis examines the peculiar development of UK policy towards ERM from the arrival of the Conservative government in office to its decision to enter the system in October 1990. For over a decade the question of ERM membership tore at the heart of the Conservative government. During the entire period the Prime Minister faced pressure for membership from somewhere within the core executive. As the question of joining occurred and recurred, first as an issue of the UK's relations with the EC and then of economic policy management and finally of both, the internal government conflicts and their consequences came to dominate core executive operations in both areas. By providing a comprehensive account of the development of policy on ERM membership, the thesis aims to throw some light on the nature of core executive decision-making on economic policy within a European context during the period.

As a central political issue of the 1980s and 1990s, the Thatcher governments' debates about ERM membership have already been the subject of much debate. Existing commentary tends to fall into two categories, both of which leave significant gaps in our knowledge of policy development. Some of those who were participants in the decision making process have given their accounts in memoirs, most notably Nigel Lawson and Margaret Thatcher. These memoirs provide useful detail of particular episodes of conflict and debate but they are inevitably subjective and self-justifying. Indeed, the participants have disagreed not only about the substance of ERM membership but retrospectively about who took decisions on the issue and how and when they were made. In themselves, the various memoirs cannot provide a systematic or comprehensive account of the development of ERM policy.

By contrast, William Keegan and David Smith in *Mr Lawson's Economic Gamble* and *From Boom to Bust: Trial and Error in British Economic Policy* have described the government debate about ERM membership in the context of the government's broad macro-economic policy in their respective books. Both have significant sources of information and are illuminating on particular episodes. But their accounts are produced under some significant constraints.

First, the secrecy which surrounds UK government makes it difficult to establish with any certainty what, when and how decisions were made. However, by rigorously seeking to reconstruct specific decisions and non-decisions on ERM membership rather than tell a readable story, it is possible to provide a potentially more accurate version of events. For example, both Smith and Keegan assume that membership only became a seriously contested issue within the Conservative government in 1985. Yet there is considerable evidence that membership was a divisive issue within the government during its first term of office and that the terms of debate for the rest of the decade were defined by that original conflict.

Second, since their primary concern is with broad macro-economic policy, Smith and Keegan do not give much detailed attention to membership as an issue of EC policy. Third, their accounts at times fall victim to the 'black box' approach to analysis. We understand the outcomes of policy without having a clear understanding of how they are arrived at from inputs into the decision-making process, particularly what interests they benefit. Through combining extensive interviews with policy-makers and a concept of the costs and benefits to the central actors of particular courses of action, it is possible to create a more comprehensive and systematic account of policy.

The remainder of this chapter has three roles. Section 1.1 describes the creation of ERM and the reasons behind the UK's non-participation in the system before the Conservative government came into office. Section 1.2 reviews some traditional theoretical approaches to decision-making. Section 1.3 constructs an analytical framework for this particular study. The final section discusses the methodology and organisation of the subsequent chapters within terms of the analytical framework of the thesis.

1.1 THE ORIGINS OF THE EXCHANGE RATE MECHANISM

In December 1978, in the aftermath of the European Council in Brussels, the EC states agreed to launch a European Monetary System (EMS) with an Exchange Rate Mechanism (ERM) as the centrepiece of the system. Whilst all nine EC states were to be members of EMS, the UK would not participate in the ERM. The start of the ERM was delayed by a French effort to raise farm prices and the system finally came into operation in March 1979.

The initial desire for monetary stability in the EC was born out of disillusionment with floating currencies. Floating produced not only diverging currencies but a licence for member-states to inflate at will, with three key effects. First, floating made nonsense of many of the trade, industrial, and particularly, farming policies of the Community, which were based on some unanimity of interests. Second, intra-Community trade was threatened. In principle, floating should have been beneficial because most intra-Community trade was of manufactured goods, producing a competition of labour costs that made it essential that exchange rates offset those cost differentials. However, floating was not achieving this result and instead rates were overshooting, that is moving in the opposite direction to inflation. As a result, protectionist pressure mounted. Finally, floating was making demand management difficult. Those countries with weak currencies which attempted to expand in an inflationary environment came under sustained deflationary pressure in the exchange markets. Meanwhile, countries with stronger currencies found that trying to stimulate demand in export-oriented sectors was ineffective as the investment climate was being primarily determined by the international monetary environment and not by their individual macro-economic policies. Disaffection with floating was expressed by a wide range of interests including the European Commission, the member state governments and economists. Many considered that the ultimate consequence of floating was that EC states' overall economic performance deteriorated in relation to those of the US and Japan.[1]

This general disaffection was most keenly felt by the West German Chancellor, Helmut Schmidt. His particular interest was tied to the downward float of the dollar and the upwards pressure this change was putting on the Deutschmark against the other EC states. The effect was twofold: German goods were made uncompetitive and pressure mounted on the Deutschmark as an international reserve asset. Schmidt wanted the effects of the falling dollar to be spread more equally between the European states. He was also concerned that floating was producing an inflationary environment from which Germany could not immunise itself. In political terms, Schmidt saw a European monetary system as an act of self assertion by Europe against the United States which he considered too weak to provide leadership out of the world economic malaise and unresponsive to Europe's interests particularly in security matters.[2] In the words of a former UK Treasury official:

> It [the ERM] was born out of the misbehaviour of the dollar and the midwife was Schmidt and he knew why he was doing it. It was a poking out of tongue at the raped international currency.[3]

Schmidt found a significant ally in President Giscard d'Estaing of France. He was concerned at the costs to French farmers of the disruption in the Common Agricultural Policy (CAP) and he believed that French industry would only become a world competitor when some anti-inflationary discipline was injected into the economy. Moreover, if Germany was to reflate its economy, as Giscard wished, it needed to be offered the carrot of monetary stability. In sum, it was from a coalition of German and French interests that the political impetus for a European monetary system came.[4]

Having decided to act, Schmidt and Giscard looked to bring the UK government into their deliberations, A triumvirate negotiating team was established to develop a possible exchange rate system. The UK representative was Kenneth Couzens, the Second Permanent Secretary at the Treasury in charge of International Finance. However, he quickly became isolated from the French and German representatives who believed that he was only trying to block their efforts. The other two simply developed their own proposals to the satisfaction of Schmidt and Giscard.

How ERM Worked

The aims of the proposed EMS were threefold. First, to facilitate trade by creating a zone of monetary stability in the EC. Second, to coordinate the monetary and exchange rate policies of member states towards the rest of the world. Third, to prepare the way for the birth of a European Monetary Federation (EMF) and the use of the European Currency Unit (ECU) as a reserve currency. However, for the short term, it was the first objective which received exclusive priority and, significantly, no effort was made to develop a dollar policy.[5]

The ERM itself was designed as an attempt to combine some of the advantages of a fixed rate system with flexibility. Each member agreed a central rate for its currency in terms of a weighted composite basket currency known as the Ecu. These central rates were organised in a parity grid and it was these rates which had to be defended by all participants within a 2.25 per cent of the parity (or a 6 per cent band for the Italian lira). Pressure on the parities was recognised through a divergence indicator. If a single currency varied by more than 75 per cent of its permitted divergence from the system as measured by its Ecu exchange rate, then some form of corrective action had to be taken whether it be central intervention or policy adjustment. In the event of sustained pressure, the parity rates could be realigned relatively easily by collective agreement.[6]

If the ERM states did not want to contemplate frequent realignments then the system would have exerted a counter-inflationary discipline on economies which expanded too rapidly in relation to their partners. A unilaterally expanding economy which sucked in imports would eventually be faced with either a balance of payments deficit or inflation or both. Consequently, its exchange rate would move towards the bottom of its parity range. Under its membership obligations, that government would either have to intervene to buy its currency; or deflate its fiscal policy to restrain the demand for imports; or raise interest rates to attract capital. States with currencies appreciating towards the top of their band would have to sell their currencies or cut interest rates to keep their currency down. The consequence for weak currency states would be that they might have to deflate to protect the exchange rate when the domestic economy needed to expand. For strong currency states the cost would be in fuelling their money supply through intervention and in renouncing the counter-inflationary weapon of an appreciating exchange rate.[7]

Yet if the provisions for easy realignments were utilised, as certainly Schmidt and Giscard envisaged them to be there would be no reason why the ERM should perform as a traditional fixed rate system at all. Rather, it would operate as a 'dirty float.' The chief aim would be to allow the exchange rate to offset some differential in inflation without allowing the exchange rate to move in the opposite direction to inflation, as frequently occurred under free floating.[8]

UK Non-Membership

With the proposed ERM a secure venture, the UK government was faced with a decision about whether to join the system. Opinion within both the government and Whitehall was divided. The Treasury was quite rigorously opposed to the idea of membership and was supported to a lesser degree by the Bank of England. It believed that a new European system of pegged exchange rates was not compatible with the UK's economic interests. First, the Treasury 'had considerable doubt as to whether it [the ERM] would survive.'[9] Second, Treasury officials believed that sterling would be a petro-currency in the 1980s and so the sterling rate would fluctuate in the opposite direction to the price of oil from the other EC currencies. According to one former Treasury official: 'We were absolutely pre-occupied in those days with the price of oil.'[10] Third, as the EC state least dependent on community trade, the UK's trade did not suffer in quite the same way as the others from floating. In fact, it was only once sterling was allowed to float in 1972 that UK manufacturing exporters were able to hold their share of world trade. Fourth, the Treasury considered it unwise for the UK to be part of a system which could be construed as anti-dollar. Fifth, it believed that the ERM was designed to serve German interests and would leave the burden of adjustment on traditionally weak currencies such as sterling. The UK would be left having to use an overly deflationary policy to maintain sterling at an artificially high rate against the Deutschmark.[11]

The primary supporter of membership was the Foreign Office. It believed that it was damaging for the UK to allow France and Germany to make all the running in the EC and that the UK needed to fully participate in the development of the Community. At the same time, some senior staff considered that sterling would actually benefit from being included in a satisfactory European exchange rate system. One such official recalled:

> We just thought that the Treasury was wrong on their own grounds but that is not an easy battle to fight. ... A lot of us felt that we were making a perfectly serious economic and financial analysis, but it happened to be different from what was certainly the majority view in the Treasury.[12]

The Foreign Office's economic argument was supported by some officials at the Ministry of Agriculture and Fisheries and Food (MAFF) and its political case was backed by the European Secretariat at the Cabinet Office. Whilst the head of the European Secretariat was not particularly enthusiastic about the ERM concept, he believed that it was important that the UK should not be left behind if such a system began operating.[13]

The Labour government saw the issue primarily within the terms of the Treasury argument. Whilst Callaghan and Healey did not relish the prospect of isolation from the other EC states, they were concerned that the UK would not be able to maintain a parity within the ERM without heavy costs. Within the Cabinet, there was significant opposition on essentially Treasury grounds that membership of the ERM would be deflationary and subordinate UK interests to those of Germany. This view was shared within the parliamentary party, the NEC and the TUC. Callaghan wanted to keep his options open as long as possible but the committed opposition came to a head at the Labour Party conference in October 1978 where a barrage of motions against ERM membership were submitted. According to the columnist, Peter Jenkins, it was this debate which was decisive in Callaghan's judgement against joining the system.[14]

Callaghan's and the Treasury's opposition to ERM membership has to be understood in terms of the UK's historical experience of fixed exchange rate systems. By the end of the 1970s, the UK core executive tended to see sterling's participation in a succession of fixed exchange rate systems as a series of failures. Certainly, failure was obvious in the case of the 'snake' which linked the values of certain European currencies by allowing them to fluctuate only within narrow margins. Sterling survived only six weeks in this system before it was withdrawn in May 1972. With sterling under pressure from the Deutschmark, the Heath government decided that economic growth should take priority over the exchange rate. The experience was perceived as an overwhelmingly negative one by the Treasury and left officials there deeply sceptical about the whole idea of European exchange rate systems.[15]

By contrast, the UK's membership of the Gold Standard and the Bretton Woods system were seen as unsuccessful because core executive actors generally believed that sterling was maintained and defended at too high levels for too long. In the process, the UK's international competitiveness was seriously eroded, causing balance of payments problems. In 1926 the UK rejoined the Gold Standard and was forced to pursue deflationary policies to maintain sterling's fixed parity. After 1931 when sterling was forced off the Standard, there was a significant improvement in the UK's trade performance. From 1949 to 1967, successive UK governments defended a $2.80 parity in Bretton Woods which by the early 1960s appeared to be restricting growth. The economic policy of the first three years of the first Wilson government, in which Callaghan was Chancellor of the Exchequer, was to a large extent determined by the defence of sterling but it was not enough to avert devaluation in 1967. When Bretton Woods collapsed five years later, and sterling also quickly departed the snake, UK policy-makers believed that sterling was now liberated from the yoke of fixed rates. With floating came the hope that deficits in the balance of payments could be financed without having to resort to deflationary action.To some extent, this optimism was justified in that the UK's trade performance did improve under floating.[16]

Yet the UK's previous experience with fixed exchange rate systems cannot alone explain all the opposition to ERM membership. Rather, it is necessary to consider why the Treasury examined membership solely in terms of the advantages and (predominantly) disadvantages of returning to *fixed* exchange rates, rather than entering a 'dirty float'. In the early 1980s the UK need not have been tied to an artificially high rate against the Deutschmark, with the ensuing deflationary consequences, if the government were to use the ERM's realignment provisions.The explanation now offered by Treasury officials for the failure to accurately see how ERM would work is that it was not presented to them in this way. There was according to a senior official, 'no belief that we could realign within two years.'[17]

By conceiving membership as a return to fixed exchange rates, the core executive did not address the ongoing disadvantages of floating for the UK economy. Removing the floor under sterling produced the humiliating sterling crisis of 1976. At the beginning of that year, the government came to the conclusion that sterling was still too high to ensure competitiveness. In March, the Bank of England sought to manage sterling down by selling on a falling market. When the markets realised this, they sold sterling at a rapid rate and it fell beyond the level the government wanted to achieve. By October 1976 sterling sank to $1.55 and appeared to have no floor despite interest rates of 15 per cent. To secure adequate foreign exchange reserves, the government was forced to negotiate a loan from the IMF, which was conditional on public expenditure cuts.[18] The crisis demonstrated that floating vested considerable power in the exchange market operators. At the same time, it deprived the UK of most of its reserves and required deflationary action at least as harsh as the defence of the $2.80 parity in the 1960s.

In the light of this experience the Treasury could have seen ERM membership as an insurance policy against a repeat of the 1976 crisis, because it offered a definite floor for sterling and promised collective action by many central banks to defend it. With sterling inside an exchange rate system with international obligations, it would be far less likely that the exchange markets would view the UK government as indifferent to sterling's fate as they had done in 1976. However, the Treasury retrospectively saw the 1976 crisis as a problem of 'economic fundamentals', not of the relationship between a government's monetary intentions and the exchange markets. This view ignored the fact that there were many examples of currencies being moved by the foreign exchange markets in the opposite direction to 'economic fundamentals' with very damaging consequences. For example, the appreciation of an inflationary currency is often disastrous for international competitiveness. Yet without developing such a critique of floating, UK core executive actors could not see ERM as a means of addressing the problem of overshooting.[19]

1.2 THE CORE EXECUTIVE AND A RATIONAL ACTOR FRAMEWORK

In producing a decisional study of this kind, a range of theoretical and methodological questions arise, which can be handled in three parts. The first part of the section argues that a core executive model is more appropriate to a macro-economic decisional study than the traditional policy community approach, and, then considers who are the central actors within the core executive in economic and European policy. The second part discusses the problems in using neo-Marxist, rational choice, economic ideology and new institutionalist theoretical frameworks for this particular policy study. The final part outlines a detailed rational-actor framework for understanding the development of the Conservative government's policy on ERM membership.

Core Executive versus Policy Communities

As Dunleavy and Rhodes note, the operations of the UK core executive, 'those organisations and structures which primarily serve to pull together and to integrate central government policies,' are under-researched.[20] Most decisional studies of UK politics examine issues which are taken at sub-central levels of the state apparatus within a policy community framework. According to this approach, the central focus of analysis and policy making should be the civil service- interest group dynamic. Jordan and Richardson see UK policy making as characterised by an array of fragmented policy communities in which decisions are made by government departments and agencies, interest groups and professionals with shared interests in that particular area of policy.[21] Policy communities are characterised by frequent consultation between members, a shared specialist language of debate and consensual bargaining. They produce fairly stable policy outcomes. With the basic dynamics of policy change operating at relatively low levels of government, core executive activity is left as 'icing on the cake.'[22]

In down-playing the role of the core executive, the policy community approach is flawed in two ways. First, the Conservative governments and the 1987-1992 government in particular, revealed that the core executive and professionals often did not share the same language or values and that professionals were relatively powerless to stop the core executive imposing radical policy changes. In the case of both health and education, the government introduced policies with the expressed aim of reducing the power of doctors and teachers. Even a policy community approach which allowed for membership of a policy community to change over time, could not account for the fact that the proposed beneficiaries of reform were not brought into the decision-making process.

For example, the 1988 Health Service Review was conducted entirely within the core executive itself in a committee chaired by Thatcher,despite a flood of proposals from health professionals.[23] Indeed, if Lawson is to be believed, then he and the Treasury were more influential in the process than the Department of Health, the heart of the alleged health policy community:

> Throughout the course of the review the relative weakness of the official DHSS and of its successor the Department of Health meant that a remarkable amount of the work, both in terms of the analysis and the working-up of solutions, as well as the knocking down of nonsenses, fell to the Treasury.[24]

Afterwards, the core executive was able to implement its reforms despite the opposition of all the medical professions. Overall, the Thatcher years indicate that core executive actors (especially ministers) can and will develop interests independent of those responsible for policy implementation. Even in the policy sectors which traditionally have sustained a policy community analysis, the nexus of external interests and lower tier agencies are relevant only to the extent that the core executive is relatively indifferent to the outcome of decision-making.

Second, on the issue which has been the central preoccupation of post-war governments and which conditions the policy-making environment of all other sectors, namely macro-economic policy, the policy community approach has said little and can effectively contribute even less. In their own analysis, Jordan and Richardson never adequately address the issue. Although they admit that there are a few policy areas which do not fit their model, - for example abortion and the development of Trident - they do not believe that these cases threaten the paradigm's overall validity:

> Groups do not have insider access to influence all kinds of policy but even where policy is evolved internally, in the longer term it will only be tenable if it can be sold to an influential constituency.[25]

Whilst Jordan and Richardson recognise that much of their analysis is concerned with low politics, this does not lead them to exclude high politics from the approach:

> We would argue that the sectorisation of policy-making and the development of policy communities may well work towards the disaggregation of all policy issues into 'low' and 'manageable' problems. Big cross-sectoral issues are difficult to manage both intellectually and politically. It is impossible, intellectually to take account of all possible linkages between policy areas, and in political terms too many conflicting interests may be involved for a workable consensus to emerge. Thus it is no surprise that the bulk of policy-making and implementing activity is concerned with issues which might be perceived as technical and detailed .... While everyone seems to have an opinion about 'high' politics, implementation is the province of groups deeply committed to their specialised interests and concern over detail.[26]

Indeed, they firmly reject the idea that a policy community approach cannot be applied to economic policy.[27] In their original study, they used the introduction of VAT in 1973 as an example and argued that tripartite structures were the means by which 'high politics' economic policy was resolved into manageable low politics problems. In their later work, they denied that the Conservative governments killed tripartism and argued that the NEDC remained an effective policy-making forum particularly in regard to employment policy.[28]

What Jordan and Richardson persistently ignore is the discongruence between much of economic policy making and the fundamental premise on which their approach is based. They argue that UK decision-making is characterised by consultation and negotiation for two reasons. First, there is a cultural bias which emphasises the need to legitimate decisions through consultation. Second, since the whole of UK public administration rests on the assumption that groups will co-operate in the implementation of policy, it is functionally necessary for governments to consult the 'affected interests'.[29] In the cases of the introduction of VAT, tripartite negotiations over incomes policies and job creation schemes, the core executive was certainly dependent on others to implement its decisions. However, on many economic policy issues - for example, monetary policy, exchange rate management, taxation and public expenditure - the core executive simply executes its own decisions. On these issues, even the most half- hearted empirical observation indicates that decision-making is confined within the core executive itself.

It is often these kinds of decisions which do not pose problems of implementation from which other policies flow. Central policy-makers did indeed look to the CBI and TUC to implement job creation schemes but only after the decisions central actors made for themselves about monetary and fiscal policy produced rising unemployment. To suggest, as Jordan and Richardson do that 'the TUC and CBI can claim more say over employment policies than can Parliament' is rather to miss the point.[30] In the case of VAT, as Jordan and Richardson themselves admit, the Heath government took the strategic decision to introduce the tax without any consultation. Consultation with groups took place only over the technicalities and the problems of implementation.[31]

Many economic policy decisions are not and cannot be made in the conditions described by the policy community literature. The approach suggests that policy is made in a stable national environment in which governments and groups share an interest in the avoidance of sudden policy change so as to maintain their co-operative relations. By contrast, the exchange markets and the interdependence of national economies mean that economic policy-makers are forced to operate in an unpredictable international environment in which nation-states compete for scarce economic benefits. As often as not, monetary and exchange rate policy confront policy-makers with what Polsby terms an 'acute' issue where there is no time for consultation with those affected by the decision.[32] If there is a run on sterling or the Bundesbank raises its interest rates, the core executive will not wait to ask the CBI's position before deciding on a response.

Similarly, whilst policy community analysis stresses that policy-makers seek to avoid risks, much economic policy is essentially about risk assessment. Policy-makers are forced to make recurring choices about the same policy options, notably the level of interest rates, public expenditure and taxation. In each case, they are assessing how firms, consumers and financial markets (which they cannot control) are likely to respond to any particular policy change at any particular time given the prevailing domestic and international climate and the state of other policies. In a world where huge sums of capital bearing no relation to trade flows are instantaneously moved around the world by globally operating institutions and speculators with potentially huge consequences, risk avoidance is impossible.

Who Makes Economic Policy?

Rather than the broad and open policy community described by Jordan and Richardson, macro-economic policy is made in a very closed policy-making environment even within the core executive itself. The following discussion first considers how the Treasury and the Bank of England have traditionally been portrayed as the dominant policy-makers and then argues that contrary to these claims, it is the Prime Minister and Chancellor who are the key policy actors.

Through much of the general academic literature on UK economic policy, the image of an all powerful Treasury assisted by the Bank of England looms large. Those writers who have located a financial rather than industrial bias in policy have generally attributed this to a Treasury stranglehold on the policy machinery.[33] For example, Ingham identifies the City/Bank of England/Treasury triangle as the *'core institutional nexus'* of British society. The institutions share a mutual but independent interest in the production of stable money forms and have the overriding power to shape policy to that end. According to Ingham, the Treasury, not Labour ministers, was responsible for the decision not to devalue sterling between 1964-1967 with the ensuing consequences for UK industry.[34]

Writers more directly concerned with the Treasury as an institution have drawn similar conclusions. In Ham's view Treasury officials have enjoyed 'a remarkable degree of autonomy and influence and for long stretches of time..... [have] set the pattern of government for the whole civil service apparatus.'[35] Pollard firmly blames Treasury power for the 'wasting of the British economy' and concludes that 'ministers basically do what the Treasury and Bank of England tell them to do.'[36] Meanwhile, Thain sees a powerful Treasury imposing U-turns on governments of whatever party:

> The spectacle of most governments taking power with the express intention of not introducing an incomes policy only then to do so offers prima facie evidence for the existence of a dominant civil service.[37]

In their study of public expenditure decision making in the UK, Heclo and Wildavsky conclude that the Treasury's judgment on expenditure is the given factor around which official and ministerial bargaining takes place.[38]

Both participants and analysts of the Labour government of the 1960s and 1970s have supported the dominant Treasury thesis. Tony Benn for example has repeatedly argued that the Treasury is too powerful in regard to ministers.[39] Similarly, the former Chief Secretary, Joel Barnett concluded that the 'official' system defeated ministers.[40] In his analysis of the 1974-1979 Labour government, Coates argues that 'Treasury conservatism was a main obstacle to the government's radicalism. '[41]

Writers concentrating on the general policy-making process have not significantly disputed the dominant Treasury thesis. Keegan and Pennant-Rea argue that the Treasury and the Bank of England are able to gradually assert power over the lifetime of a party government:

> Indeed there appears to be something of a cycle of influence over economic policy with the political party and manifesto being in the ascendant early in the administration (and) the influence of the Treasury and the Bank of England gradually becoming more important when over-ambitious plans begin to go wrong.[42]

At the same time, they argue that on monetary and exchange rate policy, the Bank of England is generally the most powerful actor:

> Often the Bank's 'power' comes from presenting an apparently irrefutable case to the Chancellor and Prime Minister that it will not be able to sell any more government stock to the public, or hold the exchange rate at the official target rate, unless the Government introduces policies which, for example, stand a chance of convincing the market that it will fight back against inflation.[43]

Similarly, Hodgeman asserts the power of the Bank in this area:

> In general, the Bank has played a major part in determining the objectives of monetary policy, and the major part in deciding how policy is to be conducted to attain these objectives.[44]

Mosely takes an opposite cyclical view to that of Keegan and Pennant-Rea but agrees that the Treasury is still powerful. He argues that in the first three years or so of a government's life, Treasury officials will pull ministers along to their ends. Thereafter, the Treasury tends to assume a defensive posture as ministers make it more clear what measures they cannot expect the Cabinet to accept.[45] In sum, there is a general consensus among these writers that whilst ministers might have formal constitutional responsibility for policy, real power lies with the Treasury and to a greater or lesser extent the Bank of England.

Treasury Weakness

Evidence against the dominant Treasury thesis comes from several sources. Former participants in the policy process do not all share the view of Labour ministers. In his account of his time as head of the policy unit under Wilson and Callaghan, Donoughue concludes that 'without Callaghan, the Treasury was able to do little.'[46] Frank Cooper, a former Permanent Secretary at Defence told Young and Sloman:

> The knight mandarins at the Treasury are less in charge of the Treasury than any Permanent Secretary is of any other department...... It is the ministers in the Treasury who call the shots.[47]

In the view of a former senior Foreign Office official:

> They don't tolerate very much independent thinking in the Treasury. They like to think that they sort of tell Chancellors what to do. And, in some measure all officials tell their ministers what to do. But they are actually very susceptible to the views of the Chancellor and they are very faithful reflectors of those views.[48]

According to a senior Treasury official, 'All my experience of thirty odd years in the Civil Service is that if there is a departmental view it is minimal; what matters is ministers' views.'[49] Indeed, drawing conclusions from their interview-based study of the Treasury, Young and Sloman argue that 'far from being secretly dominated by officials, the Treasury is the most political of all departments.'[50]

At the same time, when specific decisions are empirically analysed it is difficult to uphold the dominant Treasury thesis. In Holmes' study of the Heath government, he shows that Heath, not the Treasury was responsible for the erroneously named Barber boom. Using four case studies, namely the production of Concorde, the applications for membership of the EC, the abolition of resale price maintenance, and the 1964-67 non-devaluation of sterling, Bruce-Gardyne and Lawson provide the most comprehensive empirical analysis of power within the core executive. They conclude: 'what is striking about our case histories is the chequered record of Treasury achievement.'[51]

Whilst the abolition of the RPM was no more than a peripheral interest for the department, in the other cases the Treasury was deeply involved and profoundly powerless. The Concorde saga was one of 'unrelieved humiliation for the Treasury' as it failed in very determined efforts to kill off and then modify the project.[52] On sterling, rather than the incoming Labour government succumbing to Treasury pressure in 1964 as many claim, it was Wilson and his Chancellor James Callaghan who took the decision not to devalue when in opposition. By contrast, 'The Treasury was chaste; but if, in the autumn of 1964, the incoming ministers had been intent on rape the department was in no mood for a struggle.'[53] Wilson then ordered that the word devaluation should be expunged from Whitehall vocabulary whilst Treasury officials believed that devaluation was undesirable but not uncountenanceable. In response: 'its (Treasury's) high command meekly accepted the unmentionability of the unmentionable and acquiesced in the brief to work within an impossible framework.'[54]

Similarly, throughout the 1960s the Treasury remained deeply sceptical about UK entry to the EC believing that it would gravely damage sterling. Yet the Treasury:

was strikingly unsuccessful in impressing its anxieties on the politicians in 1961 and again in 1966-1967, notwithstanding the fact that the Chancellor was at best an agnostic on Europe. Admittedly in 1961 its anxieties were much less acute than they later became.... But in 1966, with ... a vastly enhanced awareness of the risks involved for the currency, it was unable to dissuade the Government from accepting a determined rejection of the devaluation option with a decision to renew the Market application. The Treasury knights were powerless to prevent the adoption of what they knew to be a hopelessly contradictory strategy. [55]

The Bank of England exercised no more power during this period than did the Treasury. On the two decisions where it had a profound interest, namely non-devaluation and the EC applications, the Bank played a peripheral role. Although the Bank strongly supported EC membership 'neither the Tory government in 1961 nor the Labour government in 1966, lost a nights' sleep about the view of Threadneedle Street on Europe.' [56] Similarly, the Bank supported non-devaluation but did not exercise any influence over Wilson and Callaghan:

> At no time - either in 1964 or subsequently - did the Governor or the Bank do anything to stiffen the Government's resolve to defend the exchange rate.....At any time the Government could have cut the Gordian knot, and it is hard to see what the Bank could have done about it. [57]

Indeed, when the Bank of England subsequently found itself at odds with a Conservative Prime Minister and Chancellor over whether to float sterling, it was powerless:

> The Bank *did* resist the pressures to float, and continued to do so right up to the morning of the day the Chancellor's decision was announced. Its advice was simply brushed aside. [58]

Overall, the Prime Minister and Chancellor dominate economic policy-making within the core executive, particularly on issues of monetary and exchange rate management. They are generally autonomous both from the preferences of the Treasury and the Bank of England and from their Cabinet colleagues who tend to be involved only with issues of public expenditure since they affect all departments. [59] Nevertheless, the issue of ERM membership was a matter of EC as well as being an economic policy issue and here the distribution of influence within the core executive needs to be considered somewhat differently.

During the UK's application for EC entry and the early years of membership, both commentators and participants in the policy-making process believed that the Foreign Office was often the decisive actor. In their study, Bruce-Gardyne and Lawson conclude that the Foreign Office was more influential than ministers on the applications for EC membership. Every Foreign Office minister endorsed the Foreign Office strategy of applying for membership even though at least two took office resolutely opposed to it. In 1967, ministers almost instantly aligned themselves with the department's plans for renewal of the application when such plans were apparently doomed to failure.[60] Similarly, David Owen commented on the applications:

> Successive governments had allowed them [the FCO] too much leeway. The result was that these Foreign Office civil servants had been acting almost as politicians, making political concessions and judgements, working very closely with ministers and having great influence with ministers.'[61]

During his tenure in office, Tony Benn concluded:

> I think the Foreign Office's influence in Whitehall is now quite pernicious because the Foreign Office can properly claim that every bit of economic policy, industrial policy, social policy is now European policy and has to be fed through them.[62]

However, there are several reasons for believing that the Foreign Office is now less influential on EC policy than the Prime Minister, Foreign Secretary and Chancellor, particularly on an issue such as ERM, membership. First, whilst ministers' own electoral interests in the 1960s applications for Community membership were limited, this is no longer true. Since EC policy has become directly and indirectly significant in the party electoral conflict, ministers now have their own clear interests independent of the Foreign Office.[63]

Second, the Foreign Office has traditionally not been influential on international or European economic issues. On non-devaluation which was directly relevant to the applications for EC membership, the Foreign Office exercised no influence at all. When the government finally decided to devalue in 1967, the Foreign Office was not involved in any stage of the decision-making process.[64] Whilst the Foreign Office's expertise and involvement in international financial and economic policy has increased since the 1960s, it still lacks influence in this area.[65] Third, in foreign affairs generally and EC issues in particular, commentators have perceived a shift in authority towards the Prime Minister.[66] Jenkins and Sloman conclude that the Foreign Office's influence is now dependent on the closeness of the relationship between the Prime Minister and the Foreign Secretary.[67]

In sum, this thesis locates the core executive as the centre of decisional activity and places the Prime Minister, Chancellor and Foreign Secretary as the key policy actors. It is the interests and interactions of these three ministers which define the space in which the other institutions of the core executive operate. Nevertheless, a core executive model is an insufficient framework in itself for a decisional study. It simply describes the structures of decision-making without providing any theoretical understanding of how the actual decisional behaviour of core executive actors should be analysed. The remainder of this chapter is concerned with substantiating the particular core executive model outlined with an appropriate analytical framework of this kind.

Theories of Decision-Making

Three broad categories of traditional theorising about decision-making and economic policy-making in particular can be distinguished: aggregate neo-Marxist accounts of the relationship between the state and capital; specific models of economic policy-making which stress either ideology or a political-business cycle in the case of rational choice theorists; and new institutionalist accounts which concentrate on actors as representatives of institutional interests. The following discussion considers the appropriateness of each of these theoretical framework to the core executive model developed and the particular policy area under investigation.

Neo-Marxism and the City

Neo-Marxists argue that the behaviour of state officials cannot ultimately be separated from either the long term interests of the capitalist class or continuing capitalist social arrangements. Most neo-Marxist analysis on the UK has stressed that state actors have consistently served a particular faction of capital.[68] For example, Longstreth states:

> The state can be and in the case of Britain has been dominated by a particular fraction of the dominant class, which by no means exercises power in the general interest of the dominant class taken as a whole. Their interests have generally although not exclusively 'been the guiding thread for economic policy.'[69]

Similarly, Aaronovitch declares:

> By and large, government in Britain has been concerned with maintaining finance capital and its capitalist basis..... Finance capital is not some 'lobby' outside the political system, but is built into its foundation.[70]

In his analysis of the crisis facing capitalism in the UK, Anderson argues that the City is 'the most sectionally decisive single determinant of the shape of the economy.'[71] For Nairn, the City has been the primary force behind economic policy both in securing its positive interests and in precluding outcomes beneficial to industrial interests.[72]

These authors have stressed that the City is a particularly powerful influence within the state on exchange rate policy. For example, Longstreth builds his case for City power on the return to the Gold Standard in 1926, the emergence of the sterling area and the defence of sterling in the 1960s. In Coates' view:

> It cannot be said that City interests prevailed in total; on the debit side must go credit policies which show a true Keynesian hostility to the rentier. Governments have persistently intervened in favour of domestic and industrial borrowers, with the result that for a large part of the post-war period real interest rates have been negative. Yet this, and the persistence of exchange controls until 1979, cannot obscure the fact that the steadfast determination of both Labour and Conservative governments to maintain the exchange rate of sterling until the early 1970s, at the cost of heavy internal deflation, reflected systematic and consistent City pressure. Nor can it obscure the fact that the decision to follow that by seeking entry to the EC occurred at

the very time when the City was replacing its own dependence on sterling with an equally international preoccupation with the Eurodollar. What is striking about these policies is not only their congruence with the interests of key sections of the City, but their centrality to the whole of economic life. It was not just that the City exercised an influence beyond its numbers. It exercised an influence where it mattered most, on the whole basic framework of government policy as a whole.[73]

Nairn, Coates and Longstreth all argue that City power has at least partially resulted from the permeation of the Treasury and the Bank of England with City interests and their dominance within the core executive. Longstreth sees further power stemming from the maintenance of the City's role in the economy which allows it to set the parameters of economic policy.[74] Meanwhile, Coates stresses the City's power to inflict sanctions through the gilt edged and foreign exchange markets.

Ingham offers a critique of this analysis without disputing that the state acts according to City interests. He argues that there is no necessary reason why the Bank of England and Treasury should preserve City interests. Rather, these institutions have their own independent interests which happen to coincide with those of the City. With ministers subservient to the Bank of England and the Treasury, any potential autonomy of the state from finance capital is lost. Whilst macro-economic policy is not determined by the interests of the City, it ultimately reflects those interests.

Overall, a neo-Marxist approach to this decisional study of UK economic policy-making would mean identifying the benefits and costs to the interests of the City of the different policy options open to ministers at all stages during the development of policy. The Prime Minister and Chancellor would not be treated as autonomous actors pursuing their own interests but as the representatives or reflectors of external interests.

For several reasons, such an approach would provide an inadequate theoretical framework for this decisional study. In general, neo-Marxists face a problem of providing a satisfactory account of why the state should either be permeated with the interests of the capitalist class or face a functional imperative to act to defend those interests. Certainly, the thesis that the UK state has been permeated by City interests relies on a deterministic account of the socialisation of interests. As Ingham recognises, the Treasury and the Bank of England were by their very nature likely to develop their own institutional interests. Although historically, the City did generally rely on the Bank of England to represent its interests within government, after 1945, the Bank distanced itself from the City. By the early 1980s, the interests of the Bank and the City were clearly divided. Most publicly, in 1982-1983 the Bank deserted the Stock Exchange in its campaign against regulation. As a result, the City turned towards bureaucratic forms of representation more akin to those between other organised interests and government.[75] As Sargent argues, the City entered a forum of interest representation in which it has traditionally been weak.[76]

Despite departing from the view that the interests of state actors and those of the City are necessarily linked, Ingham still assumes with the others that City interests are secured through the Treasury's and the Bank of England's domination of the core executive economic policy. However, even on the issue of the 1964-1967 non-devaluation which is typically cited by the neo-Marxists, the policy was sustained by the Prime Minister and Chancellor and not the Treasury and the Bank. If the policy reflected or was determined by City interests, then it is necessary to explain why these ministers should act on those interests. Yet as Stones argues, Wilson and Callaghan were pursuing their own party interests within structures defined by international financiers. The two ministers believed that Labour's fundamental macro-economic interest was in a high growth-high demand economy. However, the paucity of the UK's foreign exchange reserves made their situation inherently difficult. In order to maintain high domestic demand, the government had to preserve both the level of sterling reserves held by foreigners and the ability to borrow foreign exchange from abroad. Consequently, it faced a trade off. A devaluation in sterling would have been a stimulus to growth in terms of competitiveness. Yet it would also have jeopardised the government's ability to borrow without fierce conditions. Wilson and Callaghan judged that credit was more fundamental to their high growth-high demand strategy and that the sterling parity should be preserved.

Having taken this decision, the government then did what it considered necessary to maintain the parity and international liquidity. This did not mean that the government did everything possible to keep the City satisfied on a broad front. For example, the government refused to acquiesce to City pressure for cuts in public expenditure. At the same time, it successfully ignored the City's outright hostility to the *ad hoc* nature of its monetary policy, the introduction of new exchange controls and the Selective Employment Act. It was only in regard to direct threats to international liquidity that the government pursued policies which *omnes paribus* it would not have chosen. Overall, Stones demonstrates that the Labour government's sterling policy was not determined by City interests. The fact that the City benefited from the policy outcome on non-devaluation cannot be used as evidence that it exercised power over ministers. Rather, ministers defined a set of tactical interests in relation to the structures of the financial markets in accordance with their own fundamental strategic macro-economic interests.[77]

It is simply unsustainable to claim that the operation of the financial and exchange markets force ministers to act on City interests across a broad range of policies. Whilst the City does have general interests in regard to economic policy, these are not reflected in activity in the financial and exchange markets. Financial institutions and speculators enter the exchange markets not to communicate their interests to the state but to make a profit out of operating them. Of course, the manner in which that profit is made - uncontrolled buying and selling of currencies - has very significant consequences for UK governments seeking to manage an open economy. Yet it does not and cannot in itself translate City interests into particular policy outcomes. Rather, governments must decide how they respond to the costs imposed by a rapidly falling or rising currency given their own interests. Even if the choices which a government makes in that situation coincide with the preferences of the City, this does not prove that a determinant power relationship exists. To suggest otherwise is to commit what Dowding terms the blame fallacy in which anything less than optimum outcome for one actor must be the consequence of an act of power by another actor.[78]

In sum, a neo-Marxist account of the development of ERM policy would face two main problems. It could account neither for the autonomy of the Prime Minister, Chancellor and Foreign Secretary from other institutions in the core executive nor explain why these three actors were being forced to act according to any other interests than their own given constraints.

Ideology and the Political Business Cycle

Most non-aggregate work on economic policy decision-making falls into two loose categories. The first incorporating rational choice approaches assumes that ministers decide policy according to a political-business cycle seeking to deliver benefits closely in line with the preferences of sufficient myopic voters to win re-election. In the run-up to an election, the policy will be broadly reflationary. After re-election governments will revert to a deflationary policy to mop up the inflationary consequences of the pre-election boom.

Within the approach, analysts disagree as to what governments want to deliver to voters. Nordhaus builds his analysis around the Phillips Curve to suggest that the aim of pre-election expansion is specifically to achieve a full level of employment.[79] For Tufte, governments aim to produce both a fall in unemployment and a rise in real disposable incomes.[80] By contrast, Mosely argues that governments do not target a key economic electoral asset. Rather, the government seeks to correct policy in any particular area which the government perceives as in a crisis. The only overall economic interest of governments is to maintain a stable policy configuration, implementing changes only to steer the economy out of crisis.[81]

The second approach suggests that ministers will decide on economic policy according to their ideological preferences and those of their constituencies. For example, those such as Stewart who argue that British politics is governed by 'adversary party' conflict, see ministers taking decisions according to their overall party ideology.[82] From a comparative approach again using a Phillips curve model, Hibbs concludes that governments pursue macro-economic policies broadly in accordance with the objective economic interests and subjective preferences of their class-defined core political constituencies. Consequently, social democratic governments put a far higher priority on full employment and 'bourgeois' governments on the containment of inflation.[83] Cowart drew similar conclusions from a comparative analysis of both monetary and fiscal policy.[84] In his analysis of the impact of party government on the levels of public expenditure, Castles argues that strong parties of the right are not interested in expansion whilst social democratic and other parties generally seek to provide it. This divergence reflects parties' respective ideological preferences for lesser or greater state activity structured by cleavages dating from the extension of the suffrage.[85]

The problem with both broad approaches is that they have neither stood up to rigorous empirical testing nor are they entirely satisfactory in theoretical terms.[86]Theoretically variants of both approaches incorporate a Phillips curve model into their analysis, postulating a trade-off between inflation and employment. However, the growth in importance of monetary policy since the 1970s has made this link dubious. At the same time, both accounts are too heavily focused on the ultimate ends of policy, particularly unemployment and inflation. As a result, they have little to say about governments' interests in relation to the means by which those ends are reached. Both economic ideological preferences and to an even greater extent expressed voter preferences are preferences for broad ends. By contrast, macro-economic policy concerns choices about means. Once this is accepted, it becomes a highly dubious proposition to suggest, for example, that ministers seek to accommodate voters' preferences on whether inflation should be controlled by monetary or fiscal policy. In terms of this decisional study, a further problem arises. With their focus on narrow economic options, neither approach can easily accommodate the EC and foreign policy dimension to the ERM membership issue.

New Institutionalism

New institutionalist accounts suggest that institutions shape individual actors' behaviour in very extensive ways. Individuals essentially follow institutional rules and routines rather than making carefully worked-through choices or rationalistic decisions on a case by case basis. When new issues arise, actors primarily process them by classifying the issue in terms of previous organisational experiences and the collective historical memory of institutions. Rules and norms exist because they are the best means by which both individual and collective actors can avoid disorder and potential chaos. As a result, the logic of institutional action is one of appropriateness so that actors respond to situations with the most appropriate action given prevailing rules and the consequences for institutional stability.[87]

In a decisional study of ERM membership, a new institutionalist approach must focus on the major organisational locations, the Treasury, the Bank of England, the Foreign Office and possibly Downing Street and the Cabinet Office. In addition, a full-flown institutionalist account might regard Parliament and the major parties as important institutional settings. Attention would then focus on the ways in which these organisations developed distinctive procedures for scanning and processing information, understanding the external environment, making decisions and explaining/advocating their policy to other organisations.[88] Individuals would appear in this kind of story as representatives of their institution, bearers of its roles and perceptions and culture, more than as autonomous sources of intentionality. In terms of outcomes, we should expect to see ERM policy changing only very gradually, and in response to long-run adaptions in the positions of the relevant actors.

Such an approach would have severe limitations for this decisional study. First, whilst the Prime Minister, Chancellor and Foreign Secretary have been shown to be generally autonomous from institutions in the core executive on economic policy, a new institutionalist account would subsume these actors back into the Treasury, Foreign Office and Bank of England. Whilst institutional actors may indeed have an interest in maintaining historical practice and institutional stability, the Prime Minister, Chancellor and Foreign Secretary operate in an electoral arena and will define their interests accordingly. Consequently, any new institutionalist account of UK economic policy-making will be radically incomplete: it will explain only the ballpark in which the game is played and some of the enduring rules but not the strategies adopted by the central actors or the eventual policy outcomes which result.

Second, the new institutionalist framework for analysing decision-making does not fit well with the unique macro-economic policy-making environment. New institutionalists suggest that policy change is gradual and driven by changes within institutions themselves. However, economic policy has traditionally changed very rapidly as changing economic conditions and the volatility of foreign exchange markets have instantly transformed policy choices. This does not mean that institutional actors will not develop preferences for certain kinds of policy approaches over others (see pp 34-35 for a discussion of this in particular relation to the Treasury, Foreign Office and Bank of England). Rather, particular institutional preferences will consistently be redefined within a dynamic and unpredictable policy-making environment.

1.3 A RATIONAL ACTOR FRAMEWORK

Given the limitations of existing theoretical approaches to decision-making for the core executive model outlined in Section 1.2, it is necessary to develop a specific analytical framework of behaviour for this particular study. The following discussion sets out a 'thick' rational actor framework in which the behaviour of the Prime Minister, Chancellor and Foreign Secretary will be analysed in Chapters 2-6. A 'thick rational actor account may sound somewhat contradictory but it denotes a descriptively rich approach to understanding how actors behave by showing the premises and motivations which underlay their decisions. Policy actions adopted by actors can be seen as rational in these terms, if they maximise actors' benefits, net of costs, subject to constraints. We 'understand' actors' behaviour when we can construct an account in these terms of causes which are commensurate with the effects we need to explain.[89] In terms of the issue of ERM membership, this means that there are three key aspects to the framework, namely that the ministers will have interests in economic policy, EC policy and in relation to capital accumulation which will impact on their consideration of policy. The question for this discussion is, how should we conceptualise each of these interests?

Economic Policy Interests

Despite the specific limitations of the rational choice political business cycle approach to understanding politicians' decisional behaviour in economic policy, it has considerable general utility in postulating a clear set of interests for ministers, namely re-election.The assumption that governments maximise their chances of re-election as their fundamental aim is justified on several grounds. First, the attempt to win power through the electoral system is what distinguishes political parties from other political organisations. It would seem reasonable then to define the interests of their elite actors in relation to that activity. Second, the nature of the UK political system intensifies what is the logical preference of any set of ministers to hold onto power. Since there are no alternative sources of power to control of the House of Commons in the form of an effective second chamber or regional government, governments which do not secure re-election are left with nothing.[90] Third, it is widely accepted that macro-economic outcomes and considerations are significant determinants of general elections. With the electorate so sensitive to a government's economic performance, it would be very strange if governments did not consider the electoral consequences of economic policy options. Fourth, by allowing the Prime Minister to select the election date, the UK political system gives full scope to managing economic policy in an electoral cycle. However, as Dunleavy recognises, accepting the primacy of electoral interests does not mean that governments will exclusively pursue preference-accommodating policies or strategies. Rather it is quite logically and empirically reasonable to believe that ministers can use their political power to shape preferences to their own advantage.[91]

Indeed, governments have the scope to pursue electoral objectives in economic policy beyond preference accommodation. In their study of economic policy making, Grant and Nath argue that voters' view of the relative importance of different economic issues changes over time and that governments have engineered that change. Indeed governments are able to affect voters' perception of what is and is not possible regarding certain economic variables. As a result they attempt to ensure that they are judged on the main economic variable which they said was important on entering office.[92]

In itself, preference accommodation may have adverse electoral consequences for a governing party. The electorate's perception of governments is by no means solely dependent on their assessment of the relationship between their policy preferences, however those preferences are shaped, and the government's policy performance. Rather, the electorate's perception of a government's general competence is also important. Governments are likely to suffer electorally if they pursue policies which cause serious public divisions either in ministerial ranks or in the parliamentary party. Voters will react against muddle and conflict whatever their views on actual policy. In addition, a government's electoral interests will deter them from policies likely to involve problems of effective implementation. Such problems will arise when a government has conflictual relations with those institutions or groups on which it relies to execute particular policies. Again, the electorate may well react against its impression of weak government whatever its underlying policy preferences. As a result, governments are unlikely to chose from an open ended series of policy options. Certain policies may therefore be ruled out neither on ideological grounds nor because they fail to accommodate sufficient preferences on the immediate policy issue.

In sum, the analysis of the thesis is based on the assumption that ministers do not have fixed interests in economic policy. Rather, their behaviour has to be analysed within the context of a range of considerations defined by the electoral cycle. First, ministers want to provide material benefits to sufficient voters particularly in the run-up to a general election. Alternatively, they may look to strengthen the economic position of their political constituencies vis a vis other social and geographic groups. Second, ministers seek to deliver particular policy benefits on which they have, or can at least plausibly claim to have, a comparative advantage over opposition parties. Third, they have an interest in delivering an economic policy package to the electorate which can be sold effectively by the rhetorical political language they have adopted. Fourth, ministers are interested in pursuing policies which they can implement effectively and do not pose problems of party management. Finally, ministers' economic policy interests are not independent from their position in other policy areas.

By postulating a collective electoral interest for ministers, it is still possible to account for divisions between them. At a simple level, ministers will disagree over the best short and long term means to achieve that end whether it be the electorate's likely response to particular policy outcomes or issues of general credibility. More profound conflict will occur for example over fundamental assumptions of how the macro-economy works or assessments of the UK's position in the international economic and political system. Different beliefs about underlying economic relationships and structures will lead to different judgements about the relationships of both individual policies and series of policies to electoral ends. This is not to suggest that all rhetorical conflict between ministers can be simply reduced to a dispute over electoral strategy without regard to ideological disagreement. Rather, the resolution of conflict between ministers over specific policy decisions cannot be analysed without consideration of the relevant electoral yardsticks.

EC Policy

Analysis of the EC has increasingly recognised that the domestic politics of member states is a vital determinant of its policy making output.[93] As Bulmer argues:

> There is little value in examining member states' European policy in isolation from their other policies. European policy is conditioned by much the same set of factors which shape domestic policy.[94]

EC policy offers governments potential electoral benefits in terms of leadership and controlling resources. Yet the adversarial nature of UK party conflict and long standing political ambivalence towards EC membership means that opposition parties can potentially reap rewards from a government misjudging its European policy. Moreover, with EC membership serving as a cross-cutting party cleavage, governments' freedom of manoeuvre is often constrained by their own party if they want to avoid a problem of party management. As a result, governments are likely to have a strong interest in whether their overall policy stance strikes a pro- or anti-European tone, so that their policy choices centre around an isolationist or active dynamic.

In pursuing their EC objectives, governments have since 1975 been primarily concerned with the heads of government summits. Decision-making within this forum is dominated by a conflict between leaders acting as the champion of national interests, and mutual policy adjustment so as to resolve their domestic problems to their own advantage.[95] Typically, summits culminate in broad package deals over a range of issues. If a government wants to secure active resources from their EC policy, their interest is in finding what Helen Wallace's terms 'an acceptable package of resources and burdens.'[96] Without a deal, a government will present its position as an act of national defence. Consequently, the actions of the Prime Minister, Chancellor and Foreign Secretary in regard to any particular EC policy issue cannot be understood outside their objectives in regard to the full range of policy issues dealt with at EC level.

Capital Accumulation

Pluralists and elite theorists would argue that on an issue such as ERM membership ministerial behaviour could be understood simply in relation to their own interests in economic and EC policy. For example, in his analysis of UK economic policy-making, Grant offers an essentially pluralist analysis of the relationship between capital interests and policy outcomes. He sees no necessary reason why ministers should act in the interests of capital nor empirical evidence that they do. Nevertheless, like the neo-Marxists he believes that ministers' relationship with the City is distinctive from those with other sectors of capital.[97] The City has been particularly successful at taking its fundamental interests, such as self-regulation, out of the political process. Through the sanction of the financial and exchange markets, the City has an important but not determinant role in the decision-making process. Its influence is likely to be greatest at a time of economic crisis when governments assign priority to secure the confidence of domestic financial markets and institutions. [98]

Otherwise, Grant argues, capital in the UK is weak in relation to the state. Whilst it does possess certain second dimensional power to keep certain issues out of the political arena:

> Once a matter is subject to political decisions, the outcome for business is uncertain. This is not only because other interests come into play, but because business often has considerable difficulty in deciding what its interests are, and in having made such a choice, in choosing a strategy to pursue them.[99]

However, in stressing capital's weakness in terms of representation, Grant ignores the likely interactive relationship between ministers and capital interests. If the aim of macro-economic policy is to deliver particular outcomes in the real economy organised around capital, then governments have an interest in the general performance of capital. At the same time, since governments can affect the process of accumulation, they may develop an interest in the growth of particular forms of accumulation.

Certainly, selective intervention in the accumulation process offers ministers in general, and the Prime Minister and Chancellor in particular opportunities to pursue preference shaping strategies. Of the four broad strategies identified by Dunleavy, two are directly relevant. First, ministers can identify social locations or geographical areas where their support is concentrated and then systematically facilitate their growth. By contrast, growth in locations preponderantly supporting opposition parties can be discouraged. Second, even if the size of particular social groups is not altered, ministers may intervene to alter their relevant social and economic position in order to strengthen their party's support among a target category. Electoral benefit can accrue to governments by increasing the perception of advantage of particular social and economic groups vis a vis other such groups.[100] To achieve these ends governments can give financial assistance to investment in particular sectors of the economy through R&D partnerships and direct subsidies and grants. Alternatively, governments can assist selective sectors through the regulatory framework which is applied for business operations. They can create incentives for investment in particular geographical areas through special tax breaks and infrastructure expenditure. Such policies can add both to the absolute and relative prosperity of the groups who are dependent upon the economic performance of a geographical area and\or sector of the economy.

It is ministers own attitude towards accumulation which is likely to determine the impact of capital interests on policy outcomes. A government's interest in this regard will vary according to circumstance. The potential electoral gains of preference-shaping in the medium term have to be measured against the short term costs in terms of time and resources. Governments may chose not to intervene, or opt for limited intervention, or try to develop a systematic accumulation strategy to ensure a steady flow of material benefits to a potential electoral base.

If ministers do not have priorities in terms of capital accumulation, then they are unlikely to be constrained in their economic policy areas by the effects of different outcomes on particular sites of accumulation. By contrast, ministers who possess a fairly systematic accumulation strategy for particular groups of capital are more likely to consider the preferences of those capital groups in their policy choices. The pursuit of a particular intervention strategy may act as a self-imposed constraint on economic policy. This does not mean that ministers' interests in regard to the former will necessarily triumph over the latter. Rather, intervention strategies will create an additional cost-benefit analysis. Ministers face incentives to pursue particular policies and will embrace costs when they decide on policies which are detrimental to their favoured sites of accumulation. In sum, the analysis assumes that there is no uniform relationship between capital interests and economic policy outcomes. The impact of capital interests has to be understood in terms of ministers' own interests in capital accumulation and their place within a governments' overall electoral interests.

Institutional Actors

The behaviour of the Prime Minister, Chancellor and Foreign Secretary lies at the heart of this thesis. Nevertheless, the positions of other core executive actors are not ignored. Whilst the interests of ministerial actors are understood within the 'thick' rational actor framework described above, the position of institutional actors are considered within a broadly new institutionalist perspective. Although the Treasury, Foreign Office and the Bank are not necessarily able to act on what seems to officials an appropriate course of action given their particular rules and norms, in each case, broad institutional interests are apparent. The fundamental interest of all the institutions is in the avoidance of crisis and disruption in their core administrative activities. For the Foreign Office, this means stability in relations with the states with which the UK is most closely linked. The Bank of England's prime interest is in general stability in the exchange markets and the maintenance of routine and uncomplicated techniques of controlling money.

Whilst the Treasury has traditionally been characterised as an institution dedicated to the control of public expenditure, this is more an often appropriate outcome than a necessary interest in itself. [101]It is at least as plausible that the Treasury prefers fiscal restraint not in itself but so as to avoid the multi-faceted difficulties of raising funds to borrow. It is perhaps better to understand the Treasury as a small closed department which seeks to minimise dependent and potentially fraught relations with other departments and outside groups. Since there are economic policies which function as an automatic pilot and/or which do not involve detailed intervention in or association with units of production, these policies would be deemed more 'appropriate' than those which do not involve such difficulties. In general, appropriateness is defined in terms of Treasury autonomy.

1.4 ARGUMENT, METHODOLOGY AND ORGANISATION

The organisation of the thesis reflects the analytical framework described in this chapter. The analysis locates the core executive as the centre of decisional activity and places the Prime Minister, Chancellor and Foreign Secretary as the key policy actors. The decisional behaviour of these actors on ERM membership is discussed within a rational actor framework in which these actors are motivated by broad electoral considerations in regard to economic policy, EC policy and their capital accumulation priorities. The secondary roles of core institutional actors within the core executive are understood within a broadly new institutionalist perspective where what counts are institutional interests.

Chapters Two to Six eachbegin with an examination of the operation of the ERM during a particular period. This provides a clear yardstick for assessing the costs and benefits to the government of membership and non-membership at that time. The narrative then traces the development of the core executive's attitude towards membership chronologically, with particular emphasis given to those periods when ERM membership was actively discussed within the Prime Minister-Chancellor-Foreign Secretary triangle.

In considering these periods of decision-making, the aim is to reconstruct the choices facing the government given its range of possible interests on the issue and against this background to describe the core executive's subsequent activity. The specific objectives are threefold. First, I seek to assess the costs and benefits of ERM membership for the government in economic policy and in EC policy given the preferences of the Prime Minister, Chancellor and Foreign Secretary and the government's overall electoral position. In terms of economic policy, the analysis considers the effects of membership on the government's ability to pursue all three of its monetary and exchange rate and fiscal objectives. In terms of EC policy, the analysis identifies the government's overall aim given its domestic considerations and the impact of ERM non-membership and possible membership on its relations and bargaining power with other member states.

Second, I outline and examine the likely effects of ERM entry on particular capital groups and the efforts of those groups to influence policy. By examining the government's own attitude to capital accumulation priorities, it is possible to assess the likely effect of particular capital interests on policy outcomes. Third, I identify and explain the positions taken by and the interactions between the Prime Minister, the Chancellor, the Foreign Secretary, the Treasury, the Foreign Office, and the Bank of England, in the process analysing the terms and assumptions in which those actors saw the membership debate and related issues. Periods of core executive decision-making are systematically examined in roughly the same way. However, as the decision making process itself became less well defined and more *ad hoc*, this approach becomes more difficult and a less rigid structure is used.

Such a 'thick' rational actor approach to the key aspects of core executive decision-making does run into some potentially serious methodological problems and difficulties. The effort to make policy choices and changes understandable in these terms can easily degenerate into a rationalisation of events in which the ultimate message is no more than 'whatever is, is rational.' The problem for 'thick' rational actor accounts is especially serious in the case of ERM policy because there were multiple policy constraints and a constantly shifting background of relevant policy variables (such as international interest rates, flows of capital in the foreign exchange markets, domestic economic conditions, and the fluctuating fortunes of the ERM itself.) Despite the inherent push in Chapters Two to Six for a 'thick' rational account of the complex and multiple causation processes at work, the partially conditional character of this analytical narrative needs to be borne in mind. Consequently, in Chapter Seven, I step back from the detailed circumstances of this or that conjuncture and look instead at the broad sweep of policy and the fit between actors' interest and their behaviour over a longer period of time. This amounts to using a 'thin' rational actor model to provide a more critical insight into core executive decision-making, by suggesting that strong limits should be placed on the range of benefits, costs and constraints that are allowed to feature in social science explanation.

Methodology

The study is based on both published and non-published sources. The main published sources provide the basis for examining the ERM's operation and assessing the costs and benefits to the government of membership and non-membership at any particular time. Key sources were: a systematic examination of all coverage of the ERM membership issue in the *Financial Times,* the *Times* and the *Economist*; the general accounts of government economic policy from 1979-1990 given by major commentators; academic studies of the ERM and discussion of the Thatcher government; the relevant reports and minutes of evidence of the House of Commons and House of Lords select committees; the reports of international economic organisations such as the OECD; and, biographies and memoirs of involved political actors, particularly those of Nigel Lawson and Margaret Thatcher.

Of these sources the Lawson and Thatcher memoirs are the most problematic. Whilst both authors present their accounts as the authoritative record of the Thatcher governments, at times they offer directly contradictory analysis of ERM policy and related issues. In this thesis, neither memoirs are taken at face value. However, an important distinction is drawn between them. Whilst Lawson and Thatcher's interpretation of events can be jointly criticised, Lawson's offer a depth of detail about day-today policy-making on ERM membership and a general consistency strikingly absent in Thatcher's. The former Prime Minister's memoirs are generally top heavy on glamorous overseas trips and often ahistorical on ERM membership.[102] The thesis regularly draws upon Lawson's account of internal meetings within the core executive as at least a starting point for discussion even if it is subsequently challenged. By contrast, Thatcher's memoirs tend to be used only as an account of her own struggle with Lawson and as insight into her motives.

In addition, 26 non-attributable interviews were conducted with those involved in the decision-making process. (For a further discussion of the use of these interviews see Appendix I.) For the most part, the interviews are used in conjunction with Lawson's and Thatcher's memoirs to analyse the core executive operation itself. Used with due caution and cross-checked against other sources, they provide detail both of the processes by which decisions were made and the motivations and assumptions of the central actors.

ENDNOTES TO CHAPTER 1

(The last number in all endnotes is the page number/s.)

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CHAPTER 2
THE FIRST CONSERVATIVE GOVERNMENT AND ERM MEMBERSHIP

This chapter traces the evolution of the Conservatives' policy on ERM membership during their first term in office. Section 2.1 describes the operation of ERM during the whole period. Section 2.2 examines the government's handling of the issue from its entry into office in May 1979 to the first Prime Ministerial meeting on membership in October 1979. Section 2.3 analyses the brief discussions on ERM membership which took place in March 1980. The final section considers developments between June 1981 and the 1983 general election focusing on the choices which confronted core executive actors between October 1981 and January 1982.

2.1: ERM AS A DIRTY FLOAT[1]

Between 1979 and early 1983, the ERM operated as a 'dirty float' without any currency dominating the system on a permanent basis. In 1979-1980 balance of payment differentials were the primary determinants of currency movements which initially left the lira as the strongest currency. By contrast, the Deutschmark was often relatively weak due to a large German external deficit. Member states sought to maintain their currency parities by monetary policy adjustment. However, they made no effort to co-ordinate fiscal policy and accepted realignments of the parities when those parities came under serious pressure. The first realignment occurred in September 1979 six months after the system's birth when the Danish krone was devalued and the Deutschmark revalued. Two months later, the krone was devalued again.[1]

In February 1980, France and Germany agreed to postpone the creation of a European Monetary Fund and the use of the ecu as a reserve asset. D'Estaing and Schmidt partly blamed the UK's non-membership of

[1] The endnotes are organised so that the endnote at the end of each paragraph contains all the references for that paragraph unless there is a direct quote. In this case, all references before the quote are endnoted together, then the quote itself and finally all references after.

ERM for the decision but neither government saw any incentive for further institutional development. Nevertheless, after a year's operation, both the ERM states and commentators generally heralded the system a success. The European Commission reported that in a generally poor economic environment ERM was cutting exchange rate instability between EC states by two-thirds. Despite the two realignments of the krone, intra-Community exchange rates were more stable than at any time since 1972.[2]

In the summer of 1981, the ERM came under pressure from the meteoric rise of the dollar which began in November 1980 and continued through 1981 as a result of the Reagan administration's tight monetary policy and benign neglect of the exchange rate. The Deutschmark bore the brunt of the dollar's rise forcing the Bundesbank to raise its interest rates. With their currencies subsequently under pressure against the Deutschmark, the other ERM states ultimately followed suit. Whilst 1980 passed without any realignments, the lira was devalued twice in 1981, the French franc was devalued and the Deutschmark and guilder were revalued. The combination of high interest rates and the disruptive effects on trade of exchange rate instability threatened the fragile recovery of the EC economies from recession. Neither was there any likelihood of a change in American policy in view of the volume of the budget deficit and the size of the domestic market which allowed the USA to withstand a high dollar.[3]

As a result, in the latter half of 1981, the ERM states became increasingly enthusiastic about developing ERM further. In November 1981, the French Finance Minister Jacques Delors set out proposals for extending the use of the Ecu and defining an 'agreed zone' across the Atlantic in which the dollar would be maintained in a stable relation to other currencies within that zone. However, the ERM states were ultimately unable to agree to a dollar policy.[4]

By the end of 1982, the French franc, the lira, the krone and the Belgian and Luxembourg franc were all devalued and the Deutschmark and guilder revalued. Against this background of flexibility, overall European inflation rates remained high and differentials between the ERM's member states accelerated. Unlike a fixed exchange rate system, the ERM was not producing inflation convergence. Rather, with all the realignments occurring in the same direction as inflation it was preventing overshooting.[5]

2.2: CONSTRUCTIVE EUROPEANISM?

The Conservative party first became involved with the ERM issue in the aftermath of the Bremen Summit. In July 1978 after the summit, Thatcher condemned Callaghan in the House of Commons for standing outside of the mainstream of the EC on the issue. She insisted that there was no way out of the world recession by standing alone and that the British people were shocked to find themselves 'relegated to the European second division' having been 'the victors in Europe.'[6] However, the Conservative leadership themselves possessed no developed policy on the matter. By the start of October, Thatcher was expressing no clear view in the House of Commons and it was only during that month that the Shadow Cabinet began intensive talks on the subject. During their deliberations a group of twenty-seven Europhile Conservative MPs led by Julian Critchley signed a motion supporting the formation of EMS.[7]

On 15 November Geoffrey Howe led the Shadow Cabinet into supporting the principle of the proposed ERM not as an ideal but as a possible way forward.[8] However, the position did not secure unanimous support. John Biffen, shortly to return to the Shadow Cabinet after illness, declared that membership would be incompatible with a free market economy, money supply targeting, and reform of CAP. John Nott expressed similar views. He argued that priority should be given to the abolition of exchange controls and that without exchange controls the ERM would be unworkable.[9] Nevertheless, when Callaghan announced in the House of Commons on 6 December that the UK would not join the ERM, Thatcher declared, 'This is a sad day for Europe.' She charged that the Prime Minister was content to have 'Britain classified among the poorest and least influential countries' in the Community.[10] The attack was later renewed by

Francis Pym who argued that the UK's non-membership left it dangerously isolated in the EC. However, these criticisms of the government did not contain any implicit promise that a Conservative government would reverse the decision. Indeed, the 1979 general election Conservative manifesto did not mention the subject at all.[11]

Monetary Targets

The Conservative government came into office publicly committed to reducing inflation as its fundamental macro-economic objective. It would reduce inflation by controlling the growth of the money supply, as measured by the monetary aggregate, sterling M3 (£M3). Sterling M3 is a broadly defined monetary aggregate consisting of cash and current and deposit bank accounts of which the two main counterparts are bank lending and the Public Sector Borrowing Requirement (PSBR). The PSBR would be reduced by cutting public expenditure and bank lending would be controlled by using interest rate policy. In theory then the government wanted to direct both monetary and fiscal policy so as to reduce inflation. What the government renounced on the counter-inflationary front was an incomes policy, preferring to revert to free collective bargaining.[12]

In practice the government's policy as manifested in its first budget in June 1979 was more ambivalent. In terms of monetary policy, the government honoured its counter-inflationary commitment by tightening the £M3 range inherited from Labour and increasing interest rates by 2 per cent. It further reduced the volume of public spending in 1979-80 by £1.5 billion and set cash limits on expenditure to squeeze out another £1 billion.[13]

However, other aspects of policy were inflationary. First, the budget increased demand by a three per cent cut in the standard rate of income tax and a reduction in the top tax rate from 83 to 60 per cent. Second, the income tax cut was financed by increasing VAT from 7 per cent to 15 per cent which boosted the inflation rate figure for the next year by four per cent. Third, the government cut subsidies to nationalised industries which responded by raising their prices adding another 2.5 per cent to the inflation rate. Fourth, the government implemented the Clegg Commission recommendation on public sector pay awards which led to an increase of 25 per cent in the wage bill. Private sector claims correspondingly shot up.[14]

In terms of the exchange rate itself, the government simply left sterling to the market. Sterling swiftly appreciated responding to its new status as a petro-currency as the second oil price shock hit in 1979 and to the government's high interest rates. As a result, the exchange rate operated as a counter-inflationary bias in the government's stance.

As sterling appreciated further than the 2.25 per cent range allowed to ERM currencies, and the government made no effort to halt that appreciation, UK policy towards the exchange rate was incompatible with ERM membership. In addition, firm monetary targets and an exchange rate target would to a certain extent simply have been contradictory as objectives. The central bank intervention which is necessary to keep a currency within a fixed range means that money will enter and leave circulation according to the policy requirements of that objective. When a currency appreciates, its central bank will have to sell that currency and so add to that state's money supply, whatever the consequences for monetary growth. In 1977 the UK government wished to hold sterling below a rate of $1.70 to $1.75 whilst money supply targets were in use. However, the Bank of England's exchange market operations meant that £M3 overshot its target. As a result, the attempted ceiling on sterling was abandoned. Similarly, Switzerland temporarily abandoned monetary targets in 1978 to stop the Swiss franc rising too much.[15]

The conflict in policy objectives between money supply and exchange rate control was intensified by the policy instrument which the government chose to limit money supply growth. With bank lending an important component of £M3, £M3 could be controlled primarily either by interest rates or by some form of qualitative credit controls. Rationing credit in some fashion would have made it possible to reach some accommodation between strict monetary targets and ERM membership. Yet the government chose to rely on interest rates which prevented any simultaneous pursuit of both policies. During July some exchange controls were lifted and in October all remaining controls apart from those pertaining to Rhodesia were abolished. As a result, the corset which set a limit on the growth of banks' interest-bearing liabilities became redundant since banks could by-pass the controls by lending to UK customers from overseas subsidiaries. Interest rates were left as virtually the exclusive instrument of a monetary policy directed at a money supply target, whilst the ERM states used interest rates as the exclusive policy instrument of membership. By contrast, ERM membership would not have posed a problem for the UK in fiscal terms. Since the ERM was not working through fiscal adjustment or inflation convergence, there was no reason why the government's fiscal policy could not have been pursued inside ERM.[16]

No Accumulation Strategy

The government's priorities towards capital accumulation were ambivalent. Before 1979, both the manufacturing sector and the City declined relative to international competition without government taking any significant initiative to galvanise them. Whilst many believed that the UK was deindustrialising, it was not compensating in invisible earnings. Between 1970-1980, the UK's share of world trade was falling. Invisible earnings grew in volume by only 4 per cent over the decade compared with 16 per cent for its major Western competitors. One particular invisible earner losing competitiveness was the Stock Exchange. The only new area of growth was North Sea oil.[17]

The new Conservative government did not offer any alternative programme for accumulation. Rather, it looked to manufacturing industry to increase its international competitiveness. To this end, regional aid and, subsidies to ailing nationalised industries were cut and exchange controls were abolished. At the same time, there was no programme either to revitalise the City or to stimulate the service sector.[18]

Manufacturing industry would generally have benefitted from the lower exchange rate and interest rates that ERM membership would have brought in comparison to the policy that the government was pursuing.

Nevertheless, there was no pressure from industry for entry. In 1978, the CBI believed that membership would run the risk of leaving sterling overvalued and overall policy deflationary. However, by September 1979 sterling was far higher than it could have been inside ERM.[19]

The implications for the City of non-membership are more difficult to assess. In 1978 the Midland stood alone among the clearing banks in being completely opposed to the system. The other three considered that the time was not opportune for ERM because of the volatile monetary environment produced by the falling dollar. They argued that the UK should stand aside in the short term but make it clear that it would eventually participate. Whilst there were no City voices for membership during the Conservative's first four months in office, the City's support for the government's actual policy was muted. A high exchange rate and high interest rates benefitted some City firm; but other firms which were themselves dependent on borrowing or relied on manufacturing clients were disadvantaged. In addition, there was some general disaffection from the volatility which policy entailed.[20]

Budget Contributions

The UK's membership of the EC at this time was largely dominated by the issue of the fairness of the UK's large budgetary contributions. On taking office, the government signalled both a willingness to link the issue with other outstanding matters, and in contrast to the Labour government a general desire to be more *communitaire*. By August, the government made significant concessions over farm price rises, EC authority over industry subsidies, nuclear energy research and pollution. It also implicitly accepted that the EC states should have some special rights in regard to North Sea oil. On ERM itself, in June the government agreed to contribute 20 per cent of its gold and dollar reserves to the European Monetary Co-operation Fund in exchange for Ecus. The next month, the government dropped the Labour government's claim for an automatic interest rate subsidy if the UK were to join and accepted that this would depend on the UK's economic position on entry.[21]

The problem for the government in using ERM entry to improve its chances of securing a deal on the UK's budgetary contribution was that once sterling started to appreciate, none of the other EC member states were keen for sterling to enter. They believed that sterling's strength, especially as a petro-currency would disrupt the mechanism. France now actively preferred that the UK stay out of ERM and was at the same time the most reluctant to compromise over the budget. Meanwhile, the Thatcher government most wanted to engage Germany as an ally over the budget. However, the German government was most interested in gaining concessions over access to North Sea oil in view of the second oil price shock. By embracing an appreciating exchange rate as a counter-inflationary weapon, it was difficult for the UK government to use ERM membership as an instrument in its general European policy.[22]

Foreign Office Weakness

Within the core executive, the Foreign Office was most enthusiastic about the policy review. Senior officials were still convinced that membership made sense on economic and political grounds. They believed that if the UK were to adjust its economic policy, it would increase the chance of an early settlement on the budget. One diplomat commented that 'we would have had less of a battle over the Budget if we had been more accommodating on the ERM.'[23] A member of the European Secretariat at the Cabinet Office commented:

> Had we been a full participant in the ERM our general standing could have made our task on the budget that much easier. ... It would have reduced the antagonism. [24]

However, it was difficult for Foreign Office officials to make this case successfully to the Prime Minister and Chancellor. First, the officials did not receive the support of either the Foreign Secretary, Lord Carrington, or his ministerial team. Carrington identified Rhodesia as the fundamental problem facing the department, and he was not well-versed in the economic issues involved in ERM. Second, the Treasury dismissed the Foreign Office's case on the EC budget and was able to virtually exclude the

Foreign Office from the economic debate about membership which meant that its political argument lacked credibility. [25] According to a Foreign Office official:

> Although it [the FCO] has consistently had some very bright people on the economic side, who understand the issue as well as anybody else, the Foreign Office is perceived both in Number 10 and the Treasury and elsewhere in Whitehall, as sort of stepping outside of its own parish if it gets involved in financial and monetary discussions. And it is always quite difficult for the Foreign Office to influence that although they have had people who understand the issue just as clearly in economic terms as anybody else. It's part of the Whitehall one-upmanship. In the same way, the Foreign Office will tend to say to people, 'Oh, you don't understand the foreigner' and so on. The Treasury will always say to the Foreign Office: 'You don't really understand finance, you're amateurs dabbling in this game. We're the real professionals.'[26]

The Treasury remained firmly opposed to membership and was supported by the new Chancellor, Geoffrey Howe. To the case it made against membership in 1978, the Treasury now added that ERM entry would be incompatible with the money supply policy which the government wished to pursue. ERM was no longer simply undesirable but precluded by government policy. Neither did the Foreign Office find real support for its economic case at the Bank of England. Although the Governor of the Bank Gordon Richardson publicly expressed cautious support for the objectives of the ERM, in June he was not firmly committed to membership.[27] According to one Foreign Office official, Richardson was not prepared to 'put its [the Bank's] head very far "above the parapet" on the issue.'[28]

Overall, core executive actors engaged in little systematic discussion of the issue and the review was low key in tone. On 22 July, the government announced that the final decision on membership would be postponed from September until October or November. After rumours in the exchange markets from 14-17 September that the UK would enter by the end of the month, the government made it publicly clear a few days later that the UK would not be joining ERM. According to Thatcher, she then held a meeting in October with Richardson, Howe and other Cabinet officials to discuss the issue. They quickly agreed that ERM membership was not appropriate but devised a formula that the government would join the system when the 'time was right.'[29]

2.3: ERM RESURFACES

On 5 March 1980 Chancellor Schmidt told Thatcher that ERM membership could increase the UK's chance of securing a satisfactory budget deal and Thatcher reopened the question. In March 1980 sterling was continuing to rise steeply without the government taking action to curb the trend. At the same time, the government was putting the finishing touches to its Medium Term Financial Strategy (MTFS). It presented in the budget that month, and setting out a firm economic strategy for the rest of the Parliament. The aim was to control inflation by progressively reducing the rate of monetary growth measured by £M3 through cutting the PSBR over four financial years. The strategy attempted to concentrate both monetary and fiscal policy on the problem of inflation which rose from 10.3 per cent in May 1979 to 19.8 per cent in March 1980 following the 1979 budget. Monetary policy would be set according to £M3 growth and fiscal policy would remain tight so that any further cuts in taxation would be left to the future. There was no mention of an exchange rate objective.[30]

Overall, the government's monetary policy remained incompatible with ERM membership. Since monetary targets were so central to the design of the MTFS, it is difficult to conceive how the strategy could have been pursued inside ERM. With sterling already appreciating and the UK having the most favourable external deficit in the EC, sterling would probably have come under heavy upward pressure inside ERM. If as a result it was necessary to revalue sterling, then the ERM states would have had to revalue an inflationary currency which was just the kind of overshooting which they sought to avoid.

Schmidt and the Budget

The context of the government's European policy remained defined by the budget issue. At the Dublin Summit in December 1979 Thatcher's insistence on 'our money back' reduced the chances of a settlement within the immediate future. After the summit, the French press reported that France did not care whether the UK stayed in or left the Community. In 1979, Schmidt was the most sympathetic of the EC's leaders to the UK's case, but by the start of 1980 he felt that increased German security expenditure in the wake of the Afghanistan crisis placed the EC budget negotiations in a different perspective. Now, another summit loomed in Brussels at the end of March without sight of an agreement on the budget. At the same time, the economic advantages to the UK from EC membership were at their lowest since UK entry in 1973. Labour was starting to commit itself to withdrawal from the Community and could possibly make electoral gains from such a stance.[31]

Schmidt offered Thatcher a potential deal on the UK's budgetary contributions because he believed that sterling's participation in the ERM would balance the system and reduce the pressure on the Deutschmark as a reserve asset.[32] Nevertheless, in practice there was no clear trade off between ERM membership and a budget solution. Germany wanted concessions on a common energy policy as well as ERM in return for its support. Led by France, the other member states still believed that UK membership would be disruptive to the system and wanted different concessions. France saw progress on the budget as inexorably linked to a common lamb policy. Meanwhile, Denmark and Holland wanted an early agreement on a common fisheries policy rather than UK entry to ERM.[33] In sum, ERM membership offered limited benefit to the UK government's European policy objectives. There were no guarantees that membership would resolve the budget issue and allow the government to pursue the active European policy it initially envisaged. At the same time, the government's incentive to be more *communitaire* was diminishing.

The Bank Shifts

Whilst ERM resurfaced in the context of the government's European objectives, the Treasury remained firmly opposed to membership. The only significant shift in domestic opinion from 1979 was at the Bank of England and was based on economic policy considerations. Gordon Richardson and some of his senior officials wanted to replace the strict monetary targets of the MTFS which they opposed with ERM membership. In their opinion ERM membership would serve as a means to devalue sterling and restore industrial competitiveness, and make intra-European trade easier. [34]

However, other Bank officials remained firmly opposed to membership particularly in the domestic monetary division. Insiders argue that these officials saw ERM as eroding the active role which they enjoyed under the existing discretionary monetary regime. Nevertheless, their scepticism was somewhat irrelevant to the Bank's formal position in the core executive debate which was defined by Richardson. As one senior Bank official put it on an issue like ERM, 'In a way all that matters is what the Governor says'.[35]

For its part, the Foreign Office was unable to build on Schmidt's offer and influence Thatcher or Howe. Thatcher generally did not like trade-off bargaining on EC issues. One Foreign Office official commented: 'it was a constant difficulty to try and persuade her to see things that way... She would say that was typical Foreign Office stuff.'[36] On the budget, Thatcher appeared particularly reluctant to horse-trade, believing that the UK's case should be resolved on its own its merits. In addition, the cost to the government of Europeanising the ERM issue in terms of the Conservatives' macro-economic objectives was even greater than in 1979. As Thatcher told French television on 10 March, sterling's performance gave rise 'to very considerable difficulty.'[37] Richardson's support on ERM membership did not in itself constitute economic back-up to the Foreign Office's political arguments since, in part, he saw ERM as an alternative to the government's economic policy.

Despite a Prime-Ministerial meeting in March 1980 and some support for entry in the Cabinet, there is no evidence that either Thatcher or Howe ever seriously contemplated taking up Schmidt's offer. In her own words, Thatcher's view was that 'domestic monetary policy must remain paramount.'[38]Towards the end of March, Howe told a German financial magazine that the time was not ripe for membership because of sterling's volatility, the UK's high inflation rate and the possibility of further capital outflows following exchange control abolition. On 28 March, after another summit with Schmidt, Thatcher declared that control of the money supply must have priority. At the same time, she was articulating a different way forward in European policy. She told the House of Commons that the UK might withhold part of its EC payments if a satisfactory budget agreement was not reached. Such an action would have breached the Treaty of Rome but France's recently successful violation of EC law in banning UK lamb imports made this a more reasonable possibility than it otherwise would have been. At the same time, playing tough had the advantage of allowing the Conservatives to present themselves as the nationalist defender of UK interests within the Community and remove Labour's possible charge of pro-Europeanism.[39]

2.4: HOW CLOSE TO ENTRY?

By the summer of 1981 the government was displaying a new attitude towards the exchange rate and ERM membership resurfaced as an issue within the core executive. The first sign of an economic U-turn came in the previous year when in November 1980 the government cut interest rates from 16 to 14 per cent despite the fact that £M3 was rising rapidly. The cut came after the CBI promised the government a 'bare knuckle fight' over sterling's appreciation and ICI announced a third-quarter loss. It was a recognition that the strength of sterling was badly damaging industrial competitiveness and deepening the recession. The government proceeded to commission the Swiss economist Jurg Niehans to investigate the cause of sterling's appreciation. He concluded that sterling's rise was largely due to excessively high interest rates and that sterling's status as a petro-currency was responsible for only 20 per cent of the appreciation. If monetary policy was too tight, then the strict pursuit of the £M3 targets was the problem.[40]

The Niehans Report inspired the 1981 budget. The budget combined cuts in public expenditure and an increase in income tax with a 2 per cent cut in interest rates to 12 per cent. The aim was to use monetary policy to bring sterling down to stimulating growth and switching the emphasis of counter-inflationary strategy to fiscal policy. The government now accepted that the exchange rate did matter as a determinant of economic policy and sterling began to fall.[41]

By the summer of 1981, the government believed that sterling was falling too steeply, reacting not only to the lower level of UK interest rates but to the strength of the dollar. As a result, rising inflation seemed likely. The Bank of England intervened unsuccessfully to protect sterling. On 16 September, the government raised interest rates from 12 to 14 per cent and, then on 1 October by a further 2 per cent despite the risk of producing a secondary recession. As sterling stabilised, the government then reversed the increases in four half a per cent stages between 14 October and 22 January.[42]

Henceforth, it was evident that despite its claims to the contrary, the government was using a fairly narrow exchange rate target rather than a £M3 target as the basis of its monetary policy. Between October 1981 and October 1982, sterling averaged 88 to 92 on its effective index against other currencies and changes in interest rates clearly occurred within the context of sterling's performance. The government's attitude was determined both by its acceptance that exchange rate policy was important and its failure to run a successful policy around £M3. The money supply targets were never achieved, and by the end of 1981 the government could no longer offer the distorting effects of the corset abolition and the civil service strike as credible excuses. Although the government examined other possible monetary targets such as money GDP (GDP in current prices) and M0 (cash plus banks deposits with the Bank of England) as different methods of monetary control, it did not elevate them to the status previously held by £M3. The government's experiment with strict monetarism was over.[43]

ERM membership was now much more compatible with the government's apparent economic objectives. First, and most fundamentally, the government was committed to the general aim of exchange rate stability. Whilst the government was pursuing an exchange rate target based on sterling's effective index (which included its performance against non-

ERM currencies), ERM membership would not have required a significant shift in policy. Second, the government accepted in the 1981 budget that monetary and fiscal policy could be used for different purposes. In assigning the former to the exchange rate and the latter to controlling domestic expansion, it assigned them in the way most compatible with ERM membership. Third, in the autumn of 1981 sterling was falling against the dollar in the same way as the ERM currencies and the UK government responded in a similar way to the ERM states. Rather than the UK having singular interests as a petro-currency state, the new situation revealed certain shared interests between the UK and the ERM states.

At the same time, ERM membership offered the government positive benefits in achieving its objectives if the UK had joined. Sterling should have become established as a strong ERM currency because of the importance of balance of payment differentials within the system. Membership was likely to mean that sterling could be defended at a chosen rate with lower interest rates and with reserve intervention by the Bank supported by other ERM states.

Support for Industry

In terms of accumulation priorities, the government was now demonstrating a more positive and interventionist stance towards manufacturing industry. In making its U-Turn in economic policy, the government was at least partly motivated by a desire to alleviate the effects of sterling's appreciation in worsening manufacturing competitiveness. In the first quarter of 1981, the government gave financial assistance to British Leyland (BL) and International Computers Limited (ICL) respectively. When Patrick Jenkin took over from Keith Joseph at the Department of Trade and Industry (DTI) in September 1981, he developed a positive industrial policy without ever naming it as such. It involved actively promoting rationalisation and re-industrialisation in declining industries, help for small firms with loans, and support for innovation in sunrise high technology industries such as fibre optics and telecommunications.[44]

By the second half of 1981 ERM membership offered potential benefits to most of manufacturing industry. If membership could deliver a measure of exchange rate stability and lower interest rates, manufacturing industry stood to benefit. At the beginning of October, sterling was lower than at any time since the government came to office. Whilst the chemical industry, for example, wanted sterling to go lower, there was some consensus in industry that the exchange rate was tolerable. Even if industrialists did want a lower rate, the government was not prepared to allow sterling to fall (at least in the short term) and membership would have reduced the risk of a new appreciation in sterling. Nevertheless, the CBI remained opposed to UK entry to ERM.

EC Presidency

In July 1981 the UK assumed the Presidency of the European Community. At the same time, UK electoral politics was being transformed by the rise of the Alliance. The government now faced two opposition parties; one strongly committed to the EC at the same time as public opinion seemed to be shifting back towards maintaining EC membership and the other committed to withdrawal from the EC which remained the majority view of the electorate. After securing a temporary two year agreement on its European budgetary contributions in May 1980, the government was now enmeshed in a further dispute with the other member states over UK trading practices. Overall, although the government saw the UK Presidency of the Community as an opportunity to create goodwill with the other member states, it appeared quite content to avoid a final settlement on the budget issue so as to strike a nationalist chord with the electorate .[45]

Sterling's depreciation and the desire of the ERM states in 1981 to develop the system meant that the UK's non-membership of ERM was a more salient issue within the Community than in 1979-1980. In June the Commission President, Gaston Thorn, publicly called for the UK to enter ERM to help strengthen the EC zone against the dollar. Another commissioner, Christopher Tugendhat made a similar call three months later. More importantly, the other member states were now displaying a new interest in UK entry. In September, Delors reversed previous French antagonism on the issue when called on the UK to enter the ERM. A month later the Bundesbank chief, Karl Otto-Pöhl, argued that UK entry would protect sterling and was necessary for the system to develop. If the UK government wished to make an active effort to resolve its EC budgetary contributions, then there were considerable incentives for the UK to enter ERM.

Howe Moves

In June 1981, the influential Financial Secretary, Nigel Lawson, then third minister in line at the Treasury tried to initiate a new Whitehall debate on joining ERM. Lawson believed that membership was likely to operate as a more successful monetary discipline than the discredited monetary targets. According to one Treasury official, Lawson's attitude was that if the UK could not successfully run monetary targets as a counter-inflationary discipline, why not let the Bundesbank fight inflation and tie sterling to the Deutschmark?[46] In his memoirs, Lawson recalls that on 15 June, he sent a memo to Howe outlining his case:

> I have no doubt that ideally a straightforward monetary discipline is superior. But we are now getting onto that phase, which will become increasingly evident as the election approaches, when the political pressure for relaxation of monetary discipline will start to mount. This raises the question of whether, in practice, we may not be able to maintain a greater degree of effective financial discipline if we were to embrace the exchange rate discipline, for all its imperfections. ... Essentially what this would mean is tying the pound to the German mark. You will not be surprised to know that I have very mixed feelings about the course I have sketched out.[47]

In July and August, the press reported that the government was considering ERM membership again. However, at this stage, there is no evidence that Lawson's views were having a significant impact on either Howe or his senior officials. On 14 September Lawson joined the Cabinet as Secretary of State for Energy and was removed from the policy debate.[48] He left a final memo to Howe on the subject:

> [We are] receiving increasing evidence of the weakness of £M3 as a reliable proxy for underlying monetary conditions, without any greater confidence being able to be attached to any of the other

monetary aggregates. This clearly strengthens the case for moving over to an exchange rate discipline.[49]

Howe appeared to remain unconvinced, claiming to the press that sterling's depreciation did not alter its petro-currency status and that the other ERM states did not wish the UK to join.[50]

The reconsideration of policy was given its real impetus by the increase in interest rates on 16 September and 1 October to protect sterling and there is some evidence that Howe's position on ERM began to shift at this time. In his memoirs, Lawson suggests that no-one else at the Treasury, Howe or the officials, took up the case for ERM after he left. According to Lawson, Howe did not become a full supporter of ERM membership until he became Foreign Secretary. Similarly, Thatcher states in her memoirs that Howe was still opposed to membership in autumn 1981. Yet if Howe continued to oppose membership, it begs the question of why ERM membership remained on the agenda after Lawson's departure to Energy.[51] One official personally close to Howe commented:

> It was the overvaluation of the pound in 1980 and 1981 and Geoffrey Howe's experiences outside the ERM, when he had to put interest rates from 12 per cent, in the autumn just before the party conference, to 16 per cent in order to protect the pound as the pound had started to decline. [Why they wanted to do that I don't know because the pound was still far too high.] It was that that convinced him that stability of exchange rates was an aim that was worth pursuing in the ERM.[52]

In his only public pronouncement on the issue, Howe told the House of Commons on 11 November:

> The EMS question is a serious one which deserves careful consideration. Difficult questions are involved. As we have one of the major international currencies and because of our self-sufficiency in oil, the effects of world events on sterling tend to be diametrically opposite to their effects on other EMS currencies. However, with some prospect of increased stability in the price of oil, it is right that the question should be kept under constant review.
> ... One other message is clear. Whether sterling is pegged to some other currency or currencies, or whether we simply continue to regard the exchange rate as one of the factors to be taken into account in the conduct of monetary policy, if we try to borrow too much we

cannot avoid putting up interest rates.[53]

The extent to which the Permanent Secretary at the Treasury, Sir Douglas Wass shared in the development of Howe's views is difficult to assess. Certainly, some time before he retired at the start of 1983 he dropped his earlier opposition to membership without becoming an active supporter of ERM entry. He came to believe that the system was durable, the provisions for realignments were being used, and that without strict monetary targets, UK policy was no longer fundamentally incompatible with ERM membership. However, this changed situation did not make entry imperative. According to one Treasury official Wass did not believe 'we were losing much by not being in.'[54]

Meanwhile, the other two most senior Treasury officials, Sir Kenneth Couzens and the Chief Economic Adviser, Terence Burns remained firmly opposed to membership as did lower level policy staff. The Treasury's overseas finance division which was most directly concerned with the issue, maintained a comprehensive critique of membership. They still believed that sterling was a petro-currency. They judged that the current strength of the Deutschmark in ERM would produce short-term instability and make it costly for the UK to tie sterling to the Bundesbank's monetary policy. They considered that at some stage a further depreciation in sterling was necessary to assist competitiveness, and this devaluation could be better achieved outside ERM. In addition, they were sceptical of the Bank of England's ability to intervene effectively on the scale required to maintain an ERM parity. Finally they believed that the government could successfully pursue exchange rate stability whilst avoiding the inflexibility of setting another public target which could become a hostage to fortune.[55]

At the same time, it is clear that the Treasury did not want to publicly admit that a policy compatible with ERM membership was already being pursued. The Bank of England was not allowed in its press releases on changes to interest rates to even mention the exchange rate as a supporting reason for the action.[56] Eleven years later one Treasury official declared that the policy pursued from autumn 1981 was not centred on the exchange rate but involved 'looking at all the dials' from monetary aggregates to the exchange rate.[57] Even to itself, the Treasury was reluctant to admit the failure of monetary targeting. In the words of one senior official:

> [Even by 1983], I don't think the exchange rate had become the dominant factor. There was still a great deal of lip service being paid to £M3 and the MTFS was still the article of faith.[58]

Another official commented that the Treasury very much wanted to believe that the monetary targets would come right in the end.[59] In combination with their view that sterling was a currency with singular interests, civil servants consequently did not connect the stable exchange rate policy they were indeed pursuing with ERM membership.

Foreign Office officials still supported ERM entry, particularly given the UK's Presidency of the EC. However, The Foreign Office remained in a weak position in the debate in two respects. First, by the second half of 1981 Foreign Office officials believed that Thatcher 'tended to discount Foreign Office advice completely.'[60] In 1980, Thatcher 'resented the feeling she was being pushed around by the Foreign Office' to settle on Rhodesia and became guarded in her relations with the department.[61] In the words of one Foreign Office official:

> There is no doubt that the Foreign Office were a kind of bunch of demons who were trying to sell Britain down the river at all occasions and with great enthusiasm. She became extremely attached to and respected the advice of individual senior Foreign Office people. ... I can think of a whole number of individuals whose advice she profoundly respected. I don't say she took it always. But she respected them and liked them and recognised that these were people of quality. But once they became submerged in the 'Foreign Office' they became highly suspect and basically insidious agents for foreign powers.[62]

Second, whatever the Treasury's doubts about non-membership, the Treasury still claimed ERM as its exclusive domain and appears to have kept the Foreign Office away from its thinking. A Foreign Office official commented: 'I never saw any sign that the Treasury or the Prime Minister were seriously interested in making a move.'[63] The Treasury's attitude fitted in with a long pattern of behaviour. According to one Foreign Office official, when the UK joined the EC the Treasury considered that nobody outside their ranks should have any view on matters affecting the Treasury. 'It was always the Treasury which was reluctant to share their thoughts with the Permanent Representative at the Foreign Office; that was still persisting in the early 1980s.'[64] Without an effective inside briefing on UK economic policy, both the Foreign Office and the UK's Permanent Office in Brussels were in a weak position to make a joint European and economic policy argument for ERM entry.

Neither was the Foreign Office in a position to make a strong alliance with Richardson and his supporters at the Bank. The Foreign Office's relations with the Bank on such issues were very informal. In the words of one official, 'the Treasury regarded the Bank as their usurer.'[65] As a result, the Foreign Office believed that there was little chance of successfully pressing their case and were now pre-occupied with finding a solution to the EC Budget issue in isolation from other problems:

> [Our attitude was] let's not waste too much time trying to persuade the Treasury and the Prime Minister that we ought to be in this thing. Let's go on with the [EC] budget and leave it till later.[66]

Outside the core executive, sections of the Conservative Party began to put pressure on the government to enter ERM. In July, Conservative Euro-MPs called for membership. After the Cabinet reshuffle of 1981, two of the ministers sacked, Ian Gilmour and Lord Soames came out in favour of entry. Gilmour argued for membership as part of a general package of reflation and Soames that entry was necessary to provide industry with exchange rate stability and to provide discipline in the economy. Meanwhile, Edward Heath called for the UK to enter the ERM so that a fortress could be built around EC money and capital markets to prevent vast capital outflows to the United States.[67]

By December, a certain momentum appeared to be developing towards membership. On 7 December, the Financial Times reported that the Cabinet was 'inching towards membership in the Spring' although the final decision was yet to be made. A senior minister previously opposed to membership told the Financial Times that membership was now 'probable.'[68] According to one policy-maker, at the beginning of 1982, the core executive was working to a date for entry which the government got within ten days of reaching.[69]

Thatcher slams the door

Whatever provisional decisions were made, presumably by Howe, on 22 January 1982 Thatcher held a full Prime Ministerial meeting on membership. Having minuted Thatcher on the issue through the autumn, Alan Walters, the Prime Minister's personal economic adviser, now prepared Thatcher's brief for the meeting. Walters was well known as a fierce opponent of pegged exchange rates in general and of ERM in particular. His brief attacked the system on several grounds. ERM produced overvaluation of its currencies. It depended on undemocratic leadership by the Bundesbank. It required exchange controls to work. In addition, it was inflationary because Germany was allowed to spread its inflationary costs, and high inflation states ended up with lower real interest rates than low inflation states.[70]

The meeting itself was attended by Thatcher, Howe, Lord Carrington, Douglas Wass, Alan Walters, Gordon Richardson and his deputy, Kit MacMahon. By common consent among those who have commented on the meeting, Richardson and MacMahon expressed strong support for ERM entry. They believed that stability for sterling was important in itself and that the ERM provided the best framework for using the exchange rate as a monetary discipline.[71] However, despite the Foreign Office's position Lord Carrington's did not offer them support. According to one source:

> I think that the Foreign Office was pretty keen. I'm not sure that Peter Carrington was keen. The Foreign Office was claiming that if we joinedthe ERM, the budget issue would be resolved. ... We'd find that the French and Germans were much more amenable to all Britain's suggestions and so on, a big list of wonderful results. I remember Peter Carrington said: 'And that's what my advisers tell me, but I don't believe a word of it.' [72]

Geoffrey Howe's contribution to the meeting is a matter of dispute. According to Lawson, who admits that he did not know of the meeting until some time afterwards, Howe did not argue for membership:

> At the [January] 1982 meeting, he could see the attraction but was worried that the ERM might conflict with domestic monetary policy. He also sympathised with industry's view that the prevailing exchange rate [of around DM4.30] was too high a level at which to join. His most percipient objection [from the viewpoint of the committed European he always was] was that people might be turned off the whole EC ideal if the ERM were, rightly or wrongly, held responsible for high British interest rates.[73]

Similarly, Thatcher states that Howe believed that the time was still not right for membership.[74] However, at least one participant in the meeting stated that to the contrary, Howe argued the case for entry with 'modest enthusiasm.'[75] This recollection fits with the suggestion that Howe's views on ERM began to change in the autumn of 1981 and that some initial provisional Treasury decision about membership was taken before the meeting. Another interviewee recalled that after Thatcher left office she told him that Howe had 'started hankering after membership as early as 1982.'[76]

Whatever the nature of Howe's advice, Thatcher remained implacably opposed to membership. According to Lawson, Thatcher summed up by declaring that she was not convinced of the advantages of ERM, did not want to lose the existing 'freedom of manoeuvre' and that the case would be stronger once UK inflation and interest rates were closer to German level.[77] One participant commented that 'She destroyed the Bank's case.'[78] In the words of another:

> She really slammed the door seven or eight times. The arguments were very much in her mind as to why we should not join. ... The door was slammed and that was it.[79]

Thatcher herself comments:

> I said that I was not convinced that there would be solid advantage in joining the ERM. I did not believe that in practice it would provide an effective discipline on our economic management. Rather, it removed our freedom of manoeuvre. I accepted, however, that when

our inflation and interest rates moved much closer to those of West Germany the case for joining would be more powerful. For the time being, we would maintain our existing position on the issue.[80]

Thatcher's opposition to membership can perhaps best be understood in terms of the particular economic electoral benefits which continuing non-membership offered. First, membership would have constituted a very public repudiation of the previous £M3 policy and Thatcher wanted to be seen as the resolute leader who was 'not for turning.' Although the government was already pursuing an exchange rate policy, neither Thatcher nor the Treasury had any interest in proclaiming the fact given the political significance attached to the Medium Term Financial Strategy. This government was supposed to be distinguished from previous governments by its willingness to stick to an articulated economic plan whatever the short term cost not by its U-Turns. So, in these terms, a disguised exchange rate target was more beneficial than ERM membership.

Second, Thatcher's claim for freedom of manoeuvre outside ERM made some sense in terms of the government's electoral position. Autumn 1981 represented the lowest point in the government's political fortunes between 1979 and 1983. On the economic front, the rise in interest rates risked a secondary recession, inflation was predicted to rise again, unemployment was heading towards the three million mark and the PSBR was way above target for the year. Correspondingly, between September and December 1981, there was a steep fall in the government's already weak position in the opinion polls culminating in a Conservative poll nadir of less than 20 per cent in December. During this period the government also lost two by-elections in Croydon and Crosby to the Alliance, and commentators concluded that the government was heading for a huge electoral defeat. By the time, Thatcher decided not to enter the ERM, the government was recovering some ground but still stood below 25 per cent in the opinion polls.[81]

In trying to reverse the situation and win the election, the government faced conflicting imperatives. On the one hand, it needed to reduce inflation since its credibility was fundamentally tied to inflation rather than unemployment (which the government successfully blamed on external forces.) On the other hand, ministers wanted to stimulate some kind of recovery through manufacturing industry with tangible benefits for voters. The crucial question was whether the government could afford to tighten fiscal policy again if inflation was to rise given the need for an economic upturn. If the government was not prepared to raise taxes or cut expenditure, then some other policy instrument would have to be assigned to the task. With an incomes policy and credit controls already repudiated. ERM membership would have cost the government the opportunity to use an appreciation in sterling as a deflationary policy weapon. By contrast, non-membership left the government with the discretion if they wished to use interest rates for counter-inflationary purposes within their own commitment to an exchange rate policy. At the same time, non-membership offered the government the opportunity of devaluing to recapture competitiveness and stimulate the economy once inflation was under control. Outside ERM, the government possessed the freedom to allow sterling to appreciate when necessary for its own purposes without obligations to others.

ERM as a Non-Issue

In practice, the government did not need the counter-inflationary discretion which non-membership offered because inflation began to fall. From 12 per cent in January 1982, it fell to 4.5 per cent by the end of the year. This decline was due to the lagged effect of the government's deflationary policy in 1979-1981 and a fall in world commodity prices. Consequently, the government was able to pursue its effective exchange rate target for sterling and to significantly reduce interest rates without having to pursue restrictive policies elsewhere. Indeed, the bias of the government's policy was now firmly expansionary. In July 1982, it abolished hire purchase controls which boosted consumer spending. Then, in the 1982 Autumn Statement, the government exhorted local authorities and nationalised industries to meet their capital spending targets.[82]

In November with inflation falling, the Chancellor initiated an internal debate about whether there was scope for a devaluation in sterling to boost competitiveness. Despite the economic stimulus provided through 1982, the government did not believe that sufficient recovery was taking place with demand rising faster than output. The Autumn Statement forecast a zero balance of payments surplus at the existing exchange rate in 1983 despite the huge positive contribution of oil. However, when the exchange markets learned of the debate, sterling fell steeply. The Bank of England quickly spent 10 per cent of the UK's foreign exchange reserves in intervention but it was not sufficient to protect sterling. The government was unwilling to countenance a further devaluation in this way and the Chancellor raised interest rates by 1 per cent on 26 November and a further 1 per cent on 12 January. [83]

In deciding against the devaluation option, the government chose not to use part of the freedom of manoeuvre which non-membership gave them. By continuing to pursue a stable exchange rate policy backed by monetary policy, the government embraced the costs of membership, namely a managed higher rate for sterling, and the costs of non-membership in a unilateral loss of the reserves and probably higher interest rates. However, the costs of non-membership in these circumstances were not great enough to force a re-examination of the ERM issue. Following the Falklands victory in June 1982, the government was now in a strong position in the polls and planning an election in 1983 so there was no incentive to make any major policy changes. [84]

Nor did the government face an imperative from its European policy to re-examine ERM at the end of 1982. The government's EC relations reached a nadir in May 1982 when the other member states overrode the UK's veto on farm price increases, the first failure of a national veto since the 1965 Luxembourg Compromise. Afterwards, the government looked to repair relations, without reaching a deal on the budget or reconsidering ERM membership. Although the European Commission became increasingly exasperated by the UK's non-membership, the other member states did not exert the kind of pressure on the government to enter ERM which they did towards the end of 1981.[85]

Conclusions

In 1979 and 1980, the Conservative government had some incentive to re-examine the UK's non-membership of ERM to further its objectives in European policy. However, during this period, ERM membership would have put paid to the government's economic strategy. At the same time, non-membership did not impose any costs on the government in terms of its relations with the capital groups it wished to support. By June 1983, the government was left with an economic policy which it could have pursued inside ERM but at Thatcher's insistence was now pursuing it alone in tandem with an isolationist EC policy.

Despite non-entry, the terms of the new core-executive debate on ERM membership as macro-economic policy which emerged between 1979 and 1983 were highly significant. The debate centred around the question of whether monetary targets or exchange rate stability were the best means of using monetary policy as a counter-inflationary discipline. It was the failure of the former policy in the form of the MTFS which underlay the position of both those who opposed and supported membership. The opponents of ERM were in part simply unwilling to admit or accept the failure of the MTFS as terminal. Meanwhile, ERM supporters either never really believed in the MTFS (Gordon Richardson and other Bank of England officials); or they believed that after the failure of monetary targeting, ERM membership represented an alternative counter-inflationary *monetary* framework (Lawson and Howe). Lawson, for example, conceived of ERM membership as means of pursuing exchange rate stability through a disciplined interest rate policy to reduce inflation. Similarly, Richardson argued at the Prime Ministerial meeting in January 1982 that ERM would be beneficial in stopping sterling from depreciating and inflation from rising. These actors judged the advantages of UK entry to ERM as if sterling would enter either a relatively fixed rate system or at least UK monetary policy would be operated as if this were the case ignoring the ERM's flexibility.

They believed that what monetary targets could not deliver as a counter-inflationary monetary discipline, could be achieved through exchange rate stability and ERM membership. This view stood in direct contrast to the more flexible benefits that ERM membership actually offered currencies at this time.

Despite the prospect of a new Conservative term in office and the possibility that offered for policy renewal, it appeared likely that the core executive ERM debate would remain within the terms of reference induced by the MTFS. By June 1983, senior officials uncommitted to the MTFS had either left their post or were soon to depart. They were replaced with people for whom the MTFS represented a greater personal investment. At the Treasury, Douglas Wass retired in April 1983 and Peter Middleton took over as Permanent Secretary. Wass was always sceptical about the money supply policy whereas Middleton was consummately involved with the development of the MTFS, despite his more junior position at the time. Indeed, Thatcher supported Middleton's promotion over more likely candidates precisely because of the commitment he showed to the MTFS. At the Bank, Thatcher did not renew Gordon Richardson's term as Governor of the Bank of England. She was angry at his apparent failure to achieve the MTFS monetary targets and wanted a more like-minded Governor. In July 1983 Robin Leigh-Pemberton took over at the Bank. Although he supported ERM entry in his previous position as Chairman of National Westminster Bank, his lack of central banking experience meant that at least in the short term he was unlikely to either challenge Thatcher or the intellectual assumptions of the Treasury. As a result, the way was open for a return to some form of monetary targets policy. If that were to fail, then ERM membership was likely to be re-discussed as an alternative within the same terms as in 1981 and 1982.

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62. Non-attributable interview with Foreign Office official.

63. Non-attributable interview with Foreign Office official.

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This account of Carrington repudiating his brief is also told as a dateless anecdote in J. Bruce-Gardyne, (1986) *Ministers and Mandarins: Inside the Whitehall Village*, London: Macmillan, 61:

'Lord Carrington, equipped with a cast-iron Foreign Office presentation in favour of immediate British accession to the European ERM, and knowing that his Prime Minister would not touch it with a bargepole, read it out with due solemnity, and concluded that Prime Minster, is what I was told to say, and it seems to me a load of rubbish.'

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74. Thatcher, *Downing Street Years*,693.

75. Non-attributable interview.

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CHAPTER 3
THE STERLING CRISIS AND THATCHER'S VETO

This chapter examines the development of policy from the Conservative party's June 1983 election victory to the end of 1985. The crucial developments on ERM membership in this period took place after a sterling crisis in January 1985. To understand these developments, it is first necessary to consider both the operation of the ERM itself (3.1) and the government's macro-economic policy and the views on ERM membership in the core executive prior to the sterling crisis (3.2).

3.1 A COUNTER-INFLATIONARY ERM

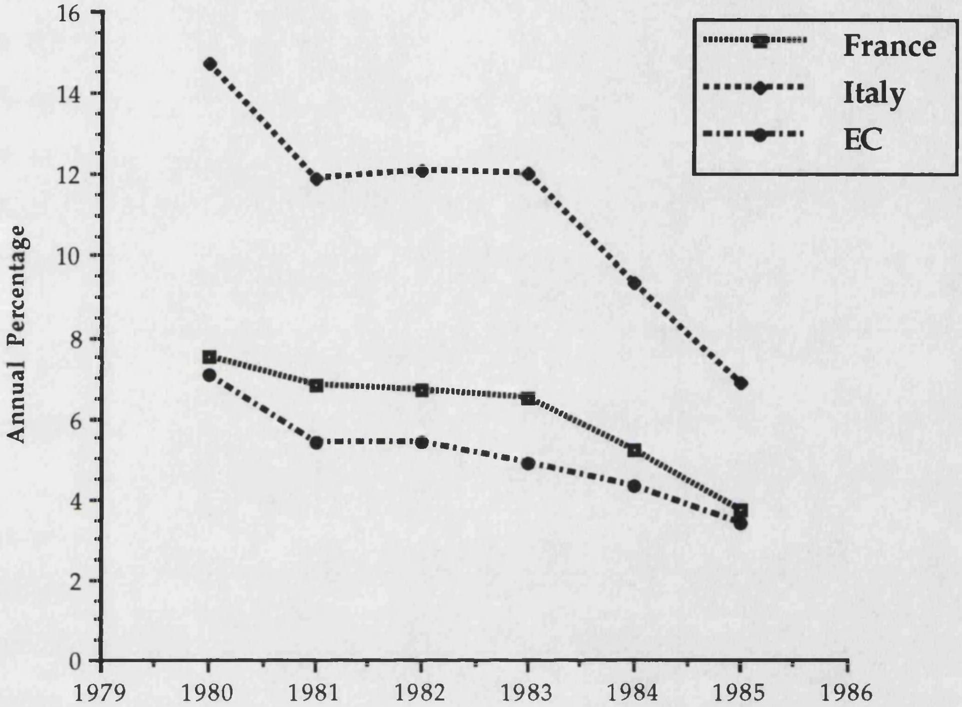
Between March 1983 and June 1985, there were no realignments of ERM currencies. Indeed, by 1985 the ERM was akin to a relatively fixed exchange rate system after operating more as a 'dirty float' between 1979 and 1983. In July 1985, the lira was devalued but the devaluation was not interpreted as a sign of weakness in the new order. Although the realignment coincided with a bout of dollar weakness which was previously the achilles heel of the system, the adjustment was actually caused by the pressure of the Italian budget deficit on the lira. At the same time, there were none of the acrimonious disputes over the terms of the devaluation which characterised previous realignments.[1]

The ERM now contained a counter-inflationary bias, both in monetary and fiscal terms. In monetary terms, the bias operated through German leadership of the system. Rather than the relatively neutral divergent indicator demonstrating currencies position within the exchange grid, the Deutschmark was now the anchor currency of the system. The Bundesbank set its monetary policy to fit its counter-inflationary objectives and the other ERM states adjusted their monetary policy accordingly. A rise in German interest rates usually meant that the other states would also raise their rates so as to maintain a premium over German rates, and with it the parity of their currencies against the Deutschmark. Similarly, in terms of intervention by central banks, the emphasis shifted from obligatory intervention in the fluctuations margins signalled by the divergent indicator to 'intra-marginal' intervention in Deutschmarks. By intra-marginal intervention, states aimed to act before currencies came under so much pressure in the fluctuation margins that speculators possessed a one way option on the direction of a currency's future movement. [2]

In fiscal terms, the member states were now prepared use restrictive fiscal policies to defend parities, rather than resort to devaluation when those parities came under pressure. As early as 1981, Italy and Ireland started to make more rigorous efforts to reduce their budget deficits and allowed their currencies to appreciate in real terms to reduce inflation. Then in March 1983 the French socialist government abandoned its efforts at unilateral expansion and embarked on a policy of fiscal adjustment to reduce inflation.

The socialist government came into power in 1981 committed to reducing unemployment by increasing public expenditure. However, with its competitors reducing demand to combat inflation, France soon faced a massive balance of payments crisis which put pressure on the franc. Devaluation in October 1981 and June 1982 accompanied by some mild deflationary measures failed to avert the pressure. By March 1983, Mitterrand faced the choice of withdrawing from ERM and pursuing a neo-protectionist policy, or retaining membership and acceding to German demands for further and drastic public expenditure cuts. Despite internal opposition, Mitterrand chose the latter option. The franc was devalued by 2.5 per cent and the Deutschmark revalued by 5.5 per cent and the France drew up a fiscal austerity plan to reduce inflation.[3]

Figure 3.1: Comparative Inflation Differentials with Germany 1980-1985



(Source: Economic Outlook)

As figure 3.1 indicates, the new deflationary bias in policy produced a gradual convergence in inflation among the ERM states towards German levels. Whereas in 1980, German inflation was 5.8 per cent compared to an EC average of 12.9 per cent, in 1985, German inflation was 2.1 per cent compared to an EC rate of 4.3 per cent. Overall, the ERM states were gaining a new long term credibility in the counter-inflationary process through their individual and collective unwillingness to accommodate inflationary pressure through devaluation.

3.2: A SLEEPING ISSUE

After the 1983 general election, Geoffrey Howe went to the Foreign Office and Nigel Lawson became Chancellor of the Exchequer. On taking office, Lawson quickly initiated a Treasury review of monetary policy in collaboration with the Bank of England. As part of the review, Sir Geoffrey Littler, the new Second Permanent Secretary and Head of Overseas Finance, wrote a paper assessing the value of ERM membership as a monetary framework. He argued that France was demonstrating that ERM membership could bring considerable benefits. The UK should look to join the ERM in 1984 on the conditions that the oil market remained stable, the UK and German economies continued to converge, progress was made on the negotiations on the EC budget, and that the dollar fell against the Deutschmark. However, neither Lawson nor Middleton and Burns were interested in Littler's proposal. Certainly, Littler was not typical of other senior Treasury officials. He long considered himself a European in a department in which such a conviction was rare and he had a strong background on the international side of policy.[4]

By contrast, Middleton and Burns had little experience of European finance ministers meetings. Along with Lawson, they were steeped in the intellectual culture of domestic monetary policy and the MTFS. All three used the policy review to try and find an operational framework for another money supply policy, rather than as a means of developing the implicit exchange rate policy which the government operated between 1981 and 1983.[5]

The Bank of England played a minimal role in the policy review. The Bank was in a period of transition since Leigh-Pemberton was new to central banking. Kit MacMahon, the Deputy Governor, was in effective charge at Threadneedle Street but he had poor relations with Lawson. Consequently, whilst both Leigh-Pemberton and MacMahon favoured membership, neither were in a position to lend support to Littler's proposal.[6]

After rejecting ERM membership, the problem for Lawson was to decide upon which money aggregate to target in the wake of the previous failure of £M3. After a debate on the respective merits of £M3, MO, M2, (money available for transaction purposes) Non-Interest Bearing M1 (cash plus non-interest bearing deposits withdrawable on demand) and Monetary

Base Control (targeting banks' reserves with the Bank of England), Lawson tentatively concluded that MO 'could have a more important part in monitoring monetary conditions.' In the 1984 budget, Lawson announced five year monetary targets for both £M3 and MO as part of his effort to rekindle monetarism.[7]

In practice, from July 1983 to the end of 1984, the government did not consistently run monetary policy according to the monetary targets any more than between 1981 and 1983. In the year from June 1983, the government reduced interest rates and allowed sterling to depreciate. When sterling began to slide more rapidly against the dollar towards $1.30 in July 1984, Lawson raised interest rates twice. Such action suggested that the government was keen to loosen monetary policy to try and stimulate growth but that it was also not prepared to ignore the exchange rate.[8]

After July 1984, the government changed to a policy of benign neglect. When sterling fell below $1.20 in November, the government cut interest rates to 9.5 per cent. It appears that the cut was driven neither by the performance of MO nor by the exchange rate but the desire both to stimulate an economy threatened by the miners strike and to create an environment conducive to the success of the British Telecom share issue.[9]

By the end of 1984, the financial markets were unwilling to attach much credence to the MO target and the government was unwilling to exclude other considerations from monetary policy. Yet Lawson and the Treasury were not prepared to admit the failure.[10] In October 1984 Lawson declared in his Mansion House Speech:

> It is the monetary aggregates that are of central relevance in judging monetary conditions and determining interest rates. That has always been our policy and remains so. We take the exchange rate into account when its behaviour suggests that the domestic monetary indicators are giving a false reading, which they are not. Provided monetary conditions are kept under firm control, excessive movements whether in money or exchange markets in response to outside influences, will tend to correct themselves relatively quickly. [11]

However, as Lawson himself admits:

> This line was a fiction even when I uttered it, as the exchange rate played a much larger part in policy than I was prepared to admit in public. But there was genuine difficulty about any alternative presentation. ... The idea of giving weight to the exchange rate as a factor in monetary policy decisions, but not having an exchange rate target, was extremely hard to put across.[12]

Yet any suggestion that the exchange rate was the determinant factor in monetary policy was also a fiction in view of the loosening of policy at the end of 1984. Monetary policy and its presentation were riddled with inconsistency.

The government's aim in fiscal policy in 1983-1984 was to reduce both the PSBR and income tax without cuts in public expenditure, combined objectives made possible due to the additional revenue created by the privatisation programme. In the 1984 autumn statement, Lawson declared that tax cuts of £1.5 billion should be possible in the 1985 budget and that the government's aim was now to 'really get down to the business of reforming taxation.' In the remainder of 1984 Thatcher and Lawson used every opportunity to celebrate the likelihood of even greater tax cuts of £2-3 billion.[13]

In sum, by the end of 1984, the government's economic policy was totally incompatible with ERM membership. The Chancellor was not pursuing exchange rate stability and monetary policy was not clearly assigned to the exchange rate. The government conceived fiscal measures as ends in themselves, rather than seeing them in the counter-inflationary terms which characterised the fiscal polices of the ERM states. And acquiesence to the fall in sterling and a relatively loose monetary policy both suggested that the government's main priority was not inflation as ERM membership would demand.

ERM Stirrings

Having found his feet at the Bank of England and uneasy with the ambivalence of the government's monetary policy, Leigh-Pemberton publicly declared support for ERM membership in late October 1984. In a university lecture he cast doubt on the utility of monetary aggregates and argued that despite 'some technical difficulties' there were 'a number of attractions' to ERM membership.[14]

In addition to his long-standing personal judgment, Leigh-Pemberton's views reflected an increasing interest in ERM membership in financial circles. In August 1984 the Lloyds Bank Economic Bulletin argued that the UK should enter ERM since the fall in sterling in the previous month could have been avoided inside ERM. In November a prominent City broker went on the record in favour of ERM entry and a group of City bankers and economists published a report which highlighted the benefits of membership given that inflation was converging throughout the EC. They argued that sterling could no longer be considered a petro-currency.[15]

Leigh-Pemberton's growing willingness to assert himself on ERM membership coincided with Lawson and Howe tentatively re-examining the issue for themselves. During the Christmas and New Year break of 1984-1985, Lawson concluded that ERM membership was seriously worth considering. In his memoirs, Lawson states that his support for membership ran in a continuum from 1981 when he was Financial Secretary to 1985 and that he did not believe that the 'right opportunity' to persuade Thatcher arose until 1985.[16] However, one of his officials recalled that during the 1983 review of monetary policy, Lawson was 'rather dispassionate' about ERM. Only at the very end of 1984 and start of 1985 did he begin 'to see real positive merit' in entry.[17] Indeed, Lawson himself admits that problems in policy during this period contributed to his support for entry:

> I had become increasingly concerned both with the weakness of sterling and with the continuing problems I was having with the conduct and presentation of a domestically based monetary policy.[18]

In 1983 and the first half of 1984, ERM did not surface as an issue of EC policy. Despite continued wrangling over the UK's budgetary contributions, ERM membership was neither offered by the UK nor demanded by the other states as a means to advance negotiations. The other member states led by France and Italy demanded that the UK should acquiesce to a VAT rise as the price of a budget deal. For its part, the UK government preferred the threat of non-payment of its budget contribution to obtain its goal. In June 1984, at Fontainebleau, the EC finally reached a settlement on the issue without reference to ERM. The Cabinet now believed that non-payment would provoke a Conservative back-bench rebellion and did not want to be left behind as the other states pushed forward with a new agenda for integration. However, by autumn 1984 monetary co-operation was moving to the top of the EC's new agenda as some member-states sought new ways to strengthen the EC's economic performance in relation to the US and Japan. It was against this background in November that the European Commission and the German Finance Minister called for UK membership of ERM to improve monetary co-operation. As a result Howe, already convinced an economic case for ERM entry, concluded that if the UK stayed out of ERM, this stance was likely to assume a more direct salience in EC affairs in the future.[19]

In sum, at the start of 1985 the Chancellor, the Foreign Secretary and the Governor of Bank of England were all independently giving thought to the question of ERM membership. Within two weeks, a massive sterling crisis with very significant implications for the government's economic policy fortified their individual conviction and precipitated a new and broad debate on ERM within the core executive. To understand that debate, it is first necessary to examine the crisis and its implications.

3.3 THE STERLING CRISIS OF 1985

At the start of 1985, the dollar was rising against all currencies and sterling in particular. By the end of the first week of January, sterling was headed towards $1.15 without a floor in sight. In continuing its policy of benign neglect from the autumn, the government decided neither to intervene nor to raise interest rates. In public, ministers argued that sterling's fall was not due to its weakness but to the strength of the dollar and a fall in the price of oil. They also claimed that there was no inflationary risk attached to the fall since the rise in the price of imports would be offset by lower oil prices. On the basis of the government's actions and statements and a briefing from

Bernard Ingham, Thatcher's chief press officer, the *Sunday Times* ran a story on 6 January that Thatcher and Lawson were determined to maintain a hands off policy even if sterling fell to 1-1 parity against the dollar.[20]

As a result, sterling fell further. Thatcher and Lawson responded angrily. They were indeed practising benign neglect but they did not want the media to report policy in this way. To avoid a repetition of the story, they insisted that all future questions about sterling be referred to the Treasury. In fact, neither Thatcher nor Lawson were indifferent to sterling's depreciation, but they did not want to take action to stem it. Rather, they hoped that the publication of good £M3 figures on 8 January would convince the markets that there was nothing fundamentally wrong with the UK economy, and that the problem would then go away. However, when the £M3 figures were published, sterling continued to fall. Still, the government took no corrective action and declared that the fall did not matter. [21]

On Thursday 10 January, sterling fell further to $1.13 and lost four pfennigs against the Deutschmark despite the price of oil stabilising. Both the markets and financial commentators blamed sterling's fall on the government's unwillingness to demonstrate that it accepted the importance of a floor for sterling as a counter-inflationary discipline. The next morning, Lawson discarded benign neglect and raised interest rates by 1 per cent to 11.5 per cent. It was a recognition that monetary policy could not be divorced from the exchange rate in the circumstances. Moreover, in view of the fall in £M3, the rate increase demonstrated the irrelevance of the monetary targets as the guiding principle of monetary policy. [22]

The new policy was soon undermined by Bernard Ingham. During the afternoon of 11 January, Ingham told the lobby that foreign reserves would not be 'thrown' at sterling and that no particular rate was being defended. This view was in obvious direct contradiction to the morning's events. Ingham appeared to assume that having no formal exchange rate target, and the continued government resistance to large scale intervention on the markets were the same as government indifference about sterling.

With the exception of the *Observer*, the Sunday papers and the BBC all carried the Ingham line. The *Sunday Times* led with the headline, 'Thatcher ready to let one pound equal one dollar.' The effect of the interest rate rise was effectively wiped out and the government's commitment to sterling again was thrown into disarray. To try and avert the damage, the Treasury hauled government information officers out of their beds and into Whitehall to call around financial journalists to urge them to ignore the morning's newspapers.[23]

The Monday newspapers reported that the government would raise interest rates again to defend sterling. Ministers hoped that such an explicit commitment would avoid the need to actually raise rates. At the same time, Lawson ordered the Bank to intervene in the markets on a large scale. However, sterling continued to fall as the markets punished the government for its apparent indecisiveness. To demonstrate the strength of the commitment to sterling, Lawson told the Bank to reactivate the Minimum Lending Rates for the day to raise rates by a further 1.5 per cent. Lawson himself declared that inflation was now the overriding priority.[24] In the House of Commons on 13 January, Lawson went on to accept that confusion and ambiguity within the government itself was partly responsible for the crisis:

> I am afraid that there was a feeling in the markets that the government had lost their willingness and ability to control their affairs so as to maintain the downward pressure on inflation.[25]

During the remainder of the week, sterling steadied. At the same time, Thatcher persuaded President Reagan of the need to take some action to hold down the dollar. On 17 January, the G5 finance ministers announced an unprecedented agreement to act to together to stabilise exchange markets through intervention where necessary. It was the first time that the Reagan administration recognised that the dollar's rise was an international problem. However, in the following weeks, the US administration failed to match its words with actions. By contrast, the Bank of England joined other European and the Japanese central banks in co-ordinated action against the dollar. [26]

At home, the government continued to demonstrate its resolve to defend sterling. Thatcher and Lawson respectively declared that sterling was 'far too low' and that the dollar 'was grossly over valued.'[27] However, sterling continued to fall. On 28 January, after oil prices weakened and speculation against sterling increased, the government raised interest rates a further 2 per cent to 14 per cent. Lawson declared that speculation against sterling 'was greatly overdone' but the government would not 'run any risk of misapprehension as to our continuing resolve to conquer inflation.'[28]

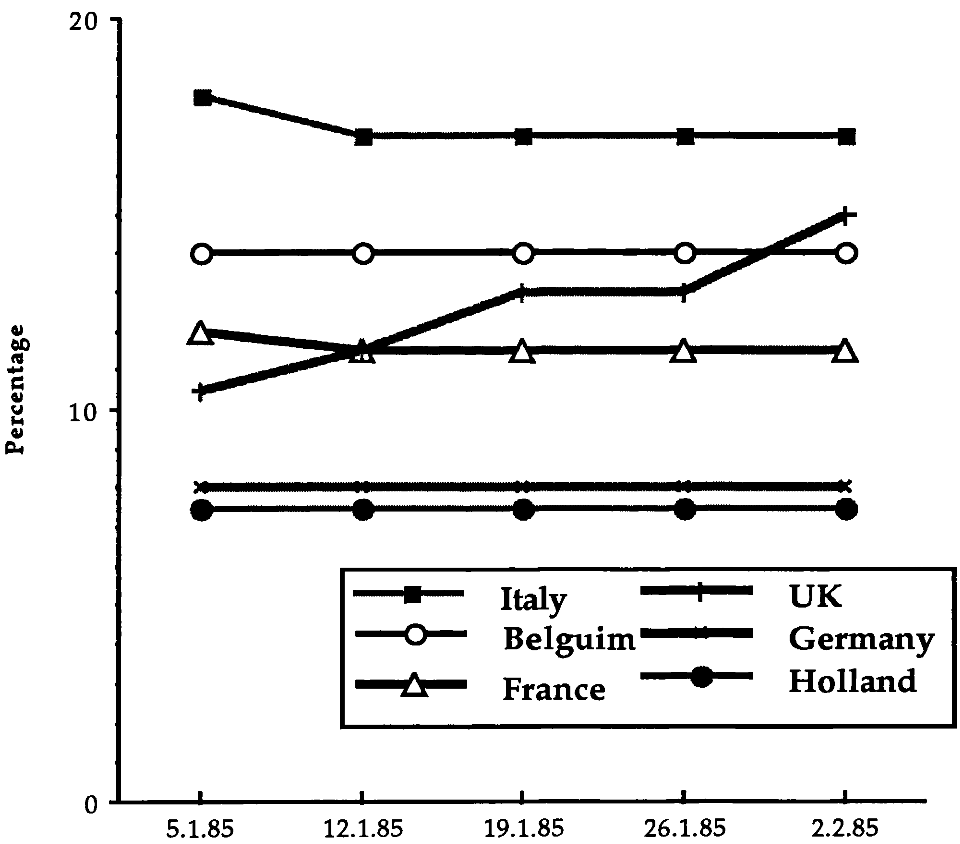
The Costs and Lessons of the Sterling Crisis

The sterling crisis was a defining moment for the second Conservative government because it completely exposed the previous inconsistency in both the practice and presentation of monetary policy. In just over a week, the government was forced to totally reverse its policy. After rejecting the idea of 'throwing' money at sterling, the government proceeded to broker an international agreement to 'throw' money against the dollar. The government moved from benign neglect towards sterling (and the inflationary consequences of sterling's depreciation) to place the exchange rate and the reduction of inflation at the centre of its economic strategy. If the MTFS was designed as a particular monetary means to reduce inflation which denied the importance of the exchange rate, then the sterling crisis vividly demonstrated that this proposition was untenable. A counter-inflationary framework could not exclude the exchange rate.

After raising interest rates by 4.5 per cent very obviously to defend sterling, the government could no longer credibly present monetary policy as determined by the monetary targets. In 1980-1981, the government was able to claim that the MTFS was being maintained at the same time that the policy was abandoned to manage sterling downwards. However, in the wake of the sterling crisis, no such an option for covering the end of the post-1983 MTFS existed. Not only was the exchange rate central to the government's monetary policy but it was essential that the government publicly present policy in these terms to the financial markets and media.

The crisis imposed significant political costs on the government. First, at a conservative estimate, £100 million was lost in reserve intervention.[29] Second, the UK was left with exceptionally high nominal and real interest rates. Real rates stood at almost ten per cent which was a serious blow to the government's efforts to stimulate growth. Although the dollar rose against all currencies during January, as figure 3.2 indicates only the UK government was forced to raise its interest rates. Indeed, France and Italy both cut their rates in the same period.[30]

Figure 3.2: Comparative Prime Lending Rates January-February 1985 (Prime Lending Rates are UK base rates plus one per cent)



(Source: Economist Economic Indicators: January and February 1985)

Third, after heralding tax reform and tax cuts of £2-3 billion for the 1985 budget, Lawson was forced to tell the House of Commons on 15 January that as a result of the sterling crisis the tax cuts were at risk and public expenditure cutbacks might be necessary. The crisis imposed a new fiscal constraint on the government. The City was suspicious that the government desire to cut taxes lay behind its benign neglect towards sterling because a depreciating pound increased oil revenues (since oil is priced in dollars). To maintain its counter-inflationary credibility in the markets, the government needed to renounce the tax-cutting option. At the same time, the increase in interest rates raised the cost of financing the national debt and limited the government's room for fiscal manoeuvre. The budget which Lawson eventually delivered in March 1985 was reduced to a series of supply side measures on national insurance and expanding the Youth Training Scheme without tax cuts or reforms.[31]

The lessons of the sterling crisis directly related to the issues which ERM sought to address. Primarily, the crisis rammed home the fact that no UK government could afford for the markets to believe that it did not have an opinion on the exchange rate. It was not sufficient for the government to have a private view on sterling. Rather, to deter excessive speculation it was necessary that the exchange markets be able to take for granted the government's commitment. At the same time the fiasco with Bernard Ingham's briefings demonstrated the cost of any ambiguity within the government itself. The Prime Minister, Chancellor and their officials and the Bank of England needed to speak with one voice on the subject.

In February the benefit of the government's new public commitment to an exchange rate policy was well demonstrated. The dollar continued to rise against all currencies including sterling. In one week, the dollar rose 3.5 per cent against other currencies, with the Deutschmark taking the brunt. On 25 February, the dollar climbed 1.5 per cent and sterling fell to a low of \$1.03. The Reagan administration appeared content to let the dollar rise and did not abide by the G5 agreement. At the end of the month, concerted and co-ordinated intervention by European central banks finally succeeded in pushing the dollar down.[32]

The significance of the episode was twofold. First, sterling fell to lower levels than during the January crisis without the government having to raise interest rates further, since the markets now believed that the government was committed to sterling. Second, despite the Deutschmark and other ERM currencies bearing the brunt of the dollar's rise in February, their depreciation did not result in the kind of crisis which befell sterling in January. The Bundesbank raised its Lombard rates by 0.5 per cent but not its base rate. Of the other ERM states, only Holland raised its base rates and, then, by just 1 per cent. The ultimate arbiter of the credibility of the ERM states was not their performance against the perennially volatile dollar. By contrast, with sterling falling 6 per cent against the dollar but only 1.8 per cent against the Deutschmark, the British government was severely punished for sterling's fall despite the decreasing importance of Atlantic trade to the UK.[33]

Initiation of Policy Review

Inside the core executive, ERM membership resurfaced early on in the sterling crisis. On 11 January, the day of the first interest rate hike, Lawson brought up the issue at an internal Treasury meeting with his senior officials and the Economic Secretary, Ian Stewart. In Lawson's view 'the case for buttressing the pound and firmly dispelling the increasing uncertainty over monetary policy was clear.'[34] Both Stewart and the senior Treasury officials, with the exception of Littler, remained opposed to membership. One senior official commented:

> Nigel Lawson decided he wanted to join for reasons that none of us were terribly clear about. It was almost as though having pursued a successful policy, he wanted to pursue an unsuccessful one for a spell.[35]

The meeting concluded with an agreement that officials would examine the mechanics of ERM membership and make contingency plans to increase the foreign exchange reserves. [36]

On 28 January Thatcher and Lawson met to discuss the final interest rate rise. Thatcher told her Chancellor that she had discussed the UK's currency turbulence with the right-wing Dutch Prime Minister, Ruud Lubbers. Lubbers suggested that the guilder was a more stable currency than sterling because of its membership of the ERM. On the basis of this conversation, Thatcher asked Lawson to examine whether in present circumstances, the UK should enter the ERM.[37]

For Leigh-Pemberton, the sterling crisis added vigour both to his belief that the government's monetary framework was confused and unsatisfactory and to his support for ERM membership. On 30 January he publicly stated that in his view, sterling might be suffering less from speculative attacks and would be easier to defend inside ERM. At the same time Leigh-Pemberton pressed for a new core executive debate on ERM. Meanwhile, on 3 February, in a bilateral meeting with Thatcher, Lawson suggested a Prime Ministerial seminar on the issue before the budget, to which Thatcher agreed. Lawson discussed the issue again with his officials on 8 February. He hoped to reach a quick agreement in principle, with a view to entering ERM in the summer.[38]

Outside the core executive, various sections of the Conservative party drew a connection between the sterling crisis and ERM membership. On 15 January Heath made the first of several calls for UK entry to help counter American dominance. On the same day, Henry Plumb, the leader of the Conservative MEPs, declared in the European Parliament that the effects of the fall in sterling would be less acute within ERM. He also made it clear that the Tory MEPs as a group would increase their pressure on the government to enter the system. In February, twenty-four backbench Conservative MPs led by Geoffrey Rippon signed a motion in the House of Commons calling on the government to enter ERM.[39]

The Prime Ministerial meeting itself took place on the 13 February and was attended by Thatcher, Lawson and his senior officials, Leigh-Pemberton and other Bank officials, Howe and John Redwood as Head of the Prime Minister's Policy Unit. Alan Walters, Thatcher's former economic adviser and now in the US, was invited but did not attend. Lawson, Howe and Pemberton all argued that membership would be beneficial. Although they believed that immediate entry was not appropriate, they concurred that within a fairly short time, it would be right to act. Thatcher showed less enthusiasm for membership and was also concerned that the exchange reserves were very low in comparison to the ERM states. Nevertheless, she agreed that once the reserves were increased, ERM membership could be reconsidered. [40]

The core executive now geared itself up for another review of policy within a few months. However, in public, Thatcher and Lawson denied the relevance of ERM membership to the sterling crisis. On 30 January, Lawson told the House of Commons that ERM membership would not have protected sterling. The next day, Thatcher declared that membership would not have prevented the interest rate hike and could make no difference to sterling's performance against the dollar. According to Thatcher, the government had its own financial discipline and did not want to forfeit its freedom of action. A month later, Thatcher insisted in the House of Commons that the crisis did not justify ERM entry.[41]

A Procession for Membership

The government was not alone in reconsidering its attitude towards ERM membership in the wake of the sterling crisis. In the preceding months, a succession of business groups, economic organisations and financial commentators came out in favour of ERM entry. On 20 February the CBI's policy-making body voted for the first time by an overwhelming majority to support ERM entry, and strongly recommended membership in its annual budget submission. The CBI believed that there was both an economic and political case for entry. In economic terms, the CBI's members disliked the existing level of exchange rate volatility. They invariably put exchange rate stability as the first item on sensitivity analysis in investment projects. Although firms were able to hedge against exchange rates in the short term, they saw no consolation in this over the long term. [42]

The sterling crisis brought the issue of currency volatility to a head for industry. Previously, firms valued exchange rate stability but believed that it could be better achieved outside than inside the ERM. Now, they believed that the UK was suffering from a uniquely damaging level of volatility. One CBI official commented on the sterling crisis:

> There was a surprising degree of unanimity, that if we were going to set up Britain on a proper basis, if British industry was going to be set up satisfactorily, we'd got to have something better than this.[43]

Kenneth Edwards, the Deputy Director General of the CBI told the Treasury and Civil Service Select Committee:

> There has been a marked change in their [CBI members] views recently and they are now strongly in favour of ERM membership. This has been based on a particular concern about exchange rate volatility for the last twelve months. It is at least arguable that full membership of the EMS or adoption of a complete exchange rate target might have enabled us to avoid the exchange rate crises of July 1984 and 1985. In the event we had the worst of both worlds - a combination of exchange rate volatility and interest rate volatility - so that must be seen as the background to the change in thinking.[44]

At the macro-level, the CBI believed that ERM membership could achieve the convergence of UK inflation towards the lowest EC levels which was necessary for the UK to participate successfully in the EC trading bloc. If the costs of UK companies went up faster than keeping the exchange rate in a relatively fixed parity would allow, then those companies would lose profits and decline. At the same time, the ERM would act as a counter-inflationary discipline on the government.[45] One CBI official said that 'the CBI had no confidence in the UK government's ability to manage our monetary affairs.'[46] In sum, the CBI believed that ERM membership could cure the UK's inflationary habits.

In political terms, the CBI's main concern was that UK business would not reap all the benefits of EC membership until the UK was a member of all its institutions. Kenneth Edwards told the Treasury and Civil Service Select Committee:

> We are desperately concerned that we are moving to a two-speed Europe situation, and there are a number of factors to which we can draw attention. First of all in regard to broader controls, we tend to be excluded from the internal marketing arrangements. In the case of standards, there is an agreement between West Germany and France

about the recognition of each others' standards over a particular band. There is also the question of the satellite broadcasting sector where the Germans and the French are getting together in the area of technical co-operation. We are outside that, as we are sitting outside the EMS. We believe that we are in danger of losing the advantage of being in the Community and I think that if you look at the experience of the large companies, they are very pre-occupied with that dimension of the problem. .... The EMS is another example of a two-speed Europe developing.[47]

The political concern was central to the CBI's case. In Edwards' view:

> It may be suggested that the economic arguments for entry into the ERM are finely balanced. Certainly, the CBI believes that, at worst, there is no economic disadvantage and at best the UK will secure significant economic benefits from full membership of the EMS. However, the political arguments seem to be overwhelmingly in favour. Real and significant progress, in areas of major importance to UK business, is not only possible but very likely if we join.[48]

By depreciating the currency, the sterling crisis also opened up the prospect of entry to ERM at a rate at which the CBI considered more competitive than when the organisation previously discussed the issue in October 1983. On the day that the CBI announced its support for membership, sterling stood at DM3.62. Certainly, some businesspeople in the CBI remained doubtful that industry could compete at this rate.[49] Edwards admitted to the Treasury and Civil Service Select Committee that 'many companies would like to see a different parity.'[50] Nevertheless, in the view of Terence Beckett, the CBI's Director General, 'exchange rate volatility was more serious to industry than the level of rates.[51]

Throughout 1985, Beckett, in the words of one CBI official, 'thumped the drum very hard about ERM'.[52] With other CBI officials Beckett continually stressed industry's view that membership was essential at the NEDC, at dinners with government ministers and in meetings with Conservative MPs. CBI representatives also directly brought up the issue with Thatcher and Lawson on several occasions, but neither displayed any interest in entry on these occasions.[53]

At the same time the sterling crisis increased support for membership in the City. For example, in March Lloyds of London called for entry. It argued that sterling's volatility with the dollar was causing problems to the insurance trade and that ERM membership would reduce the volatility. Generally, City institutions believed that the sterling crisis demonstrated an absence of counter-inflationary will in the government. They believed that politicians should be kept as far away from monetary policy as possible and that ERM membership was the best means to discipline governments. City institutions did not appear to lobby the government on the issue as much as the CBI. City interest groups tend to be weak and an organisation such as the British Bankers Association, for example, does not seek to organise a collective view on an issue like ERM. Rather, the individual institutions transmitted their views to the Bank of England to pass on to the Treasury.[54]

The general support expressed in 1985 by both financial and manufacturing capital was matched by a succession of economic organisations and financial commentators. In August the National Institute of Economic and Social Research said that membership would provide greater financial discipline. The London Chamber of Commerce argued that entry was necessary to stabilise sterling and to take full benefit from EC membership. In November, the London Business School called for membership to reduce exchange rate volatility. In the same month, the influential *Financial Times* commentator, Sam Brittan came out in favour of entry. During the sterling crisis, he scathingly rejected membership on the grounds that sterling was a volatile petro-currency. He now believed that ERM membership was the only way of injecting some credibility into counter-inflationary policy and restraining the Chancellor against fiscal expansion.[55]

The Institute of Directors (IoD) was perhaps the only significant economic organisation which did not support membership in 1985. John Hoskyns, the Director-General, believed that the ERM was 'absolute nonsense' and that the pursuit of exchange rate stability only induced more damaging instability elsewhere. His view was shared by the IoD's Policy Unit, if not its less influential European Advisory Council which tended to favour membership.[56]

However, despite the strength of Hoskyns' views, the IoD's position became compromised. In the summer of 1985, Geoffrey Howe asked Hoskyns if the IoD could write him a letter stating that in certain circumstances, membership might make sense. Hoskyns agreed as a personal favour to Howe. On 30 August the IoD sent Howe its assessment of the pros and cons of membership. Howe presented to the media the part of the letter which made the potential case for membership and ignored Hoskyns' argument that membership might be unsustainable and damaging to the domestic economy. On 4 September the press reported that Hoskyns believed that there were strong financial and political reasons for joining and that business would benefit from a more stable currency framework and the future development of the ECU. To all intents and purposes, it appeared that the IoD was another passenger on the ERM bandwagon against which the government's own review of policy took place.[57]

3.4 THATCHER'S VETO

The core executive debate on ERM membership precipitated in February 1985 reached its climax in November of the same year. The ensuing analysis sets out the implications of ERM entry at that time in terms of the government's economic objectives, capital accumulation priorities and EC policy. The discussion then traces developments within the core executive itself between February and November 1985.

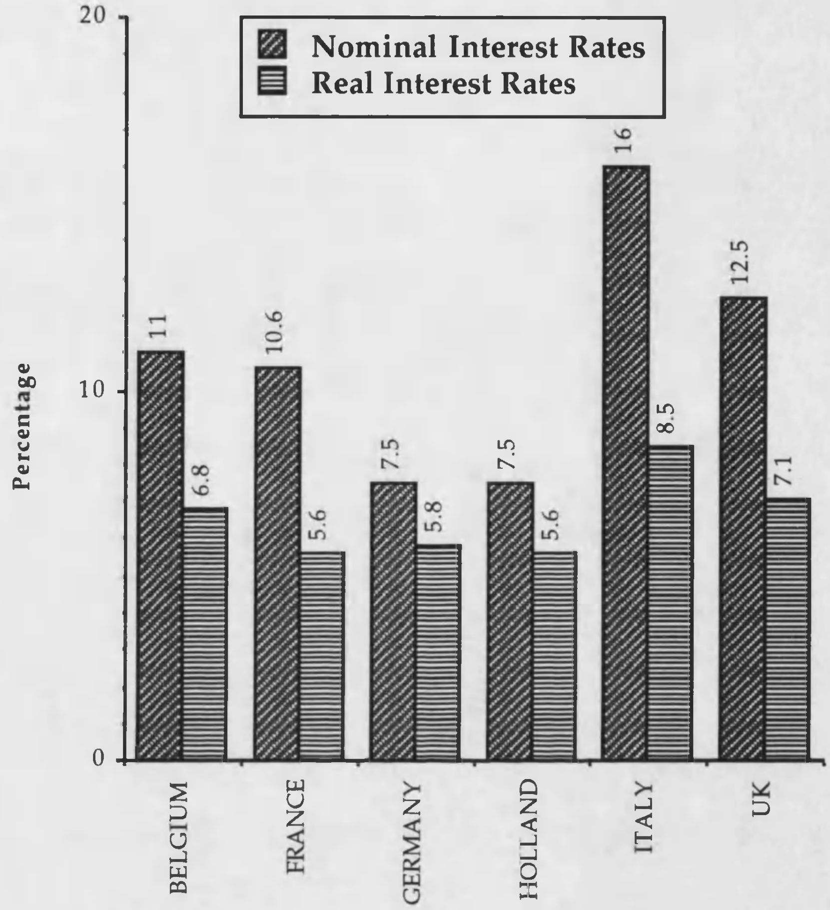
Exchange Rate Stability

In the months after the sterling crisis, the government aimed to stabilise sterling whilst reducing interest rates whenever this was possible. By the end of July interest rates stood at 11.5 per cent. Thereafter, no further cuts were possible. On 22 September the G5 finance ministers announced the Plaza agreement to reduce the value of the dollar by 10 per cent through co-ordinated intervention. It was the first active commitment by the Reagan administration to sustained international intervention. At the same time, it institutionalised the UK government's exchange rate commitment. Overall, Plaza created a new climate for international exchange rate management. One economic commentator asked whether the world was indeed moving towards 'a new Bretton Woods'.[58]

At the end of October Lawson announced the suspension of the £M3 target for the rest of the financial year. Although £M3 was no longer an operational guide to policy, it did retain some importance to the markets as a symbol of financial discipline. Lawson declared that the exchange rate and M0 were the dual guide to policy. However, in practice, the markets did not take M0 seriously as a target. At the same time, the absence of a formal exchange rate target left the government without a credible financial framework. In the autumn statement of 1985, the government announced a twofold increase in the target for privatisation receipts over the next three years. With increased room for fiscal manoeuvre, public expenditure would be stabilised (after having risen by 4 per cent across the two previous years) and tax cuts would follow. Thus, the government was looking to protect sterling and achieving limited fiscal expansion.[59]

The government's objectives were now compatible with ERM membership at least for the immediate future. The government was again committed to exchange rate stability and its monetary policy was assigned to that end. Membership would rule out the flexible approach which the government used after it first assigned monetary policy to the exchange rate in November 1980. Monetary policy would be assigned on a long term basis to countering inflation through matching the discipline of the Bundesbank.

Figure 3.3: Comparative Nominal and Real Interest Rates November 1985



(Source: The Economist Economic Indicators, November 30, 1985)

However, membership would not necessarily commit the government to a tighter monetary policy than it might otherwise choose. Rather, since the government was already committed to keeping sterling stable, ERM membership would probably lead to a reduction in interest rates. With the ERM's growing collective credibility, it was possible to defend currencies at lower rates of interest than those prevailing in the UK. Throughout 1985, the UK had high nominal and real interest rates in comparison to the ERM states. As figure 3.3 shows (page 109), in November 1985, only Italy with its consistently below average inflation performance had higher nominal and real interest rates among the major ERM states than the UK. Although France had a higher inflation rate than the UK in

1985, it enjoyed lower nominal interest rates without the franc coming under pressure. Overall, membership offered both counter-inflationary exchange rate control and the stimulus for growth which the government wanted to provide.[60]

The government's fiscal policy was also compatible with membership in that there was no excess demand in the UK economy. In 1985 UK inflation was 5.5 per cent compared to 5.8 per cent in France, 9 per cent in Italy and 5.5 per cent in the EC as a whole. Since inflation was predicted to fall below 3.3 per cent by mid-1986, the UK appeared to have made the same fiscal adjustment on the inflation front as the ERM states. Furthermore, in contrast to Italy, for example, the UK government was in control of its budget deficit. In the short term, membership would not require the government to pursue a more deflationary fiscal policy. At the same time membership would place a constraint on inflationary fiscal expansion in the future.[61]

During the third and fourth quarters of 1985, sterling averaged DM3.90 and DM3.71 respectively. Even many of those who advocated membership believed that there were competitive disadvantages to entry at DM3.70. The UK's manufacturing trade deficit with the EC in 1985 was £9.1 billion two-thirds of which was with Germany. ERM membership would have made it difficult at least in the short term to devalue against the Deutschmark to improve the current account. At the same time, growth was already disproportionately taking place in the oil sector with manufacturing investment and output still below the levels of the late 1970s. In sum, in terms of competitiveness, ERM membership was likely to act as a constraint on export led-growth.[62]

The Ascendancy of the City

By 1985 the government was pursuing a new policy towards capital accumulation. The City of London was central to the government's strategy, functioning both as a service and a site for international investment. The aim was to recreate London as the prime European centre of finance. This process began in July 1983 when the government agreed to stop the Office of

Fair Trading's Case against the Stock Exchange on the condition that the Stock Exchange reform itself. From late 1983, there was a flurry of activity in which both UK and foreign big banks took over stock exchange firms. At the same time the government intervened to start deregulating and modernising City practices: the government combined with the City to remove price competition restrictions; allowed options markets to expand and the creation of a screen based market; developed a new regulation system; allowed the opening up of the Securities Exchange; and deregulated the banks and building societies. As a result, the City became an unparalleled site for international capital operations with Japanese banks lending more from the City than UK banks.[63]

The government also increased support for non-financial services during its second term. In 1984 the Treasury made services eligible for Regional Development grants for the first time, despite the general move towards selective rather than automatic assistance in regional aid. In 1985 the DTI extended the Business and Technical Advisory Service to the service sector where it was previously confined to manufacturing industry. The government's commitment to privatisation, deregulation and liberalisation also disproportionately benefited the service sector. At the international level the government sought to liberalise trade in services both in the EC and GATT. In this climate, the service sector's share of GDP increased by 2.1 per cent as a proportion of GDP between 1979 and 1984 and by 6.8 per cent between 1984 and 1989.[64]

In its second term, the government also gave unprecedented encouragement to internal investment, especially from Japan. In 1984 the government reached an agreement for a plant in the UK which heralded growth in investment, particularly in the electronic component sector. By 1986 one in seven of the UK workforce was employed in foreign multi-national companies. As Jessop argues, the government was now identifying itself with capital operating in the UK and the operation of UK capital overseas. It did not have a national strategy for capital restructuring as other EC states did. Accordingly the government did not give assistance to manufacturing industry apart from high technology areas. Rather, the government was content to leave the UK with very few significant sectors of manufacturing capital which were secure in either the home or the export market. The UK's role in manufacturing was increasingly becoming that of branch part assembler of Japanese, American and German goods.[65]

The implications of ERM membership for the groups of capital favoured by the government were mixed. Certainly, the City wanted the benefits of reduced exchange rate volatility and a counter-inflationary discipline. At the same time, non-membership did not directly threaten the City as the prime European financial site. For the City, membership was beneficial rather than fundamentally necessary.

For the non-financial service sector, the exchange rate is relatively unimportant since much of the sector cannot export. For those service firms which do export, membership would commit sterling at a relatively high rate and act as a constraint against future adjustment. Multi-national companies operating in the UK benefitted from a relatively high rate for sterling because of their reliance on importing components from abroad. Consequently ERM membership offered certain benefits for inward investors since sterling would enter at a relatively high rate and that membership would probably strengthen sterling against the dollar.

Avoiding a Two Speed Europe

During 1985 the UK government wished to play a positive role in the Inter-Governmental negotiations which would lead to the creation of a Single European Market. However, ministers did not support demands by other member-states for the introduction of qualified majority voting nor the expansion of Community expenditure programmes. At the same time, the government did not want to be left behind in a second tier of states as a core group of states moved towards greater integration.[66]

The issue of ERM membership was directly related to the desire to avoid a two-speed Europe. In March 1985, Spain decided to remain outside the ERM after it joined the EC in 1986 which raised the possibility that ERM membership itself might come to demarcate the tiers of EC integration. In addition since the major EC states and the Commission wanted to promote closer integration, they were increasingly interested again in the UK entering ERM. Through 1985, Jacques Delors, the Commission President, made a series of calls for UK membership. In evidence to the Treasury Select Committee in 1985, two Commission officials outlined the reasons why they saw UK entry to ERM as important. UK membership was necessary for a genuinely common market to develop. Sterling's non-membership detracted from the credibility of the ERM system. If the UK were to join ERM, Norway and Sweden would move much closer to the system which would expand the European zone of monetary stability. And, UK membership would force the system to have a common dollar policy.[67]

Among the other member states, the German government and the Bundesbank were particularly keen on UK membership. The Finance Minister, Dr Gerhard Stoltenberg, the Bundesbank chief, Karl Otto-Pöhl, and the Deutsche Bank, all made public pleas for UK entry. Indeed the German government made it clear that UK membership was their condition for any future development of the EMS. The Germans wanted sterling to relieve the burden of the Deutschmark as the unilateral reserve currency in ERM and believed that the UK would be a free market ally in future debates about the system, particularly in regard to capital movement.[68]

In sum, ERM membership offered considerable potential benefit to the government in the pursuit of its EC policy. If the government was worried about a two-speed Europe, then entry to the ERM would thwart the threat of ERM becoming the catalyst of that development. And, with the other member states led by Germany having a significant interest in UK membership, then, ERM membership was a significant bargaining card in the Inter-Governmental negotiations.

Lawson Converts the Treasury

After the meeting of 13 February, Lawson and his officials examined ways to build up the foreign exchange reserves so that a decision on ERM membership could be taken later in the year. In the months which followed, Lawson did not waver in his support for ERM entry. He asked his officials to write papers on the implications of membership rather than the case for entry.[69] As one official said, '(Lawson) did not require a tremendous amount of advice on all this'.[70]Another official commented that Lawson 'was not a man who relied on the advice of his officials.'[71]

By the summer of 1985, Middleton, Burns and other senior officials were converted to membership. In part, this reflected the sheer dominance of Lawson and his views within the Treasury. Lawson recalled:

> I gradually brought my officials round to my way of thinking on the ERM. Since in the end Civil Servants have to support their Minister, they had no real choice.[72]

Similarly, one of his senior officials commented:

> If he says, I want to join the ERM, you talk about it to him, all the rest of it, but you're not going to say no, you don't think so. You've got to try and help him do it.[73]

At the same time, the Treasury's capacity to resist Lawson was diminished by the absolute nature of his commitment to membership. Once Lawson made his commitment a senior adviser commented that:

> He was a permanent problem from then on. He basically lost interest in the way we were running economic policy and proceeded to try and run it in a different way, based primarily on the exchange rate.[74]

Nevertheless, to a greater or lesser extent Middleton, Burns and other senior officials eventually came to believe for themselves that ERM membership was the best way forward. Lawson states that 'as far as I could see their conversion was genuine, if in some cases unenthusiastic.'[75]

In the immediate aftermath of the sterling crisis, some senior civil servants showed a definite reluctance to give up on the monetary targets once and for all. For example, Terry Burns wanted to try and re-anchor monetary policy around a MO target. According to Lawson:

> They [the senior officials] felt that the government - and they personally - had invested a great deal of intellectual capital in the existing monetary policy framework and were loath to abandon it.[76]

However, the officials finally concluded that there were two fundamental problems with the monetary targets. First, they were not providing information which was useful in deciding on monetary policy. One Treasury official observed that 'there was some disillusionment with the monetary targets because we did not understand the relationships.'[77] According to another, 'the monetary side of things had got very difficult, mainly because velocities were all over the show.'[78]

Second, the Treasury officials believed that their conception of monetary targets in government policy was difficult to present in public:

> We came to the conclusion that there was no single definition of money supply which is of any utility to a policy operator. The only thing which you can do is to hold very firmly to the underlying concept of what it is you want to control, get the maximum input data on what you can get, with the greatest subtlety of definition and watch how it is changing. And then [you] make almost a kind of analogue judgement, rather than a digital calculation, to get the feel of when it is getting a bit too much and you can rein back, or when its tight and ought to be loosened. But you can't explain that to the gentlemen of the press. They'll say at once, 'Don't know what you are talking about, no control, lost all sense of direction.' It translates that way.[79]

By contrast, ERM membership was an effective and presentable anchor:

> Given that background, it was becoming increasingly attractive - seeing incidentally that the European [monetary] system itself was becoming more self-confident, more robust and giving a stronger impression to the markets. It was terribly tempting to say : 'Look suppose we latched into that [ERM] in the right set of circumstances and then continued our monetary policy, we [the Treasury] would not have this problem of presentation. We could go on doing monetary policy, liaising closely with the Bank as usual.'[80]

As regard their previous case against ERM membership, the Treasury now believed that the UK economy was not unique in the EC either in the status of its currency or in its inflation performance and, consequently, it was necessary to resolve the issue. A senior Treasury official who became converted to membership in this period recalled:

> We had to take decisions of some sort. We could not just say, we'll continue to think about. That was becoming increasingly untenable. The other thing that we began to think by 1985 was that the UK economy was getting into the position where it *could* join the ERM. The inflation basis looked not unreasonable.[81]

At the same time, Treasury officials believed ERM membership offered the positive benefits of exchange rate stability and lower interest rates for a given inflation rate. In Lawson's view, low interest rates were now a clear policy goal for Treasury officials:

> I had always regarded interest rates as a vitally important *instrument* of policy. But during my absence at Energy, the Treasury had come to elevate low interest rates into an *objective* of policy. The mandarins were not helped to break out of this mould by the fact that low interest rates had an unfailing appeal for Margaret.[82]

At the top of the Treasury, support for ERM membership became uniform during the first half of 1985. However, at lower levels, some scepticism remained. Opponents of membership generally fell into two groups. The first, and larger group, was of economists who remained wedded to the idea of a domestically based monetary policy around some form of monetary targets. In the view of one supporter of membership within the Treasury, 'one or two felt almost that their metier in life was being challenged because they saw it as giving policy to the Bundesbank.'[83]The second group was made up of administrators who 'just had hackles about Europe.'[84] Neither group of officials were able to make an impact on their seniors or Lawson himself.

A Divided Bank

In the months after the sterling crisis, Robin Leigh-Pemberton and Kit MacMahon remained as firm supporters of ERM membership as Lawson. Both believed that the crisis could have been avoided inside ERM and that some financial discipline needed to be injected into the government's monetary framework. Before the end of 1985, Kit MacMahon was due to retire with Eddie George taking over as Deputy-Governor. During the course of year, George shifted from being an opponent to a supporter of membership partly in deference to the Governor.[85]

Opinion lower down at the Bank of England was fairly evenly divided between strong supporters and strong opponents of membership. As in 1980 and 1981, the greatest opposition to membership came from people in the domestic monetary division. These officials believed that sterling was still too volatile a currency to become a stable member of ERM and that the convergence of UK inflation towards the lowest levels in Europe might well prove to be a temporary phenomenon.[86] One sceptic commented on his perception of the UK's continuing economic divergence from the ERM states:

> Among those most directly and professionally concerned with monetary management, there was quite a degree of misgiving over the timeliness of fixing an ERM parity at the time. ... [Some of us believed] *de facto* a parity system of that sort would have a tendency to become very much a fixed rate type of arrangement. Or at least that any departure from fixity would come to have the characteristic of failure. And [so we came] to feel that it would not be wise to get committed to it *unless* and *until* we could be reasonably confident that that would be a discipline that we would both be able to and want to observe. What that starting point led to was self-evidently a questioning of the extent to which we could regard the optimal currency area conditions as being satisfied by the UK within the ERM economic area. [There were] two particular areas which we were immediately concerned at the lack of fulfilment of those conditions. One was the then divergence in patterns of external trade between ourselves and the continental countries with much greater [UK] involvement and exposure to other parts of the world - dollar and Pacific area - than they had. And the other was the difference in resource endowment which was most notable in our North Sea oil resource.[87]

Nevertheless, despite the divisions within the Bank, Leigh-Pemberton and MacMahon were determined to take a higher profile supporting ERM within the core executive than the Bank had between 1980 and 1983.[88]

Conception of ERM membership.

By the summer of 1985, there were for the first time more supporters than opponents of ERM membership within the institutions of the core executive most directly concerned with economic policy. Moreover, the supporters were led by a Chancellor with a very strong view on the issue. When ERM membership first became an issue of economic (as opposed to EC policy) in 1981, the debate was defined by the immense difficulties of keeping to the MTFS. The question in 1981-1982 was whether sticking to the monetary targets of the MTFS or opting for exchange rate stability was the best means of using monetary policy as a counter-inflationary discipline. Those decision-makers who then opposed ERM membership were unwilling to finally abandon the MTFS. By the end of the first half of 1985, there could be little dispute about the failure of the MTFS as either an effective or credible monetary framework. Now, opponents of membership did not envisage a return to a strict monetary target policy but rather contested the viability or desirability of entry to ERM itself.

At the same time, the failure of MTFS defined the position of those who supported membership as it did in 1981-1982. Supporters of membership were explicitly claiming that because money supply targets had not worked as a counter-inflationary monetary framework, the way forward was to pursue exchange rate stability through ERM as a similarly defined framework. It was the means used in MTFS not the policy end itself which was responsible for its failure. Lawson himself declares:

> As I said to her, the significance of the MTFS was that it represented a public commitment to the pursuit of an anti-inflationary policy. Linking the pound to the Deutschmark via the ERM would represent exactly the same sort of public commitment to an anti-inflationary policy, and one that would by that time carry greater conviction.[89]

For ERM supporters, membership would be the formal replacement of one set of monetary means to control inflation with another. They did not conceive of membership as a significant shift in policy. Two senior Treasury officials commented:

> We never saw it as a fundamental shift in policy. It's just a question of how you go about the same thing.
>
> It became very attractive simply as a device consistent with what we wanted to do but a damn sight easier to explain.[90]

However, by 1985 the ERM was decidedly more than a collective counter-inflationary monetary framework. The ERM states believed that there were multiple causes of inflation from rising levels of domestic demand, to large wage increases and unfettered credit expansion. As a result, they were committed to using a range of policy tools, including fiscal policy, to maintain stability and control inflation. Yet such a commitment was absent in the conception of ERM membership held by Lawson and his officials and at the Bank of England. Asked how Lawson perceived the relevance of fiscal policy to ERM membership, a Treasury policy-maker replied:

> In Nigel Lawson's mind, the ERM was principally a way of setting interest rates - of tying British monetary policy to well-established German credibility.[91]

In sum, the operation of the ERM denied the underlying premise of the MTFS that inflation is fundamentally a monetary phenomenon but Lawson and officials at the Treasury and Bank of England clung to that premise in their conversion to ERM membership.

Demobilising the Foreign Office

In May 1985, Lawson got the green light from Thatcher to borrow foreign currency through the issue of floating rate notes (FRNs) to build up the reserves. After a similar EC issue flopped, Lawson was advised by the Bank of England that the UK issue should be postponed. Finally, on 16 September, the government announced a $2.5B FRN issue.[92] Thatcher's initial green light on the issue in May allowed Lawson to step up the level of the ERM debate. Lawson believed that the key factor in the debate was Thatcher's own attitude as did his senior officials: 'We believed that it would be extremely difficult to convince Thatcher.'[93] Consequently, Lawson geared the tone of work within the Treasury towards assembling a case for membership which could convince Thatcher. Treasury officials who Thatcher was known to get on with were sent to brief her.[94]

Lawson and the Treasury were did not want to involve either the Foreign Office or the European Secretariat of the Cabinet Office in the debate.[95] In part, Lawson recognised that the continuing support of Geoffrey Howe and the Foreign Office for membership were counter-productive to the real task of convincing Thatcher on the issue. According to one Treasury official:

> We put a lot of effort into mobilising allies and that included actually

> demobilising the Foreign Office.... They were such an easy target for her and poor Geoffrey Howe was an easy personal target for her.[96]

At the same time, the Treasury continued to believe that the issue was its territory and expressed disdain about the political nature of the Foreign Office's arguments in favour of membership, one senior official commented disparagingly that: 'The Foreign Secretary sort of always wants to join organisations.'[97] Lawson himself clearly wanted the economic policy case for ERM entry to stand on its own merits:

> Certainly, I was conscious that our self-imposed exclusion from the ERM greatly diminished our authority and influence within the Community. But that was never why I wanted to see sterling within the ERM My case as readers will be aware, was *wholly* in terms of the balance of the economic argument. [italics added][98]

In August, Howe gave Lawson a Foreign Office paper which advocated entry to ERM within the next few months. Lawson was unimpressed by its assumption of regular and automatic realignments inside ERM. He proceeded to operate with the still sceptical Thatcher on a bilateral basis and Lawson agreed to Thatcher's proposal of a Prime Ministerial seminar on the 30 September.[99]

Lawson instructed his officials to develop the Treasury paper for the seminar in close collaboration with the Bank explaining both the case for entry and the best way to present membership in public. The Bank's monetary unit did a significant amount of work to provide supportive analysis to the Treasury's case.[100] In the words of one Treasury official, 'it was a prerequisite that the Bank should be on side' since for Thatcher its opposition would have been 'a cast-iron argument' against joining.[101] At the same time, Lawson was particularly concerned to pre-empt any use by Thatcher of the 'Walters scenario' argument. Walters claimed that inside ERM, a poor Conservative government showing in an opinion-poll during a general election campaign would put sterling under pressure forcing the government to raise interest rates and handing the election to Labour. Lawson dismissed the argument himself, but he asked Geoffrey Littler to find a way around the alleged problem. Littler suggested the 'conge' plan. *In* *extremis*, the government could formally declare that sterling would be allowed to float until polling day and that on re-election, the government would immediately restore sterling to the system at the previous parity.[102]

Outside the core executive, there remained considerable support for ERM membership within the Conservative party beyond the immediate aftermath of the sterling crisis. In March the former minister David Howell made the first of a series of public calls for membership Similarly, both Heath and the Conservative MEPs continued to put pressure the government on the issue through 1985. In May, the MEPs formally met Lawson to discuss the subject and argued that membership would reduce interest rates. By autumn 1985, it appears that there was a firm majority within the parliamentary party willing to support membership.[103]

The Lawson-Howe-Leigh-Pemberton Assault

On 30 September, Thatcher chaired a Prime Ministerial seminar on membership attended by Lawson, Ian Stewart and officials from the Treasury, Leigh-Pemberton and other Bank representatives, Howe and Brian Griffiths, the Head of the Policy Unit. Lawson argued that entry was absolutely necessary to reinforce the government's anti-inflationary strategy given that the 'monetary indicators proving increasingly difficult to interpret.' Leigh-Pemberton supported Lawson and stated that only ERM membership could provide a credible monetary policy. Similarly, Howe argued on economic policy grounds that membership would strengthen the MTFS, rather than that membership would increase the UK's influence in the EC Thatcher concluded that she remained unconvinced of the case for entry and that further discussion at ministerial level was necessary before a decision could be taken. She would decide which ministers to invite to take the decision and circulate a list of questions which needed to be answered before the meeting.[104]

After the 30 September meeting, Lawson asked the Treasury to prepare a further paper for the second meeting to be circulated in advance to all those who were to attend. He set up a joint Treasury-Bank team both to write the paper and to respond to the questions from Number 10. He recalls:

When the Number 10 questionnaire arrived, it proved to contain no fewer than twenty three questions and read rather like a rag-bag of every objection to ERM membership that anybody could come up with. In so far as there was an underlying theme, it was that sterling would be subject to greater pressure inside ERM than if it remained a non-member and that the economy was not strong enough to sustain a fixed parity against the Deutschmark.[105]

Lawson's own paper again stressed the benefits of membership as a counter-inflationary monetary framework in view of the problems with the policy based on monetary targets:

> After grappling with these problems as Chancellor for over two years now, I have come to the conclusion that joining the ERM of the EMS would deal with both the issue of substance and the issue of presentation, and is the only practicable means of doing so. The exchange rate is more readily comprehensible than monetary targets and we are already relying on it to a major extent as an indicator. To join the EMS would reinforce the discipline and commitment inherent to the MTFS, and be seen to do so. The interested public seem ready for it. Industry certainly is."[106]

Lawson sent the paper to Thatcher as a memo on 11 November, two days before the ministerial meeting was to be held.

Between September and November, optimism grew in the Treasury about the chances of success in convincing Thatcher. One Treasury official commented:

> I think I got personally to the point of believing that there might be a slightly better than evens chance. Because we had done our homework well; the seminar had gone not too badly; and the question of Alan Walters, I was inclined to dismiss and something that I still am. ... One of the things that actually persuaded me that there might be a chance was the Hong Kong issue. ... The idea that the Hong Kong dollar could be linked to the American dollar was not one that we thought was a natural subject of enthusiasm for Mrs Thatcher on any count or indeed for Alan Walters. The odd thing was that it happened to be a former pupil of his who in Hong Kong had begun to raise the whole issue and got Alan's ear and Alan persuaded the Prime Minister of this. ... After she gave the green light, I could not help thinking: 'Her antipathy to any sort of fixed exchange rate is not total.'[107]

The meeting to decide on whether to enter ERM took place on 13 November. With ministers and officials both in attendance, it was essentially an ad hoc meeting organised at the Prime Minister's discretion. The officials present were Middleton and Burns from the Treasury and Leigh-Pemberton and George from the Bank of England. In addition to Thatcher, Lawson and Howe, the ministers attending were Willie Whitelaw (Deputy Prime Minister), Norman Tebbit (Conservative Party Chairman), Leon Brittan (Trade and Industry), John Biffen (Leader of the House) and John Wakeham (Chief Whip). Brian Griffiths and one of Thatcher's private secretaries were also present. In Lawson's view, Thatcher asked Whitelaw and Brittan to attend because she could not exclude them, and the other three ministers were invited on the grounds that she supposed they were opponents of membership. Although invited by Thatcher, Lawson himself saw all the ministers with the exception of Biffen prior to the meeting to go over his paper.[108]

Lawson, Howe and Leigh-Pemberton made the same case for membership which they presented in September. They were supported by Brittan who said that having previously been an opponent of membership, he now believed in the need for a credible alternative to monetary aggregates and that the petro-currency argument against membership no longer applied. Brittan's position also reflected the view of DTI officials who were keen supporters of membership although never asked to contribute to the debate. Of the ministers invited by Thatcher as likely opponents of membership, only Biffen argued against entry as a committed free floater. Tebbit and Wakeham spoke in favour of membership and both declared that membership would be a positive benefit in the government's relations with the party and its back-benches. Thatcher responded that, to the contrary, membership would divide the party, leave the government with no control of interest rates, and that the *conge* plan would not work.[109] According to one Thatcher confidante:

> Lawson said: 'How can you stand up against it, when your Chancellor and Foreign Secretary are both agreed, that it is most urgent that we enter the ERM?' She replied that it was her constitutional responsibility to choose policy.[110]

Finally, Whitelaw declared his support for membership. For himself Whitelaw believed that it must make sense to have some means of regulating currencies in the EC which included sterling. At the same time, he believed that when the Chancellor, Foreign Secretary and the Governor of the Bank of England were united on entry, then it was extremely hard to understand why the government should do otherwise.[111] In Lawson's description of the end of the meeting:

> [Whitelaw] declared, 'If the Chancellor, the Governor and the Foreign Secretary are all agreed that we should join the EMS that should be decisive. It has certainly decided me.' I suspect he was as surprised as the rest of us when Margaret instantly replied, 'On the contrary: I disagree. If you join the EMS, you will have to do so without me.' There was an awkward silence, and the meeting broke up.[112]

Clearly not intending to resign, Thatcher was exercising an effective Prime Ministerial veto against ERM entry over the rest of the core executive concerned with the issue.

Thatcher's Opposition

During the second half of 1985 up to November, the government trailed Labour in the opinion polls by between 1 and 5 per cent in the *Guardian* average of monthly polls.[113] For Lawson, Howe and the other Cabinet ministers who supported membership, ERM entry offered certain potential benefits to the government's position. In Chapter 2, it was argued that non-membership allowed the government to manage the 'sterling problem' according to the balance of the inflation performance and the government's electoral timetable. In part, this meant the freedom to devalue when inflation was reduced so as to stimulate the sluggish economy. After the 1983 election, the government did indeed use the freedom of non-membership for this purpose. However, in January 1985 the policy ended in disaster because the government could neither control the extent of sterling's fall nor accept its inflationary consequences. There now appeared little alternative but to maintain a commitment to exchange rate stability and assign monetary policy to the task of securing it. ERM membership offered a means to this end combined with lower interest rates to stimulate growth and benefit mortgage-holders. Membership would also provide benefits for some of the types of capital which the government wished to encourage particularly, the City. At the same time, membership was likely to strengthen the government's influence within the EC both on the Community's broad and monetary future development.

Any plausible explanation of Thatcher's opposition to ERM membership must first recognise her rejection of the most fundamental of these benefits which membership would have brought, namely lower interest rates for a given rate of inflation. Certainly, it cannot be argued that Thatcher did not understand this particular benefit of membership. A pro-ERM official recalled:

> I remember her saying at some moment when it seemed to me to be completely inappropriate that the great thing about ERM is that it would allow you to have lower interest rates than you would have otherwise.[114]

Whilst all Prime Ministers and governments have an interest in low interest rates, if Lawson is to be believed, then Thatcher had a passionate desire to cut rates whenever possible. It is a point which Lawson returns to again and again in his memoirs. For example:

> Low interest rates had an unfailing appeal for Margaret. Despite her reputation as a diehard opponent of inflation, and her dislike of it was undoubtedly genuine, she was almost always in practice anxious to reduce interest rates, and thus, the mortgage rates.
>
> It was hard enough to persuade Margaret of the need to raise interest rates when I had the Bank with me.
>
> She was positively soft on interest rates.[115]

Thatcher herself admits:

> Nigel apparently now thinks that I was 'soft' on interest rates. Anyone who recalls our decisions from 1979 to 1981 will find that implausible. ... Nevertheless, Nigel and I did have rather different starting points when it came to these matters. I was always more sensitive to the political implications of interest rate rises - particularly their timing - than was Nigel. Prime Ministers have to be. I was also acutely conscious of what interest rate changes meant for those with mortgages.[116]

Whatever benefit Thatcher saw in ERM membership had to be strong enough to override her clear preference for lower interest rates.

By contrast Thatcher did not accept that ERM membership would bring any real benefits in EC policy. As in 1982, Thatcher did not want to trade one EC issue against another. She was not comfortable with the European Council as a decision making forum. In the words of one former cabinet minister:

> She hated all those Council meetings. She would come back absolutely fuming....they were all waffle,waffle,waffle, and I can just imagine that she had to sit there crossing her legs and uncrossing her legs and wondering how long she had to go on listening to all the bloody people from Greece and Portugal and all the rest.[117]

At the same time she believed that the UK was generally in a weak position with little to no bargaining power. A Foreign Office official commented:

> I used to argue with her. She would say, 'Those crafty French, they'll win again, they always win.' I remember saying to her: 'Why are you so defeatist? It's an extraordinary attitude...You know we've got a very good case here. We've got a lot of support, why do you think the French line will win?'[118]

The budgetary negotiations demonstrated that Thatcher was far happier playing the nationalist card in EC policy than developing an active strategy and negotiating to secure her ends. As Gilmour commented in respect of the budgetary issue:

> To her, the grievance was more valuable than its removal. Not for the last time during her term of office, foreign policy was a tool of party or personal politics. However badly things were going in Britain, Mrs Thatcher could at least win some kudos and popularity as the defender of the British people against the foreigner. Hence a running row with our European partners was the next best thing to war; it would divert public attention from the disasters at home."[119]

Thatcher's own explanations of her opposition to membership centred on economic policy and were somewhat contradictory. On two different occasions, she declared that membership would be too deflationary and too inflationary respectively. Then, in June 1986,Thatcher argued that the UK needed to retain the option of letting the exchange rate take the strain when there was speculation against sterling rather than monetary policy or 'precious reserves'. Later in the year, she told the *Financial Times*:

> I want to be absolutely certain that there can be no repetition of what happened before, when we came out of the snake [in 1972]. When we go in, we will go in strong and stay in.[120]

In her memoirs she declares about the 13 November meeting:

> By now I was more convinced than ever of the disadvantages of the ERM. I could see no particular reason to allow British monetary policy to be determined largely by the Bundesbank rather than by the British Treasury, unless we had no confidence in our ability to control inflation. I was extremely sceptical about whether the industrial lobby which was pressing us so hard to join the ERM would maintain its enthusiasm once they came to see that it was making their goods uncompetitive. I doubted whether the public would welcome what might turn out to be the huge cost of defending sterling within ERM - which, indeed, might well prove to be impossible in the run-up to a general election and so be compounded by a forced devaluation.[121]

Neither is it plausible to explain Thatcher's opposition mainly in terms of the influence of Alan Walters. Lawson noted in his memoirs that in the questionnaire before the 13 November meeting that 'curiously, about the only objection that was not included in the list of questions was that dubbed (by Alan Walters) the 'Walters critique'.[122]

One Treasury official commented:

> The question of Alan Walters, I was inclined to dismiss and it is something I still am. She never actually did what Alan told her or followed Alan's advice, but she found him absolutely a marvellous man to brief her with arguments to combat others with but she was never a slave to his views.[123]

Most people involved in the decision-making process understood Thatcher's opposition in varying terms. One Foreign Office official commented:

> Her main argument against the ERM was one of practicality. She was always telling one how Ted Heath had had to come out of the snake.[124]

At least one Bank of England official believed that it was the problem of managing monetary policy in the pre-election period which concerned

Thatcher:

> In the run up to an election, if there was a sterling crisis,the government would have to raise interest rates and she did not want to be dictated to by the Bundesbank.[125]

However such an argument for non-membership would only make sense if Thatcher was prepared to adopt an attitude of benign neglect which she manifestly was not. For example, six months before the 1983 general election, the government raised interest rates twice to combat sterling's weakness. Later, in November 1986, the government made it clear that it would not countenance a devaluation of sterling in the run up to the next election. As Sam Brittan argued in dismissing the argument, a much smaller rise in rates might be necessary in ERM than outside where doubts would exist about the government's exchange rate objectives. Membership would act as an insurance against the re-occurring feature of all sterling crises since 1973 where the markets have felt that there is no floor in sight and that sterling could go almost anywhere.[126]

Most people involved in the decision-making process understood Thatcher's opposition to membership in terms of her conception of sovereignty in relation to economic policy:

> She thought that it was giving too much away in terms of sovereignty.[127]

> She just did not like the idea of the Europeans getting involved in sterling....I think she always feared too much European meddling in British affairs. She thought that the Bank and the pound and all the rest were things they should not be allowed to meddle in.[128]

> It was the sense of sovereignty that she had, surrendering your political power to some outside body.[129]

> She stood out on grounds of sovereignty, a concept she had read about somewhere but could never tell you where.[130]

> [She saw it] as losing control over the economy. The government should not sacrifice that degree of ability to run the economy.[131]

Nevertheless, a question remains about how Thatcher's particular conception of sovereignty related to her understanding of the government's electoral interests. What particular freedom of manoeuvre outside ERM did Thatcher believe was of benefit enough to the government to outweigh the benefit of lower interest rates for a given rate of inflation? Certainly, ERM membership would not have been the 'shift in emphasis' which Lawson, the Treasury and the Bank of England took it to be. As a fundamentally different way of operating economic policy, ERM membership would ultimately have reduced the government's freedom of manoeuvre beyond the area of monetary policy. The most likely cost in electoral terms for the government in the short to medium term was the potential conflict between the fiscal constraint inherent in the ERM and the government's desire to reduce income tax. In the next five years, further costs of membership in areas beyond monetary policy became apparent and are discussed in the next two chapters.

Whilst Lawson and those ministers who supported membership in November 1985 clearly did not trade off interest rates cuts against income tax cuts in making their judgement, it is less clear whether Thatcher herself made the calculation. Certainly, there is no evidence that Thatcher ever articulated a detailed understanding of the relation between the constraints of ERM membership and the government's objectives. Nevertheless, analysis in Chapters 4 and 5 when the costs of ERM membership to the government extended beyond fiscal policy will suggest that she had an instinctive grasp of a difference which she wished to hold on to between the government's economic policy and those of the continental states.

Acquiesence?

After the 13 November meeting, Lawson was left to decide how to respond to Thatcher's veto of his proposal to enter ERM. Three courses of action would appear to have been open to him. He could either have resigned or carried on fighting on the issue or simply accepted Thatcher's decision. Lawson describes how he ruled out the resignation option:

> At the end of the meeting Margaret swept out, with Griffiths trotting behind her. I asked Willie, Geoffrey and Norman to accompany me next door to Number 11 to discuss what had happened. I was extremely depressed and told them that, in the circumstances, I saw

little point in carrying on and probably ought to resign. Willie, too, had clearly found it a depressing as well as embarrassing occasion, but urged me not to resign, as did both Geoffrey and Norman. Norman said he was convinced that she would eventually come around and Willie agreed.
...After much reflection [I] decided to accept the advice of Willie, Geoffrey and Norman not to throw in the towel. [132]

However, what Lawson does not explain is on what basis he saw himself staying in office: did he accept Thatcher's decision as final or not?

As one Cabinet opponent of membership admitted Lawson together with Howe would have been within their rights to demand a Cabinet meeting on the issue.[133] They would have been backed in their demand by Whitelaw who was prepared to act on their behalf in this regard if they so wished. Two ministers in Cabinet at the time commented that there was a reasonably good chance that Lawson and Howe would have been backed by the majority of the Cabinet.[134] Indeed Thatcher herself remarks that: 'I knew that I was in a very small minority within the Cabinet on this matter, though most of my colleagues were probably not overinterested in it anyway.'[135] There are three possible reasons for Lawson's and Howe's lack of action. First, they were simply not prepared to act together. Certainly, Lawson's demobilisation of Howe and the Foreign Office in the summer suggested a general unwillingness to make common allies with Howe and his officials. For Lawson and the Treasury to have combined with Howe and the Foreign Office would have flown in the face of the Treasury's understanding of its raison d'etre. One Foreign Office official commented:

I dare say there was a bit of reluctance of Treasury officials to plot with Foreign Office officials. The Treasury's view usually is that what is required is for the Prime Minister and the Chancellor of the day to be absolutely at one...and [not] of allowing the Chancellor to plot with the Foreign Secretary.[136]

Second, Lawson and Howe might have considered that the Cabinet was irrelevant to the issue and that there was no choice but to let the matter rest. As one former Cabinet minister commented on the situation:

The nature of British government invests enormous authority in the Prime Minister and if the Prime Minister is a bad loser - and I

> promise you the previous Prime Minister was a very bad loser - then I think she could have probably survived.[137]

In general terms, Lawson recognised that it was harder to persuade Thatcher at Cabinet level than in a meeting of the 13 November genre:

> She was in practice at her best in bilaterals and other small gatherings. The larger the numbers, the greater her tendency to play to the gallery,either showing off her own knowledge on the subject or rounding, in a profoundly embarrassing way, on some hapless colleague whom she felt either bullyable by nature or objectively in a weak position at a particular time. Geoffrey Howe was a favourite victim.[138]

At the same time, neither Lawson nor Howe appeared to believe that economic policy should be decided in Cabinet.

Third, Lawson and Howe may have believed that Thatcher's position as Prime Minister was vulnerable and, hence, that Thatcher's veto was only a temporary problem. There is indeed some evidence that Lawson and Howe did not view the 13 November meeting as the end of the matter. In his memoirs, Lawson describes how in December he gave the green light to a secret mission of officials to Germany which he had planned in the hope of a favourable outcome to the 13 November meeting. On 7 December, Middleton, Littler and Anthony Loehnis (from the Bank) went on a highly confidential mission to Bonn to discuss contingency planning in the event of the UK deciding to enter ERM. They talked to both Finance Ministry and Bundesbank officials with Loehnis examining with the Bundesbank possible swap arrangements (a substantial line of short term credit) to support UK entry. Lawson offers no explanation of the purpose of this meeting in view of Thatcher's veto nor how he reconciled with his belief expressed on the next page that: 'I could not see Margaret changing her mind so soon after the drama of 13 November.'[139]

One Thatcher confidant, at least, believed that Lawson and Howe reconciled their continuing tenure in office after her veto by supposing that Thatcher's own tenure in office was limited. He commented:

> Within the highest reaches of the Conservative party and Cabinet, they were always anxious to get rid of her. They thought they would

> sit it out and that they would be in a powerful position when she was ruined by something or other. Westland was only just around the corner.[140]

Certainly, Lawson has made publicly clear that at least by February 1986, the Westland affair could have finished Thatcher's premiership.[141] Nevertheless, whether Lawson and Howe hoped that the Westland affair would deliver them ERM membership or not, Thatcher did survive and the veto remained.

The Luxembourg Summit

After debating ERM membership on 13 November exclusively in terms of economic policy, the government was quickly forced to face the consequences of non membership in terms of its EC policy. In the final negotiations towards the Single European Act (SEA), three issues stood out: the completion of the Single Market; the extension of majority voting in the Council of Ministers; and the Community's future monetary development.

On the monetary issue, member states were deciding whether to write the EMS in the Treaty of Rome and the objective of monetary union into the SEA. To inscribe the EMS into the Treaty would mean that any future development of monetary policy affecting EC institutions was subject to the full reform process of Inter-Governmental Conferences and ratification by national parliaments. On 14 November, Lawson minuted Thatcher on the issue of monetary union:

> The inclusion of EMU [economic and monetary union] as a Treaty objective would be a political commitment going well beyond previous references to EMU, which have been non-binding European Council resolutions or solemn declarations. It would be perceived in political terms as a major change.
> Our objective in my view should be to avoid any amendment to Article 107 [the article in the Rome Treaty concerning exchange rates]. The Delors proposal is unacceptable both politically and in substance. So is any reference to EMU.[142]

On 18 November the UK and German Governments combined to oppose writing the EMS into the Treaty of Rome on the grounds that it would restrict the autonomy of their central banks to control monetary policy. However, Lawson was more concerned about the issue of monetary union. With the negotiations due to be finalised at the Luxembourg summit in December, Lawson again urged Thatcher to stand firm against any commitment to monetary union. Lawson believed that such a commitment would be taken very seriously both by the major member states and the Commission. By contrast the Foreign Office told Thatcher that such a commitment would be rhetorical rather than substantive. In part this may have reflected the Foreign Office's belief that it was necessary to underplay this dimension of the Treaty if Thatcher were to accept it rather than their objective assessment of the situation.[143] One former minister commented on the Foreign Office's attitude: 'they felt that you know, Christ, if she knew what we were up to, it would be like getting our money back all over again.'[144]Certainly, the Commission did regard any potential commitment to monetary union as serious.[145] However, it is not evident that this view was shared by the other member states at least for the short to medium term.

After a bilateral meeting in London between Thatcher and Chancellor Kohl, Thatcher went to Luxembourg convinced that the government had continuing German support to oppose writing the EMS into the Treaty of Rome. However, at the summit, Kohl backtracked on the issue after a heated exchange with Thatcher on the UK's non-membership of ERM. Kohl then proceeded to broker a compromise deal in which the EMS entered the Treaty of Rome together with a limited commitment to the 'progressive realisation of economic and monetary union.' The UK was left isolated and Thatcher reluctantly signed the resulting deal. Thus, the government was forced to pay a price for continuing non-membership in its EC policy.[146]

In the short term, the government's effective defeat on the monetary issue was of little significance. Writing the EMS into the Treaty changed nothing in practical terms and there were precedents of previous commitments to monetary union stemming back to 1972 which never produced any firm action. Neither was there any evidence that monetary union was on the foreseeable agenda of either the French or German governments. Nevertheless, the potential costs of the defeat in the medium to long term were considerably greater. The SEA strengthened both the transnational element of the EC and its sense of direction and so increased the likelihood of further integration. Consequently the EC's monetary arrangements were likely to reoccur as an issue again in the future. Moreover, if any member-states were to become actively interested in moving towards monetary union on economic grounds, then the SEA provided a basis for arguing that this was a fundamental part of the Community's development.

At the same time, the SEA raised additional questions about the viability of the UK's non-membership in the future. First, if the ultimate objective of the Single Market was to improve the efficiency of resource allocation in the EC, then did not sterling staying out of ERM produce inefficient exchange rate volatility? To go further, was it logical to have a Single Market without a common currency? Second, the prospect of a single financial market opened up the possibility of banks and other institutions conducting business in one EC state whilst being subject to central bank regulation in other states. In these circumstances, there would be an increased onus on co-operation among central banks to ensure effective national monetary policies whilst the UK would remain apart from the Community's monetary institution.[147]

Conclusions

The government ended 1985 outside the ERM despite intense pressure both from within and outside the core executive for entry.The sterling crisis created a new debate on new terms without resulting in ERM membership. This was entirely due to the power of the Prime Minister within the core executive. Nevertheless, Thatcher's veto could not resolve the issues which membership raised. In terms of EC policy, membership would almost inevitably remain an issue as long the EC moved towards further integration. In terms of economic policy, the government was forced to re-examine membership after the crisis caused by its ambivalent attitude towards the exchange rate and it now ended 1985 further divided on the same issue by its internal schism over ERM. An underlying question about the UK economy remained: could the UK core executive agree on its exchange rate policy? Without such agreement further sterling crises were likely to occur and the issue of ERM membership would resurface.

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CHAPTER 4
TRYING TO SOLVE THE STERLING PROBLEM

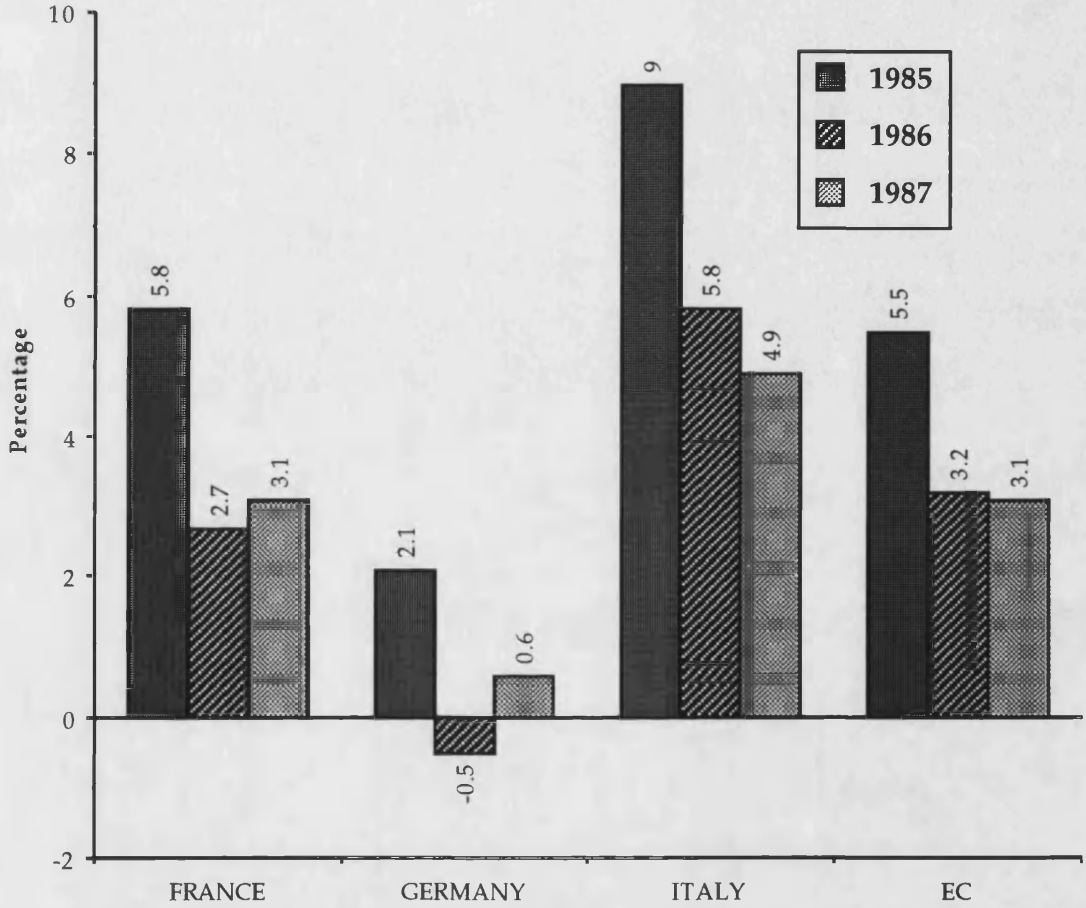
This chapter examines the evolution of policy from the start of 1986 to the Conservative party's election victory in 1987. Section 4.1 examines the operation of the ERM during the period. Section 4.2 contrasts the government's economic policy from January to August 1986 with the actions of the ERM states. Section 4.3 analyses the choices which ministers faced and made about ERM membership in September and October 1986. Section 4.3 considers the period from October 1986 to June 1987 and the decision to shadow the Deutschmark. Finally, section 4.4 examines the relation of the shadowing policy to ERM membership.

4.1: COMPETITIVE DISINFLATION AND THE FRANC FORT

In 1986 and the first half of 1987, the ERM continued to operate as a relatively fixed-exchange rate system with a counter-inflationary bias in both fiscal and monetary terms. Member states were determined to retain their parities against the Deutschmark whenever possible. On 6 April 1986, there was a general realignment of currencies in which Germany, Holland, Belgium and Luxembourg all revalued and France devalued. The French devaluation was essentially a pre-emptive strike to prevent the franc coming under pressure after a new right-wing government came into power in March. At the same time, the Italian government demonstrated its commitment to its parity by refusing to devalue despite some pressure on the lira. On 2 August Ireland devalued. As with France, this was not a competitive devaluation against the other member states. Rather, the Irish government reluctantly asked for a devaluation to offset the problems caused to its currency by its appreciation against sterling.[1]

The ERM states' determination to maintain their parities against the Deutschmark in 1986 was given added significance by a dramatic fall in the price of oil between the first and second quarters of the year. There was an opportunity to use that fall to offset other inflationary pressure. However, the ERM states, led by Germany maintained tight monetary and fiscal policies and allowed the full benefit of the fall to feed through into a lower inflation rate.[2] As figure 4.1 shows, France, Germany and Italy all achieved a substantial fall in inflation 1986 and Italy secured a further fall in 1987.

Figure 4.1: Inflation in ERM States 1985-1987



(Source: Economic Outlook)

In 1987 France demonstrated the full extent of its commitment to maintaining the franc. After the devaluation in April 1986 the French government renewed its efforts to reduce wage costs. By January 1987 wage costs were indeed rising more slowly in France than in Germany. Nevertheless, the franc came under pressure against the Deutschmark. The French government refused to devalue citing the positive comparative fundamentals in the real economy, and insisting that the situation was a problem for the Deutschmark. It allowed the franc to fall through its ERM floor which obliged the Bundesbank to intervene to support the franc. The Bundesbank ended up selling DM5 billion which was its largest sum of intervention to date within ERM at considerable cost to the German money supply. This experience was enough to convince both the Bundesbank and the German government that the Deutschmark should be revalued rather than the franc devalued. On 11 January, Germany, Holland, Belgium and Luxembourg all revalued and no state devalued. From now on, the French government was determined to hold out against any depreciation of the franc against the Deutschmark whether by revaluation or devaluation. The guiding force of French economic policy would be 'competitive disinflation' and the means to achieve it would be the *franc fort*.[3]

4.2: DEVALUATION AND NON-MEMBERSHIP

In November 1985 Thatcher denied Lawson and the Treasury their preferred monetary option without offering an alternative monetary framework either in terms of the exchange rate or monetary targets. Consequently, at the start of 1986, the government was left in a monetary policy vacuum. One Treasury official saw the problem as how to best make do with the existing policy of an non-credible and unused MO target and a *de facto* aim of exchange rate stability:

> In a sense, anything that one might have done as an alternative, we were already by definition doing. ... The problem became how can you present this stuff better without the advantage of ERM.[4]

During the first weeks of January 1986 and with oil prices dramatically falling, sterling came under pressure. On 9 January, Lawson proposed to Thatcher a 1 per cent rise in interest rates to protect sterling to which she reluctantly agreed. In the following weeks, sterling continued to fall. On 24 January Thatcher acquiesced to another Lawson proposal for a 1 per cent rate rise. However, before the announcement was due to be made, Leigh-Pemberton told Lawson that sterling was recovering and Lawson rescinded the rate rise.[5]

Having sought to stabilise sterling for these weeks in line with the

1985 policy, the government now filled the vacuum with a new policy. Between the first and second quarters of 1986 the price of oil halved. The government took the opportunity to substantially devalue sterling and offset the inflationary consequences against lower fuel prices. Between the fourth quarters of 1985 and 1986, sterling's effective rate fell by 16 per cent and its Deutschmark rate by 25 per cent. In the fourth quarter of 1986 sterling averaged DM2.86 compared to DM3.71 a year previously. At the same time inflation fell during the year to a low of 2.4 per cent in August.[6]

In his memoirs, Lawson rejects any suggestions that the government either sought or welcomed the devaluation in sterling. Rather, he claims that whilst recognising that some fall in sterling was inevitable with oil prices falling, he mistakingly acquiesced to sterling's depreciation, caught in the monetary vacuum left by Thatcher's veto of ERM membership.

> While I accepted that a halving of the price of oil made some exchange rate depreciation inevitable and necessary, I soon came to the view that sterling was falling too far too fast. .... My confidence that sterling had weathered the storm [after January 1986] was distinctly premature. Not only had I acquiesced in the relatively modest depreciation that had already occurred, but the second half of 1986 was to see a much more serious sterling slide. As a result, I lost the opportunity to lock in the marked fall in inflation that the oil price collapse had temporarily secured, and allowed policy to become looser just as the credit boom was taking off. Needless to say, I disliked intensely sterling's depreciation, in the second half of 1986; but there was a limit to what I could do, outside the ERM, particularly given Margaret's profound hostility to raising interest rates or maintaining any kind of exchange rate target. [7]

Thatcher herself under a heading 'Interest rates and Inflation: 1986' does not actually accord a single word to the decisions about interest rates and the exchange rate and their implications for inflation during the year.[8]

However, despite Lawson's subsequent claims, it is apparent on several scores that devaluation was an active government policy which was in direct contrast both to the 1985 policy and to what would have been possible inside ERM. First, one Bank of England official admitted that a devaluation policy existed:

We found ourselves, more consciously that at any other time that I

> can remember, saying this is an event [the oil price fall] that actually does require us, justifies and requires us, *to seek* to depress our real exchange rate because we have to shift resources into the balance of payments from other sectors of the economy to substitute for the adverse movements in the terms of the trade in the oil sector. That was a judgement we would not have been able to attempt had we gone into the ERM[9]

Second, the government's actions as sterling fell during 1986 are hard to reconcile with Lawson's later description of them. From February to September 1986, the Bank of England did not intervene to defend sterling and the government cut interest rates in March, twice in April and in May. Rather than acting to avert sterling's fall, the government encouraged it further.[10] During the second half of 1986, as sterling's decline accelerated, Lawson on his own admission made no attempt to convince Thatcher that an interest rate rise was necessary. At the same time, Lawson offers no explanation of why Thatcher's perennial dislike of interest rate increases should act as a 'limit on what (he) could do' in 1986 and not at other times when sterling was under pressure.

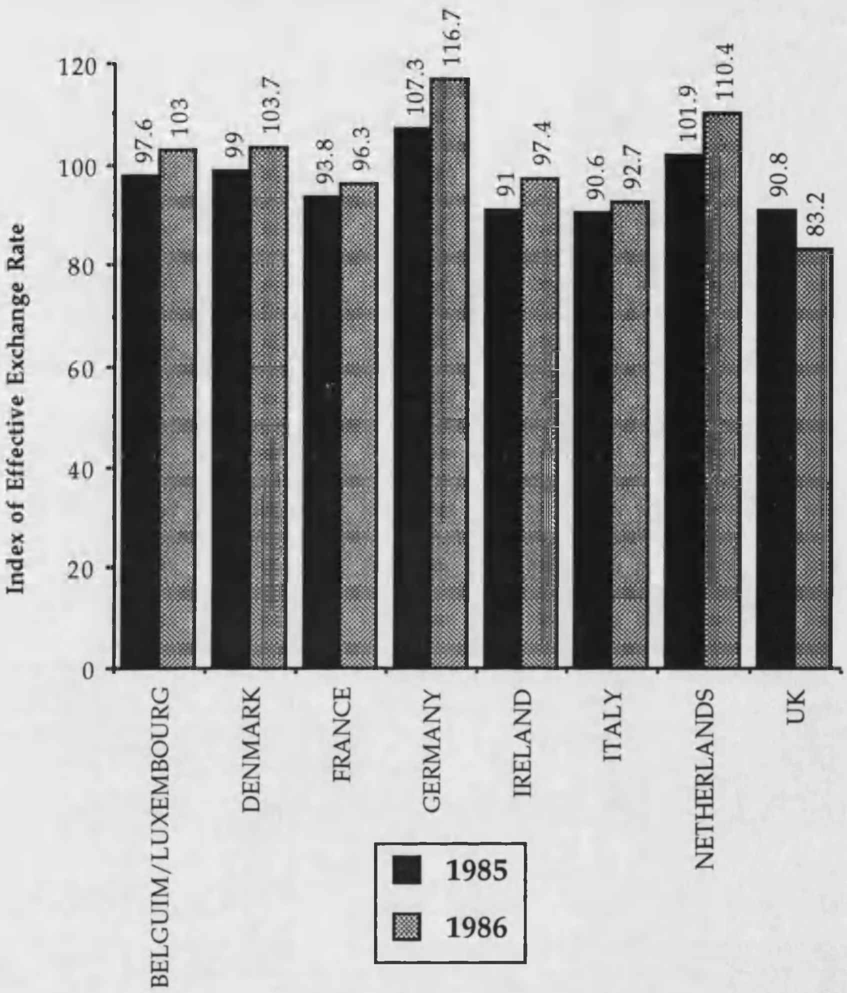
Third, the government clearly benefitted from the devaluation policy. In allowing sterling to fall and so boosting the competitiveness of exports, the government provided a significant stimulus to the previously sluggish economy. As Keegan comments:

> The beauty of the 1986 devaluation from Lawson's point of view was that it was an essential prelude to the burst of growth in the real economy which led up to the 1987 general election, but there was no great political drama attached to it in the way that affects Labour governments on such occasions.[11]

Indeed, with a one per cent cut in the basic rate of income tax in the 1986 budget, the government's obvious aim was to push for growth in all respects. As a result, the UK economy grew faster than any other G7 economy during 1986 and unemployment finally began to fall in the second part of the year.[12]

In using the oil price fall as a vehicle for growth through devaluation, the government stood apart from the ERM states.

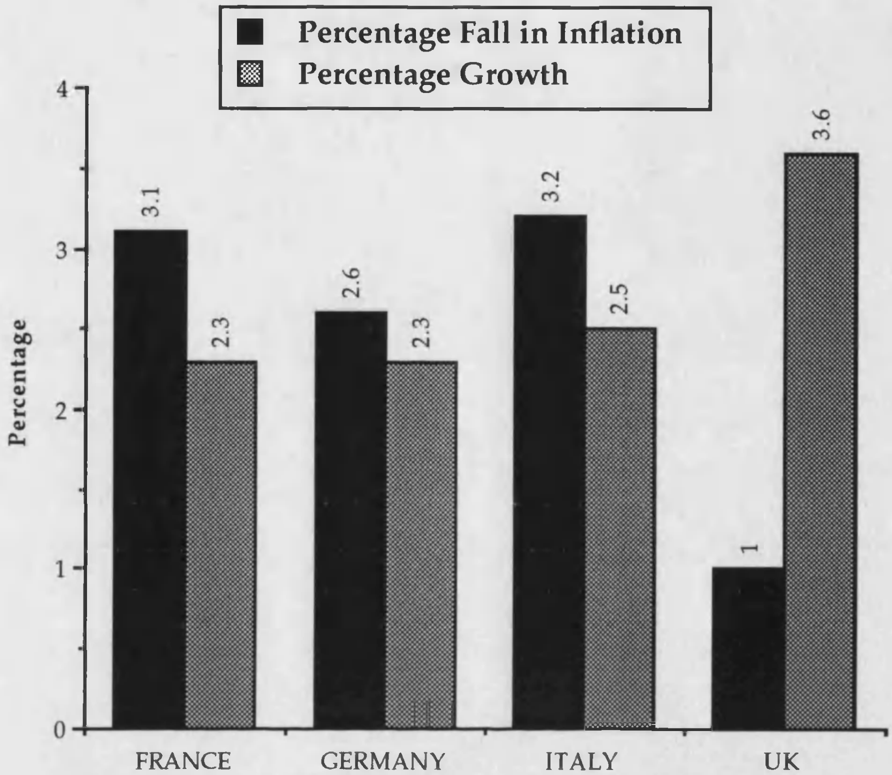
Figure 4.2: Comparative Effective Exchange Rates 1985-1986



(Source: Economic Outlook)

Figure 4.2 shows that from 1985 to 1986, the effective exchange rate of all the ERM states rose whilst that of the UK fell. Given sterling's depreciation, inflation did not fall as fast in the UK as in France, Germany or Italy as figure 4.3 (page 155) indicates. Correspondingly, UK growth was over one per cent higher.

Figure 4.3: Comparative Falls in Inflation 1985-1986 and Growth in 1986



(Source: Economic Outlook.)

Lawson and Howe Go Public

Despite the discongruence between the government's macro-economic policy and ERM membership, ERM did not disappear as an issue within the core executive. Opinions vary as to how much internal discussion continued in 1986. One senior Treasury official commented that in 1986 and 1987 the Treasury 'did not try to keep the issue alive very much.' [13] By contrast, another senior official said: 'the thing was never off the tap. It was always there.'[14]

On 16 April, Lawson and Howe broke public rank with Thatcher on the issue when both made speeches expressing supporting for membership. Lawson later claimed that the timing of the speeches was co-incidental but the press assumed that the moves were co-ordinated by the Treasury and the Foreign Office. In his speech to the Lombard association, Lawson declared:

In the right circumstances membership of a formal fixed exchange rate system can itself provide a very effective framework for monetary policy. ... Of course the exchange rate will not signal the right policy action every time, any more than monetary aggregates. But over the medium term, maintaining a fixed exchange rate against countries who share our resolve to reduce inflation is a pretty robust way of keeping domestic monetary policy on the rails.

But I see no role for an exchange rate target outside a formal exchange rate system, shared by other countries, and supported by a co-ordinated approach to economic management and intervention. And that, for the UK, means outside the exchange rate mechanism of the EMS.[15]

He then added that 'the government does not believe that the time is yet right for us to join the ERM.'[16]

For his part, Howe argued that the UK could not postpone indefinitely a decision on membership and suggested that the final say should be left to the Treasury. On 6 June Howe went further and said that some reasons for remaining outside ERM such as the petro currency argument were now diminished:

> There are still some reasons which remain, and these perhaps are based as much on the habit of not belonging as anything else....the position is not whether we are going to join. But that is an answer we cannot go on giving indefinitely.[17]

According to Lawson, their public intervention on the issue did not lead to further confrontation with Thatcher who was now in a stronger position than during the Westland affair:

> Geoffrey was keen to follow up our speeches with more private pressure on Margaret. I told him I thought it best to wait a little before returning to the charge. Not that I would have objected in the slightest had I thought that his proposed approach would have been productive, but unfortunately it was far more likely to be counter-productive. ... His relationship with Margaret had never been a particularly close one, and even by 1986 the signs of tension were beginning to become apparent. [18]

However, at least as plausible an explanation of Lawson's inaction was that the government was currently benefiting from an economic policy which was incompatible with entry to ERM. The real significance of Lawson and Howe's public action was that it demonstrated that they would put membership back on the agenda if and when the government decided it wanted to defend sterling again.

4.3: ANOTHER THATCHER VETO

In September and October 1986, membership did resurface as an active issue of economic policy between Thatcher and other core executive actors. During early September, sterling was falling towards DM3.00 for the first time. The government now decided that any depreciation beyond that level was undesirable and ordered the Bank of England to start to defend sterling. To help the process, on 3 September the government made a record $4 billion FRN issue to boost the reserves.[19] The government could not continue the devaluation policy indefinitely. With the price of oil stabilising further depreciation in sterling would translate into an increase in inflation. Indeed the inflationary costs of sterling's weakness were already increasing since the weakness of UK manufacturing industry was leading to a growth in imports. At the same time, inflationary pressure was mounting elsewhere. Despite the fall in inflation in previous years, from 1984 average earnings growth remained at 7.5 per cent. In 1986, real disposable incomes rose by 42 per cent. Similarly, there was a significant increase in consumer demand caused by the cut in income tax and a credit boom induced by financial deregulation.[20]

After the Bank of England's intervention, sterling continued to fall. On 23 September it came under further pressure after the publication of a record monthly current account deficit of £886 million for August. However, the government did not want to raise interest rates before the Conservative Party conference. Instead, it turned to the Bundesbank for help. On 28 September Lawson and Leigh-Pemberton met with Stoltenberg and Pöhl during the annual IMF and World Bank meetings in Washington. Pöhl was reluctant to offer any assistance. Lawson ended up suggesting a standby swap arrangement of a kind the Bundesbank had with the ERM states under which it effectively lent Deutschmarks for a specified period. Pöhl agreed to consider the proposal.[21] Lawson comments:

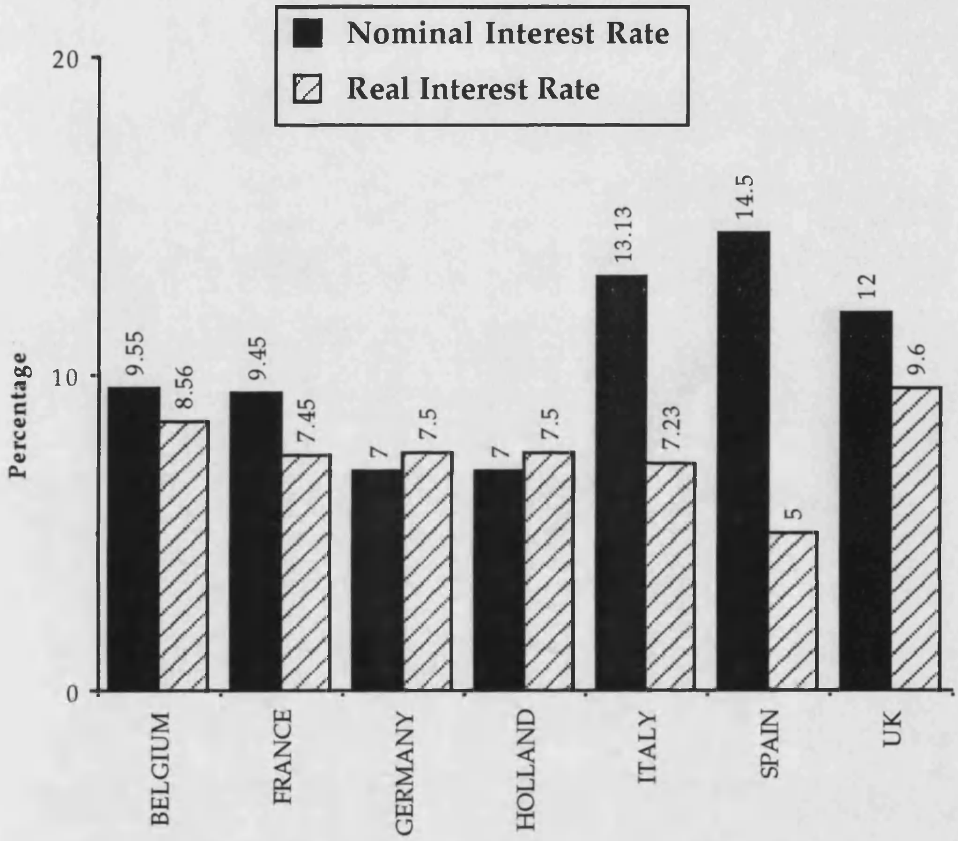
I telephoned Margaret to put her in the picture. She was furious that

> the Germans were not being more helpful, and went into her gut anti-German mode, which was never far below the surface. If the Germans would not play ball, she declared, she would pull the British Army out of the Rhine. More practically, she endorsed my proposal to secure a substantial swap arrangement.[22]

The next day Stoltenberg and Pöhl agreed that the swap deal should go ahead and that the Bundesbank would act as an agent of the UK government in the foreign exchange markets. It was the first time since Bretton Woods that the Bundesbank was asked to act in this way. Immediately it became apparent on 30 September that the Bundesbank was acting to defend sterling, the currency stabilised only to fall below DM2.90 within days. On 14 October, after the Conservative party conference was over, the government raised interest rates to 11 per cent and re-coupled monetary policy to the exchange rate. At the same time, in the 1986 Autumn Statement the government committed itself to fiscal expansion. It planned an average increase in the volume of public expenditure of 1.75 per cent year over the following four years and promised further tax cuts.[23]

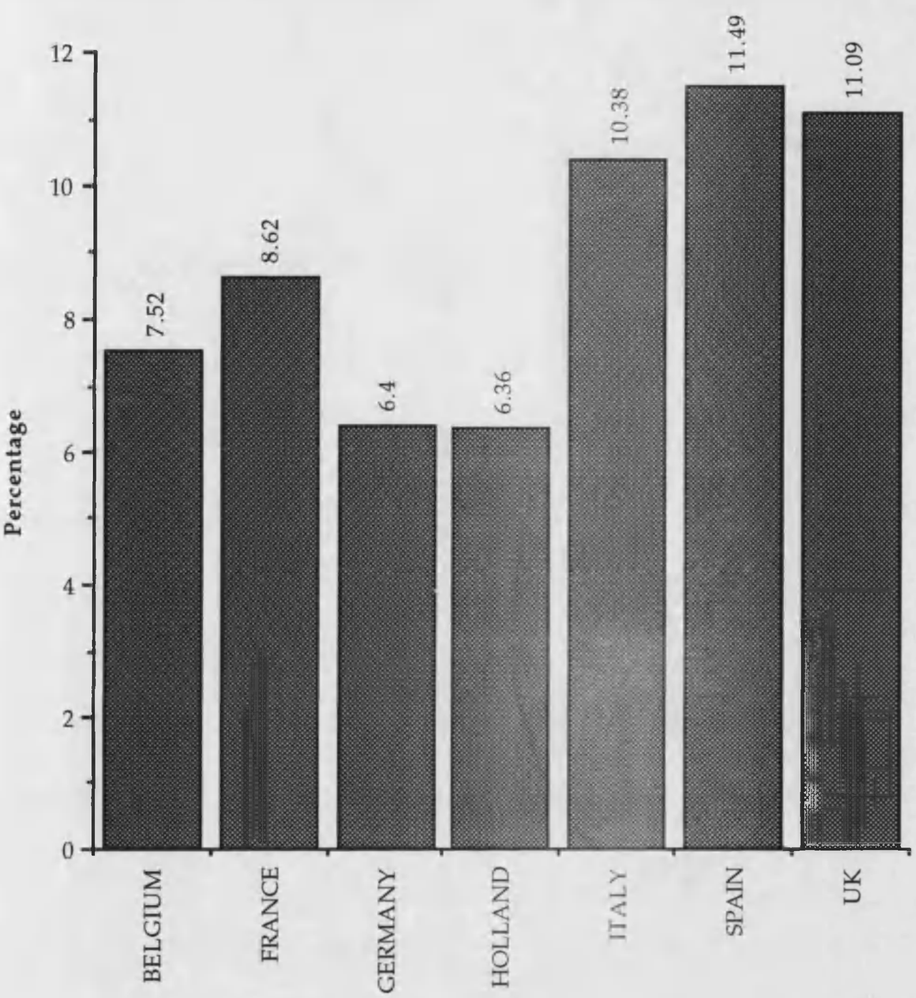
The government's monetary and exchange rate objectives were again compatible with ERM membership. Indeed, even more than in 1985, membership offered clear monetary benefits. As figure 4.4 indicates, after the interest rate hike in October, the UK along with Spain continued to suffer from higher nominal interest rates than the ERM states. The government was having to raise rates at a time when rates were falling elsewhere. In terms of real rates, the UK remained in an even poorer position with real rates over 2 per cent higher than those in France, Germany, Holland and Italy. By contrast, as another non-member of ERM, Spain enjoyed low real rates. On long term government bonds, figure 4.5 shows that the UK and Spain both had substantially higher rates than the ERM states.

Figure 4.4: Comparative Nominal and Real Interest Rates October 1986



(Source: The Economist Economic and Financial Indicators, October 25, 1986)

Figure 4.5: Comparative Long Term Government Bonds November 1986



(Source: The Economist Economic and Financial Indicators, November 1, 1986)

Financial commentators were very alert to the differential between UK interest rates and those of the ERM states and argued that the markets were demanding an UK interest rate premium because monetary policy was unclear. For example, the *Economist* commented:

> Higher than average interest rates means that Britain loses all the advantages that the anti-inflationary zeal of Mrs Thatcher and her ministers should have won for it. Just a few years ago, nobody would have believed that Italy with a budget deficit equal to 14 per cent of GDP, and a happy go-lucky record on inflation, would in 1986 be able

> to have lower interest rates in its long term government bonds than Thatcherite Britain. The moral is unmistakable: those countries with currencies inside the EMS gain twice over by having fairly steady exchange rates and also relatively low interest rates.[24]

As in 1985, ERM membership offered the government the benefit of lower interest rates for a given rate of inflation at a time when it was struggling to secure its re-election. Despite rising growth and falling unemployment, in September 1986 the government trailed Labour in the opinion polls by 4 per cent and was tied with Labour on 39.5 per cent in October. After November 1985 devaluation proved an alternative stimulus to the economy but this option no longer existed. Only ERM membership could provide lower interest rates and relative competitiveness which was likely to prove a further stimulus to the economy.[25].

The government's fiscal policy was far less compatible with ERM membership because the commitment to fiscal expansion diverged from the fiscal constraint of the ERM states. With the balance of payments moving into deficit because of rising imports, credit booming and wages rising, fiscal expansion was likely to add fuel to an inflationary fire. By contrast, the ERM emphasised inflation convergence. With sterling averaging DM2.86 in the fourth quarter of 1986 membership would impose less cost in terms of competitiveness than was the case in 1985. Nevertheless, despite the 1986 devaluation, the UK's general manufacturing trade performance continued to deteriorate. If membership would no longer have been the obvious constraint on export-led growth that it was in 1985, it would still have created a balance of payments problem for the period after the general election.[26]

In the short term, the government faced an apparent trade off of macro-economic objectives. ERM membership would mean lower interest rates, fiscal restraint and a counter-inflationary commitment. Continuing non-membership offered higher interest rates but allowed for fiscal expansion and its inflationary consequences. In these terms, the government faced a choice about whether lower interest rates or further income tax cuts were more necessary to secure its re-election.

In terms of its capital accumulation priorities, the government consolidated the position of the City in 1986 with the Financial Services Act. The City itself remained in favour of ERM membership and believed that it would inject some financial discipline into the UK economy. For manufacturing industry, membership now offered the consolidation of its new international competitiveness, in addition to exchange rate stability and reduced interest rates. During the year, the CBI continued its campaign for ERM entry: although it welcomed sterling's fall, business leaders quickly became restive about the accompanying increase in volatility. By contrast, for the multinational companies, membership was less advantageous than in 1985 because of their interest in a strong pound. [27]

The UK Presidency

As in 1985, the government wanted to play a positive role in the development of the EC. In July 1986 the UK took over the EC presidency. The government had a threefold agenda: first, and foremost to speed up the completion of the Single Market; second, to liberalise transport; and, third, to develop employment policy. By October the government was only making real progress on the Single Market.

At the same time the Commission and the other member states, especially Germany, put renewed pressure on the UK to enter ERM. As the government struggled to defend sterling in September and October, Commission officials became sharply critical of the UK's monetary performance. At central bank level, Pöhl vociferously insisted throughout the year that there would be no ecu-denominated accounts in Germany until the UK entered ERM. Later, the President of the Dutch Central bank, Wim Dulsenberg made a further call for membership and declared that: 'My feeling is that the time is becoming riper every day.'[28] One official commented on how the Bank of England saw the attitude of the ERM state central banks:

> I think there was generally a feeling that our recent and current economic, inflation and exchange rate experience meant that we were

> not likely to be a comfortable bedfellow in the ERM. So from the point of view of continued smooth operation of the ERM, they were not terribly anxious to welcome us in the near future. But there's always among the member states a feeling of common purpose and the need to develop that common purpose in an institutional way. And there was a feeling I think, even at that time, that it was going to be difficult to move beyond the then present degree of integration to something at that time not specified without UK membership of ERM.[29]

After Ireland was forced to devalue in August, the Irish government made its first public comment on the issue. The Finance Minister, John Bruton, declared that the Irish pound would continue to be vulnerable to devaluation so long as sterling remained outside ERM. Ireland's problem was that it needed to compensate against the ERM currencies for its large appreciation against sterling since more than 30 per cent of its exports were going to the UK.

Meanwhile the Commission and member state agricultural officials blamed the UK's non-participation in ERM for increasing problems with CAP. As a result of sterling's depreciation against the ERM currencies in 1986, French lamb farmers suffered as the UK was able to export more lamb to France. For the same reason, UK beef producers were undercut by Irish farmers taking advantage of the devaluation of the Irish green pound. The agricultural ministers eventually reached a compromise agreement, but the ERM member states tended to believe that the situation was an unnecessary problem created by the UK government's intransigence over ERM.[30]

Thus, ERM membership continued to offer considerable potential benefit to the government in terms of its EC policy. It would have been a *communitaire* gesture at a time when the government was looking to develop a specific agenda for action.

Thatcher Vetoes Debate

After the interest rate rise on 9 October, ERM membership assumed a new salience in the political arena. For the first time the Labour party sought to make some political capital out of the issue On 15 October, Roy Hattersley, the Shadow Chancellor declared that Labour would support entry to achieve greater exchange rate stability on certain conditions including: a commitment to expansion and fuller employment inside ERM; further convergence in the financial and economic approaches of member states; and, increased mutual currency support and co-ordination of trade policies to protect countries which wished to expand. Clearly, Labour's conditions would have transformed the ERM. However, Labour's move was significant because it contrasted with the government's profession of support in principle for membership but unwillingness to specify any conditions. On the same day, David Owen and the Liberal Treasury spokesman, David Penhaligon, demanded membership in view of sterling's recent fall. In addition, the Conservative MP, David Howell, advocated entry to stabilise sterling. Howell's intervention followed calls for membership earlier in the year in the House of Commons by the Conservative backbenchers, Stephen Dorrel and Peter Hordern.[31]

Within the core executive itself, Lawson was anxious for Thatcher to reconsider her position after the interest rate rise. Lawson believed that the cost in interest rates of the current policy was too high:

> As the autumn of 1986 went on and my political and personal standing started to rise, I remained worried about the low level of sterling. I did not see how it could be stabilised at a reasonably satisfactory level on the basis of any politically feasible interest rate changes in the run-up to an election - or even on the basis of a level of interest rates justified by the state of the domestic economy as we saw it at the time. I was convinced that we needed to bolster the effect of interest rate policy by a public commitment to a stable exchange rate system such as the ERM, not the least of whose virtues was an obligation to engage in short term intervention on the part of the central bank of the strong currency as well as that of the weak currency.[32]

Apparently, no longer believing in his own ability to persuade Thatcher, Lawson turned to the Bundesbank chief, Pöhl:

> For some time Pöhl had been arguing in public in favour of British membership of the ERM, and I knew that Margaret held him in high - perhaps exaggerated - regard.[33]

Pöhl was to come to London on 20 October and Lawson asked him to talk with Thatcher on the issue. Speculation in the media mounted that the talks would lead to the UK entering ERM. However, at the start of her meeting with Pöhl, Thatcher made it clear she would not discuss the issue. Immediately afterwards, Ingham told the lobby that the UK had no intention of entering ERM before the next general election and that sterling's current weakness was not caused by non-membership.[34]

On 21 October Lawson tried to discuss membership with Thatcher in a regular bilateral meeting but she dismissed him and made it clear that the issue was off the agenda until after the election. Again, Lawson appeared to renounce the option of confronting Thatcher in Cabinet or another broad core executive forum. Lawson claims that he lacked allies:

> I was feeling increasingly frustrated. I was also becoming somewhat isolated, since my senior officials had come to the view that the Prime Minister had vetoed entry, and that was that - at least for the foreseeable future.[35]

However, there were potential allies beyond the Treasury. At the Bank of England, Leigh-Pemberton and his supporters remained committed to membership as did Howe and the Foreign Office and other Cabinet ministers. Lawson could also draw on significant support for his position from within the Conservative party as a whole. Between September and December, Lawson chaired the economic policy manifesto group. Of twelve members, all except John Redwood supported ERM membership as a manifesto commitment dividing only between those who favoured entry before or after the election.

As in November 1985 Lawson decided not to take advantage of the potential alliance with Howe to force a Cabinet meeting. At least one official close to both men and a firm supporter of membership was exasperated by their lack of action at this time:

> I tried to 'hot' Nigel Lawson and Geoffrey Howe up to demand a Cabinet session on the subject. Because I thought it would be very difficult for her to refuse a firm demand for a Cabinet discussion on the basis of a firm paper from the Chancellor and the Foreign Secretary. And that she would find herself with not too many supporters. I don't know why the hell they didn't do that. They never

did.[36]

Apparently, Lawson and the Treasury did not want to use Howe and the Foreign Office to further their case any more than in 1985. At the same time Lawson appeared to collude with Thatcher in excluding other interested parties from the decision-making process despite their likely support for his position. MAFF and the Commission estimated that non-membership of ERM cost the UK 500 million ecus a year in CAP and Michael Jopling and his officials supported ERM entry. However, the department were not given and so did not press for a voice in the decision-making process. One MAFF official commented:

> When the British Minister of Agriculture wanted to have a bigger devaluation in order to get higher prices to UK farmers to compensate for UK inflation, the Commission would always propose a smaller devaluation. And Andriesson who was then the Commissioner for Agriculture would trot out the argument that if Britain were in the ERM then it would be much easier. In that sense it made life harder for MAFF. But we wouldn't go back [to Number 10 or the Treasury] It would not have carried any weight since the Treasury did not want to give more money to farmers anyway.[37]

4.4: SHADOWING THE DEUTSCHMARK

Thatcher second veto of ERM membership left a vacuum in monetary policy far greater than in 1985-1986. One of Thatcher's confidants' believed that the problem was the lack of Prime Ministerial power in economic policy:

> They [Prime Ministers] can give the Chancellor guide lines. But you've got open market operations, debt issues, I mean a whole host of issues which impinge on this and the Prime Minister is just not set up to control what the Treasury is doing. The thing is that the way to control it is to fire the Chancellor.[38]

By contrast, the Treasury believed that the problem was rather that Thatcher did not have an alternative policy to impose. One Treasury official commented:

> She really, as far as I know, did not address the question of an alternative because the obvious alternative was a money supply target but she knew we were in great difficulties with that. We were left in a kind of vacuum.[39]

As a result, during November the main core executive protagonists entered into public conflict. On 12 November Leigh-Pemberton told a conference of Bundesbank officials and German business people that the reasons for the UK's non-membership of ERM were 'entirely political.'[40] One week later, the *Financial Times* published an interview with Thatcher in which she accepted that ERM membership would be reconsidered after the election but gave full rein to her instinctive opposition to membership.

> In an hour long interview ... she said the economy was not 'quite strong enough yet' for EMS. 'We are getting stronger and one day we will go in.' She said repeatedly that entry would not be an easy or a soft option. ... Mrs Thatcher also argued that other EC countries should reconsider the rules, particularly the retention of exchange control in most cases. She also expressed concern about 'hitching our wagon to a Deutschmark standard and all the problems we used to have with devaluation if it comes.' She thought the pound would be tested and that would mean 'swinging up interest rates very sharply' since 'there is no way you can intervene to that great an extent.'[41]

At the same time, she demonstrated her ambivalence about the whole idea of assigning monetary policy to the exchange rate:

> Mrs Thatcher thought the pound had gone low enough against the Deutschmark. She underlined her dislike of increasing interest rates and market intervention. 'We may believe it [the pound] has gone enough but it is what the market believes and you know what the market is: 95 per cent of the movement is speculation and the other 5 per cent is trade.[42]

In response Lawson told the Treasury and Civil Service Select committee the next day that: 'I think there is clearly a case for being part of an explicit regional fixed exchange rate system.'[43] On 26 November Howe again publicly declared his support for membership in a speech to the CBI council:

> The phrase 'when the time is right' should be seen as a declaration of intent rather than the reverse. ... It is a legitimate expectation of the business community that politicians should try to increase domestic price stability. The EMS does represent a framework in which it would be possible to produce at least a measure of stability.[44]

Such public conflict was just what the Treasury always wanted to avoid. In the view of one Treasury official:

> It is absolutely essential that there should be agreement between the

> Prime Minister and the Chancellor on really important things. If and when they don't agree, you carry on until they do.[45]

This attitude left an unanswered question about what monetary policy should be until the Prime Minister and Chancellor could agree especially since the public conflict in November created pressure on sterling. In December, sterling did strengthen but the ambiguity in policy remained. According to Lawson, he believed that monetary conditions measured by MO still warranted an increase in interest rates. On 10 December Lawson and Thatcher met to discuss his proposal for a one per cent rate rise. Lawson states that Thatcher was dismissive of the proposal:

> However, she conceded with the utmost reluctance that it might nevertheless be right to raise interest rates - but if, and only if, there was 'a clear trigger' for an increase.[46]

Presumably, a 'clear trigger' meant a further fall in sterling. If Lawson's version of events is to be accepted, the policy situation at the end of 1986 was riddled with inconsistency. Lawson wanted sterling to enter ERM but outside ERM he wanted to assign monetary policy to a monetary aggregate. Meanwhile, Thatcher rejected both ERM membership and assigning monetary policy to a monetary aggregate, which was the main alternative if policy was not going to operate on an ad hoc basis.

Whose Decision to Shadow?

At the start of 1987, the policy vacuum left the government with a new dilemma. Sterling was strengthening as the short term outlook for the UK economy improved. The government could now either use monetary policy and intervention to place a cap on sterling and operate a stable exchange rate policy outside the ERM. Or it could allow sterling to appreciate and wipe out the gain in competitiveness achieved during 1986. Precisely how the government chose to resolve this dilemma became an issue of political dispute in itself.[47]

What is indisputable is that at the G7 meeting of 21-22 February in Paris, the UK government signed the Louvre international accord on exchange rate management. The G7 agreed to try to stabilise the dollar against the yen and the Deutschmark, and by implication against the ERM currencies. Although no target rates were published, the G7 central banks were to take co-ordinated action if and when there was divergence from the rough prevailing rates. At the same time, the agreement aspired to greater co-ordination of fiscal policy to try and combat the widening external imbalances between the G7 states which logically could not be rectified by exchange rate adjustment. Germany and Japan agreed, nominally at least, to provide greater stimulus and the US to restrain policy. In terms of the practice of UK policy, the Louvre Accord was ambiguous. Whilst the aim of Louvre was to stabilise the dollar (which included its rate against sterling), the means for achieving this goal was defined in terms of the Deutschmark to which sterling was not tied as a non-ERM participant.[48]

In practice, the outcome of Louvre was that the government's exchange rate policy was to shadow the Deutschmark between a range of about DM2.90 to DM3.00 using both monetary policy and reserve intervention. Between 22 February and the budget on 17 March, sterling rose to over DM2.90. In response, the government cut interest rates on 10 March to 10.5 per cent, and the Bank of England sold sterling and took massive sums into the foreign exchange reserves. As the upward pressure continued in the run up to the general election which the Conservatives looked certain to win, the government cut interest rates to 10 per cent on 19 March, 9.5 per cent on 29 April and 9 per cent on 11 May. The overall effect was to lock-in the gain in competitiveness achieved in 1986.[49]

The government did not publicly declare the new exchange rate target. Indeed, its public presentation of monetary policy remained riddled with inconsistency. In his 1987 budget speech Lawson declared that money GDP was the operational guide to the government's counter-inflationary monetary policy. He set a target for MO as a means to achieve control over Money GDP whilst noting that other indicators would be monitored of which the most important was the exchange rate.[50] By contrast, he later told the Treasury Select Committee that keeping sterling in line with the Deutschmark was likely to be over the medium term 'a pretty good anti-inflation discipline.'[51] Meanwhile, Thatcher told the *Financial Times* that 'there is no specific range - we are always free.'[52] In April at the NEDC, Lawson said that sterling rates of about $1.60 and DM2.90 were about right and that industry could base its plans on these rates. However, the next day, Lawson told a conference that these were in no way targets and he was simply stating the exchange rates prevailing at the time.[53]

What has been disputed is the process by which the shadowing policy was arrived at and how such ambiguity in policy presentation occurred. Thatcher and some of her acolytes have claimed that Lawson usurped the economic policy decision-making process and decided to shadow the Deutschmark without Thatcher's knowledge or consent. Thatcher herself states in her memoirs:

> Extraordinarily enough, I only learnt that Nigel had been shadowing the Deutschmark when I was interviewed by journalists from the *Financial Times* on Friday 20 November 1987. They asked me why were shadowing the Deutschmark at 3 to the pound. I vigourously denied it. But there was no getting away from the fact that the chart they brought with them bore out what they said. The implications of this were, of course very serious at several levels. First, Nigel had pursued a personal economic policy without reference to the rest of the government. How could I possibly trust him again? Second, our intervention in the exchange markets might well have inflationary consequences. Third, perhaps I had allowed interest rates to be taken too low in order that Nigel's undisclosed policy of keeping the pound below DM3 should continue. [54]

Nicholas Ridley claimed that Lawson deceived Thatcher over the Louvre Accord and decided for himself to use monetary policy and intervention to achieve exchange rate stability:

> Unable to prevail, but far from persuaded, he resolved to join it unilaterally and unofficially. ... The Bank was a willing, nay, keen accomplice: they had always longed for the good old days of fixed parities, and this at least was a step in the right direction. ... Margaret Thatcher could do little about all this. Nigel Lawson's stock was rising high. Although she no doubt disapproved, the Chancellor and the Bank alone were responsible for managing the currency day to day. ... I suspect Nigel Lawson just did it and bolted his doors against the protests coming from his neighbour at No 10.[55]

Keegan contends that Lawson did embark on a unilateral policy without consultation with Thatcher:

> Increasingly frustrated by Thatcher's continued refusals to countenance the EMS, Lawson decided to go it alone, by secretly conducting policy so that the pound would shadow the West German D-Mark. That way he hoped to prove to Thatcher, with a dry run, that she need have no fears about sterling's chance of stability within the EMS. ... There were two notable omissions from the list of people in on the decision to shadow the German mark: they were the Prime Minister, and her part-time economic adviser, Sir Alan Walters. [56]

Similarly, Smith suggests that Lawson decided upon the policy by himself before the Louvre Accord:

> It is inconceivable that he [Lawson] had not already made up his own mind about the desirability of a target for sterling well before setting off for the Paris meeting. ... It is also inconceivable that Lawson would have stuck so doggedly to the policy, which in the end degenerated into a full-blown battle between the Treasury and the Bank of England mainly on one side, and the markets on the other, had the Deutschmark target for sterling merely been a residual matter arising out of the wider Louvre Accord.[57]

After Louvre, in Smith's account, Lawson implemented the sterling target without Thatcher's knowledge:

> By keeping the policy within a tight Treasury circle, Lawson was also able to avoid the awkwardness of explaining to Thatcher that the Government was operating an exchange rate target. This was surprisingly easy. Thatcher did not pore over the newspapers each morning. She relied on a summary of the day's press prepared by Bernard Ingham, her press secretary. Ingham, who had a blind spot when it came to economic and financial policy, would not have troubled the Prime Minister with the minutiae of foreign exchange market reports or the speculation of City editors and economic correspondents about Deutschmark targets for sterling.[58]

By contrast, Lawson has always argued that Thatcher was fully party to the Louvre Accord:

> For we had agreed to hold meetings of the G5 and G7 at the Louvre in Paris in February, with a view to ending the dollar's long decline and ushering in a period of stability. And just as the pound had been falling with the dollar, so there was a reasonable prospect that stabilising the dollar would also stabilise the pound - just what was needed in the approach to a general election, when markets always tended to be nervous. Before going off to the Louvre, I discussed all this with Margaret, who was in full agreement with my objective. On

my return I sent her a minute, explaining what had been agreed. ... Contrary to much subsequent insinuation, I was scrupulous in keeping Margaret fully informed about the Louvre.[59]

After Louvre, Lawson says that he and Thatcher agreed to roughly stabilising sterling against the Deutschmark without a specific target in line with the Accord. [60] Lawson saw the policy as a prelude to ERM membership:

> It was a helpful prelude to the election itself, but I saw it essentially as an interim measure. My hope was to replace the policy with full ERM membership of the EMS as soon as the election was out of the way.[61]

The markets soon began to assume that the government was defending a target of DM3.00. In Lawson's words:

> At the markets meeting I held on 18 March, at which the reduction to 10 per cent was agreed, I told the senior Treasury and Bank officials present that this market view was useful, and that we should validate it, by being ready to intervene as and when necessary. ... Thus it was that the policy of shadowing the Deutschmark, as DM3 to the pound, was born.[62]

Lawson admits that there was no formal meeting with Thatcher when the DM3.00 target was agreed but says that Thatcher was kept fully informed of the new policy:

> It was always an implausible insult to her formidable intelligence to suggest that she could possibly have been unaware of it, even if I had wished to keep her in the dark, which, of course I did not. In fact we discussed it openly on a number of occasions.[63]

Indeed, Lawson claims in its initial stages, Thatcher was positively enthusiastic about the policy since it added to the foreign exchange reserves. In a television interview, Lawson declared:

> We were building up our foreign exchange reserves very substantially and she was very pleased with that. Whenever she saw the Governor of the Bank of England she said 'Tell me, Mr Governor, how much have we taken in today?' That's to say taking in of the foreign exchange, the reserves. So she liked that policy.[64]

Lawson's account of the decision is significantly more plausible than those who suggested he acted alone. Certainly, it is true that the Prime Minister is not involved in the day to day operation of reserve intervention policy. The Bank of England possesses a general authority to intervene in the foreign exchange markets on behalf of the government through the 1979 Banking Act as it relates to the Exchange Equalisation Account. The Bank does not require legal approval for any specific intervention on any one day. The Bank keeps the Chancellor informed by telephone about its activities through any day. Accountability for the Bank's actions is based on trust between the Bank and the Chancellor and the Treasury. [65]However, the Prime Minister does not have to ask to see the reserve figures. Rather, each night, the Prime Minister's economic private secretary receives the Treasury's daily market report. [66]One Treasury official commented:

> Whether she would actually see them depends on the private secretary. But I am pretty sure that given the size of the movements that were in there, the private secretary would say, here you better have a look at this.[67]

Lawson's account of the relationship between the Louvre Accord and the DM3.00 target has been supported by Treasury officials. In a television interview, Geoffrey Littler, the Second Permanent Secretary, stated:

> To the best of my recollection, we never thought of three Deutschmarks as being a ceiling until the combination of the market sensing that it might be, and the press of course choosing that as an obvious target with sex appeal in journalists' terms, more or less forced our hand. We found ourselves then in a band of sort of 2.80 or so up to three Deutschmarks willy-nilly. And if we'd failed to stay within that band, then the headline would have been 'Policy Collapses.'[68]

However, the conclusive point in favour of Lawson's account of the shadowing decision was provided by Thatcher herself when she admitted to the *Times* in June 1991 that she had known about shadowing but said that allowing it was her 'great mistake.' [69]

Rather than Thatcher, it was evidently the Bank of England which was left out of the formulation and subsequent discussion of the shadowing policy. Lawson himself omits to discuss the issue of the Bank's role and the Treasury have generally dismissed any suggestion that the Bank was excluded from policy-making. One senior Treasury official told Smith:

> I do not believe there was any stage where the Bank developed a significantly different view from ours. If they did, they certainly did not say so at the time.[70]

However, another senior official acknowledged that 'the commonality of view broke up over that.'[71] Indeed, according to Bank officials, Lawson would never even privately admit the operation of the policy to them despite relying on them to implement it. In a television interview, Anthony Loehnis, a Director of the Bank of England from 1981-1989 said:

> My recollection is that there was never any official admission of it [shadowing]. I mean clearly there was no public admission that that was what we were doing but as I've already said, I don't think that there was any reference to it, you know in private between Bank and Treasury officials. You were just sort of intuitive that it was in terms of the responses that one got to tactical options that there might actually be.[72]

The Bank's own view, according to one Bank official, was that shadowing was a 'total disaster.'[73] In the words of another former official:

> Shadowing was the worst of both worlds because the markets don't really believe it. ... You have to defend the target without credibility. You have to put more effort into defending it because they [the markets] can't really believe you should be defending it.[74]

Although the Bank believed that Thatcher did reluctantly acquiesce to shadowing, it laid the blame for its exclusion from the decision-making process on Lawson's inability to positively convince Thatcher of the policy.[75] One Bank of England official commented:

> He [Lawson] could not give it the proper airing and debate in the decision-making process that should normally attend these things because he was actually wanting to do something which he knew his neighbour next door would not actually agree to. ... It was a private enterprise attempt to be a proxy member of ERM.[76]

Thus, shadowing emerged as a response to the economic policy vacuum left by Thatcher's veto of ERM membership and in the process it created new divisions within the core executive on exchange rate management. First, Thatcher, Lawson and the Treasury agreed to a policy which they were not prepared to discuss with the Bank of England. Whilst the Governor and majority opinion in the Bank remained committed to ERM membership, they were now asked to implement a particular exchange rate policy which they could not countenance. Second, Thatcher and Lawson clearly decided to shadow the Deutschmark for different reasons. Lawson wanted to pursue a stable exchange rate policy and to demonstrate to Thatcher that sterling was fully ready for ERM membership. Meanwhile, Thatcher was prepared to accept pursuing stability against the Deutschmark so long as the policy was not broadcast in public. Rather than a prelude to membership, Thatcher evidently saw shadowing as an alternative, a means of accruing some of the benefits of exchange rate stability without conceding defeat on membership.

The Response to Shadowing

For those business interests which supported membership, shadowing offered mixed benefits. For companies involved in international trade, shadowing reduced exchange rate volatility even if it did not provide the general security of a formal exchange rate target. For its part, the CBI welcomed the stability which shadowing provided and refrained from any public campaign for ERM entry during the first half of 1987. However, it continued to believe that membership was necessary in the medium to long term.[77] The City did not believe that shadowing addressed its fundamental concerns about monetary policy since it did not provide an explicit commitment to financial discipline. From March, City rumours persisted that the government would enter the ERM soon after the general election.[78]

Since shadowing was designed to fill the monetary vacuum caused by Thatcher's veto of ERM membership, it did not address non-membership as an issue of European policy. According to one Treasury official involved with the policy, the Treasury did want to demonstrate its stable exchange rate credentials to the ERM states:

> The policy evolved from our concern that the exchange rate was falling too far and too fast in 1986, and this evolution ran through to the time when we locked into the DM. Once we had got to a situation where sterling was stable, we were concerned to demonstrate to the

> EC that, even if we were not in the ERM, at least give us credit for achieving stability outside the system.[79]

However, the Foreign Office saw little merit in shadowing. One Foreign Office official commented that shadowing 'proved very unsatisfactory - it brought all the inconveniences of membership with none of the advantages.'[80] Certainly, shadowing did not abate the pressure for ERM entry from the other member states especially from the Bundesbank. On 29 May 1987 Pöhl declared that 'Britain's membership would certainly give the EMS more weight and a new quality. We shall change the previous stance of rejection.'[81] Shadowing did not make further institutional development of the ERM any easier for the ERM states. Consequently there is no evidence that shadowing secured any additional influence for the UK within the EC.

4.5: SHADOWING AND ERM MEMBERSHIP

Lawson and the Treasury believed that shadowing was a second best means to procure the economic benefits of ERM membership. However, the day-to-day operation of the policy incurred several disadvantages in comparison to membership. First, shadowing did not provide the UK access to the short borrowing facilities of the ERM or guarantee European Central Bank intervention to support sterling. The essentially informal arrangement of coordinated intervention under Louvre was not the same as the obligatory support provided by ERM. Second, shadowing created a different relationship between the speculators and sterling than with the ERM currencies. As Hutton notes, it is very likely that sterling would have come under far less upwards pressure inside ERM than it did under shadowing. Without a formal cap on sterling's upper limit backed by collective intervention, speculators were given a likelier option on the upward movement of sterling from which they sought to profit.[82]

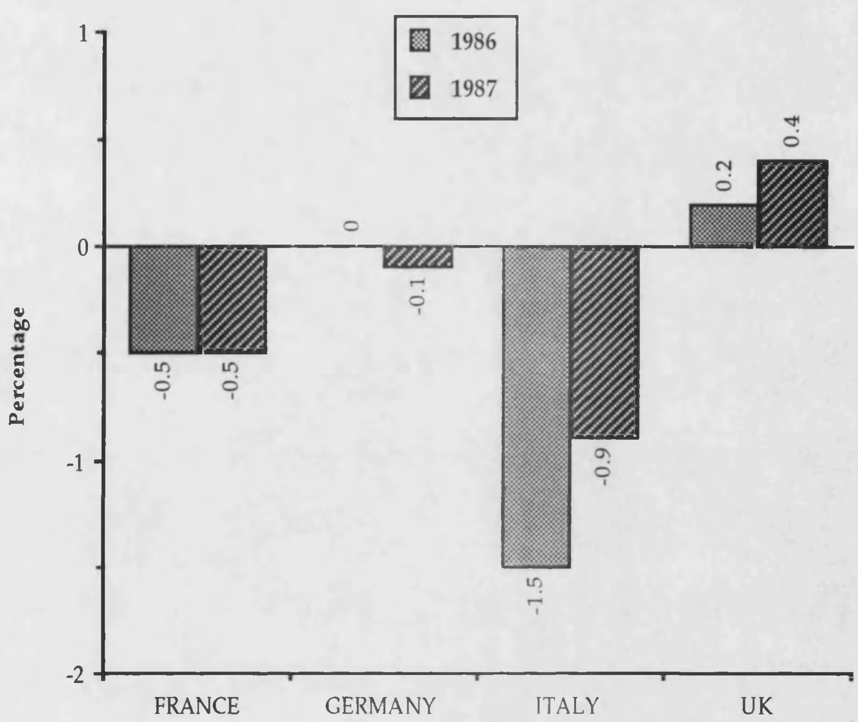
Third, in terms of monetary policy, shadowing was at best a quasi form of membership. It committed the government to exchange rate stability against the ERM anchor currency and used both monetary policy and central bank intervention to achieve that end. However this did not mean that the relationship between sterling and monetary policy worked as it would inside ERM. If relatively high interest rates were the premium demanded in autumn 1986 for non-membership, then shadowing did not abolish that premium. Although it provided an exchange rate target and an effective floor for sterling, this position was not explicitly communicated to the financial markets. The absence of a formal target, combined with the public divisions between Thatcher and Lawson continued to cause uncertainty and did not provide the security necessary to reduce interest rates. Rather, the government was able to loosen monetary policy because of the markets' new found faith in the strength of the UK economy and the likelihood of the government's re-election. At the same time, if and when sterling came under pressure again, shadowing as an unannounced policy could not reduce the interest rate premium on the ERM states necessary to defend sterling. [83]

Nevertheless, the differences between the government's shadowing policy and ERM membership went beyond these practical and inevitable difficulties. If Lawson and the Treasury saw shadowing as 'a dry run' for ERM membership, then it threw some interesting light on Lawson and the Treasury's peculiar conception of ERM membership. The question shadowing left unanswered was how Lawson and the Treasury believed that the government could match the counter-inflationary performance of the ERM states in view of its attitude towards fiscal policy, credit controls and wage restraint.

Shadowing and Fiscal Policy

Shortly after shadowing began, the government used the 1987 budget to cut the basic rate of income tax to 27 per cent.[84] As figure 4.6 (page 178) indicates, in both 1986 and 1987, the government gave a fiscal stimulus to the economy at a time when France, Germany and Italy were pursuing deflationary fiscal policies to control demand. The UK government's move towards fiscal expansion was all the more distinctive because it occurred at the same time as monetary policy was being loosened. Inside ERM, there would have been an obligation to tighten fiscal policy to offset the lower interest rates produced by sterling's appreciation. Rather than using monetary and fiscal policy in tandem as the ERM states did, shadowing was an exchange rate policy exclusively defined in monetary terms.

Figure 4.6 Comparative Fiscal Stimulus as a Percentage of GNP 1986-1987



(Source: Economic Outlook)

If shadowing was a 'dry run' for ERM membership, then how did Lawson and the Treasury believe they could reconcile the government's fiscal policy with actual ERM membership? Certainly, there is no evidence that Lawson envisaged using fiscal policy differently once inside ERM. Fiscal expansion, particularly through income tax cuts, was not incidental to the 1987 budget but central to the government's electoral strategy. The government believed the issue of taxation was fundamental to its appeal compared with the Labour party. In a radio interview in January 1987, Lawson declared:

> There is a fundamental difference of philosophy between the Labour Party and the Conservative Party. The Conservative government

> believes in bringing tax down and the Labour Party quite clearly believes in putting income tax up.[85]

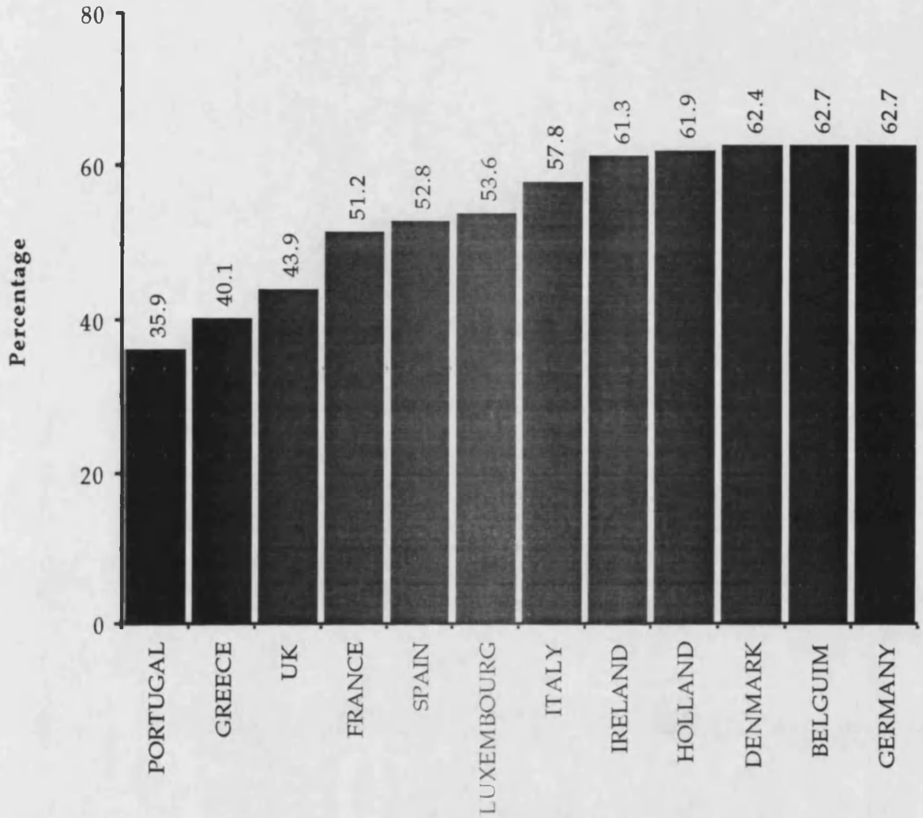
Similarly, the 1987 *Conservative Campaign Guide* stated:

> There are compelling economic arguments for lower taxation. But there are also fundamental considerations of political principle. If the government does not trust a family to spend its own money, what will it trust the family to do? It is no accident that the Conservative Party, the only political party committed to the family and opposed to the encroachment of the state, is also the only political party committed to bringing taxes down.[86]

In their study of the 1987 general election, Butler and Kavanagh concluded that taxation was the probably the most effective issue for the government.[87]

At the same time, the low income tax regime was an important plank of the government's efforts to make Britain the centre of inward investment in the EC. As figure 4.7 (page 180) shows, by June 1987 the UK possessed easily the lowest marginal tax rates on average wages among the major EC states. In the whole Community only Greece and Portugal levied less marginal tax. Although ERM membership would not categorically rule out further income tax cuts, it would place taxation policy in the context of exchange rate management. Inside ERM, cuts would have to be related to the state of monetary policy and possible increases countenanced.

Figure 4.7: Comparative Marginal Tax Rates on Average Wages
June 1987



(Source: Economic Outlook)

Neither can it be said that fiscal policy was decided by Thatcher at Lawson's expense. Lawson himself publicly rejected fiscal demand management. In a speech in July 1988 he declared:

> Inflation is pre-eminently a monetary phenomenon. Interest rates are the essential instrument of monetary policy. ... The notion that fiscal policy should be used to fine-tune demand is to hark back to the failures of the 1960s and 1970s.[88]

Lawson similarly rejected the idea that changes in taxation levels could be part of a counter-inflationary fiscal policy telling the Treasury Select Committee in 1988 that '[tax changes as part of fiscal policy] are extremely inflexible ... very slow acting and the reversal of them is extremely complicated.'[89]

Indeed, if Lawson is to be believed, he was the architect of the government's fiscal policy rather than Thatcher. In October 1986, Thatcher was worried that fiscal policy was too lax in view of the PSBR whereas Lawson was unconcerned.[90] Lawson states that whereas he planned the 1987 income tax cuts in this period, Thatcher was prepared to raise taxes.[91] His account leaves the paradox that Lawson supported ERM membership and a fiscal policy incompatible with it, whilst Thatcher rejected both ERM membership and the main constraint it would have placed on economic policy.

For its part the Treasury was less enthusiastic about the 1987 cut in income tax and initially argued for a cautious budget.[92] Lawson comments:

> The Treasury mandarins never sought to prevent me from cutting income tax .... None the less there was no disguising the fact that they disliked it, and hoped that I would do as little as was consistent with government policy.[93]

However, there is no evidence from the comments of Treasury officials that the Treasury's view of income tax cuts was determined by an alternative conception of ERM membership to Lawson's. According to Lawson himself:

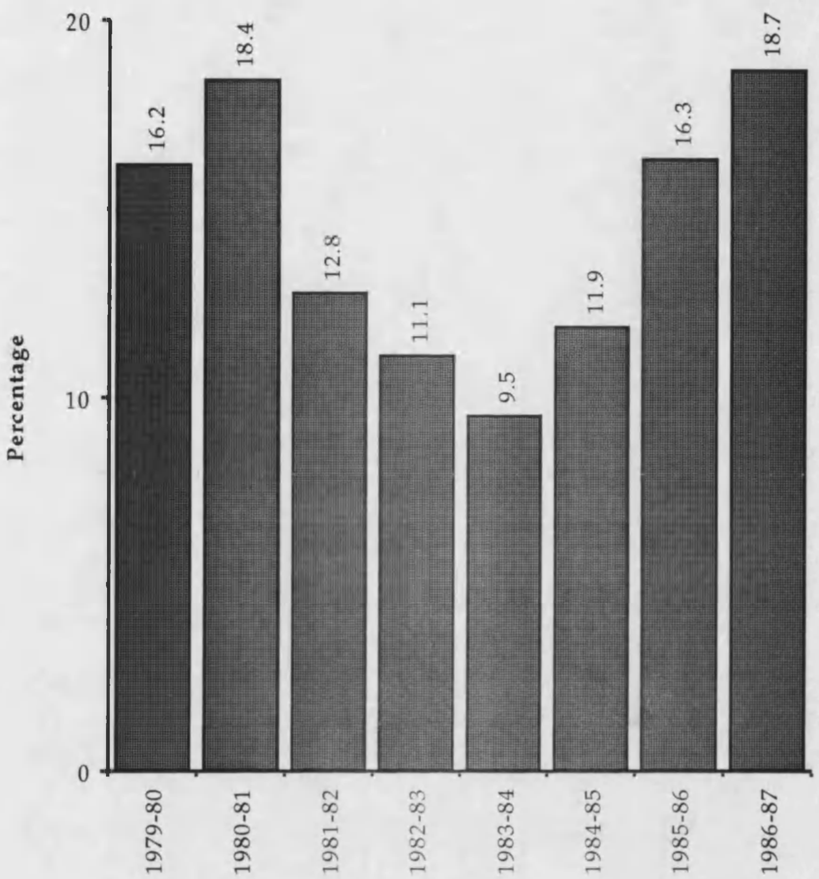
> The ethos of the official Treasury is unremittingly austere. They disapprove of tax cuts almost as much as they dislike increases in public spending. They cannot imagine what the public have done to deserve tax cuts, which will inevitably be put to frivolous use.[94]

Thus, Lawson and the Treasury were apparently unaware of the contradiction between their support for ERM membership and the government's fiscal policy. The origins of this peculiarity can be traced back to the conception of the benefits of membership which they developed in 1985. After the sterling crisis, ERM membership represented an alternative counter-inflationary monetary means to achieve the ends of the MTFS. They retained the assumption of the MTFS that inflation was essentially a monetary phenomenon. Consequently, in contrast to the ERM states, they did not believe it was necessary to manage aggregate demand in order to control inflation. Indeed Lawson did not appear to believe that fiscal policy in 1986-1987 was expansive and denied that increasing demand without a parallel increase in supply was inflationary. Rather, he measured the scale of fiscal policy by the PSBR which the government was reducing through privatisation revenues.[95] In so doing, he clung to the vestiges of the proposition of the original MTFS that the impact of fiscal policy on inflation occurred through the relationship between the PSBR and £M3.

Credit Controls and ERM membership

From 1985 to 1987, there was an inflationary explosion of credit in the UK economy. In the early 1980s the government removed a variety of restrictions on lending. However, after a surge in 1981, sterling bank lending to the private sector remained relatively steady. Then, between 1985 and 1986, bank lending doubled to reach a level about 25 per cent higher in real terms than the previous peak in 1972.[96] The expansion in credit during 1985-1987 was further reflected in the growth of the broad monetary aggregate £M3 which includes sterling current accounts of the UK private sector with banks, deposit accounts and public sector accounts. As figure 4.8 (page 183) shows the annual percentage increase in £M3 shot up from 9.5 per cent in 1983-1984 to 18.7 per cent in 1986-1987.With large mortgages easily available, rising house prices became a significant source of inflationary pressure. In the six quarters from January 1986 to June 1987 indexed house prices rose 34 percentage points compared to 17 in the previous eighteen months.

Figure 4.8: Sterling M3 Growth 1980-1987



(Source: The Economy Under Mrs Thatcher, p. 274)

The government did not act to restrain the credit boom. Indeed, in the 1987 budget, it did not even set any kind of broad money target as a yard-stick to measure its expansion.[97] The government's view, shared by the Treasury, was that in a deregulated financial world it was impossible to directly control credit. Lawson's view was:

> It was absurd to imply that introducing controls on hire purchase or credit cards would do anything significant to reduce the growth of consumer credit, or allow interest rates to be one whit lower. In any event such controls would have been simplicity itself to get around in a deregulated financial market without exchange control. As for direct controls on bank lending, these had proved increasingly ineffective even before exchange controls were abolished. By the late 1980s they would have been simply a field day for foreign lending

institutions.[98]

At the same time, the government and officials privately tended to the view that the credit expansion was not dangerous. One Treasury official commented on the prevailing attitude:

> You had gone in for deregulation. You had got a much more efficient financial system out of it. There was a stock adjustment going on while people adjusted their debt-asset ratios to the new deregulated environment. And as soon as that stock adjustment was over, everything would sort of come back and you'd be on a rather golden path with the stock of credit higher but the growth of credit from then on no higher. The problem was that we had absolutely no idea how long that stock adjustment was going to take.[99]

During the government's second term of office, only a consumer credit tax emerged briefly as a possible method of control. Lawson recalls that he first proposed such a tax in 1985 but dropped the idea after Thatcher refused to countenance applying it to mortgages. In January 1987, in preparation for the budget, Lawson and the Treasury agreed to a 5 per cent tax on all consumer credit payments except mortgages. However, after the Bank told Lawson that a tax announced in March 1987 could not be introduced until July 1988, Lawson 'dropped the whole idea without even bothering to put it to Margaret.'[100]

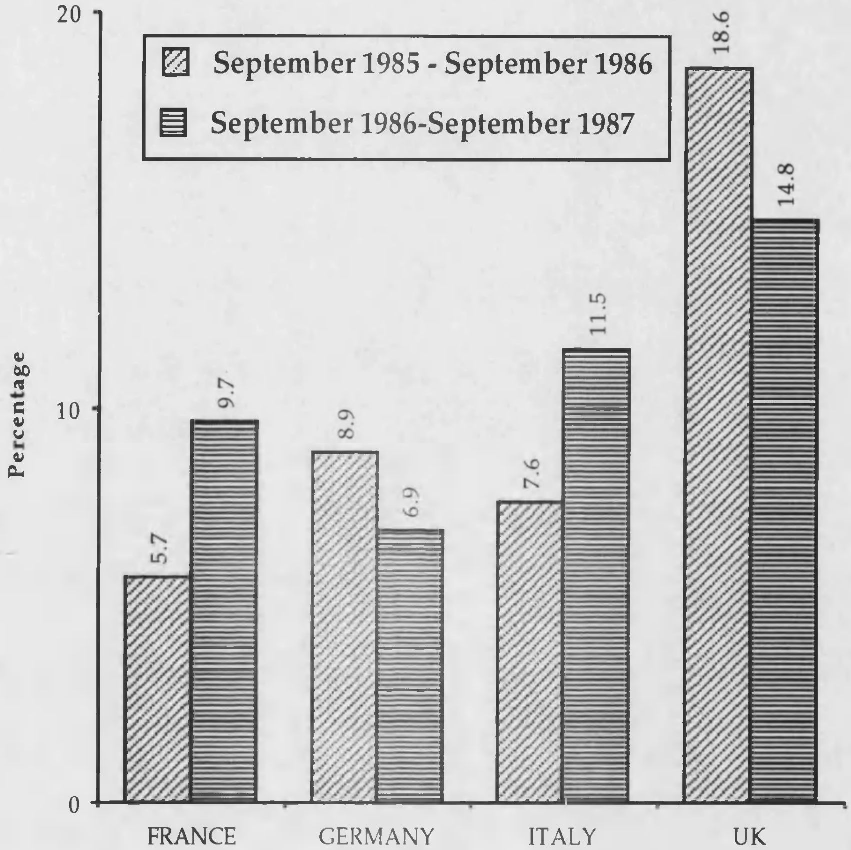
By contrast, all the ERM states controlled credit to a lesser or greater extent in this period and did not incur the same kind of credit boom. From 1985 to 1987, the UK had easily the highest broad money growth among the G7 European states as figure 4.9 (page 185) indicates. Lawson and the Treasury, or indeed the Bank of England, did not believe that there was any contradiction between their attitude towards credit expansion and their support for ERM membership. In their view, Germany did not use credit controls, and since Germany was the ERM benchmark, there was no need for the UK to control credit if it were to join. One Treasury official commented:

> We didn't think that Germany practised credit controls. They had a different way of running their monetary system. ... They ran a form of monetary base control. I don't think we regarded it as equivalent to

control of credit.[101]

Figure 4.9: Comparative Broad Money Growth 1985-1987

(Measured by M3 except for Italy by M2)



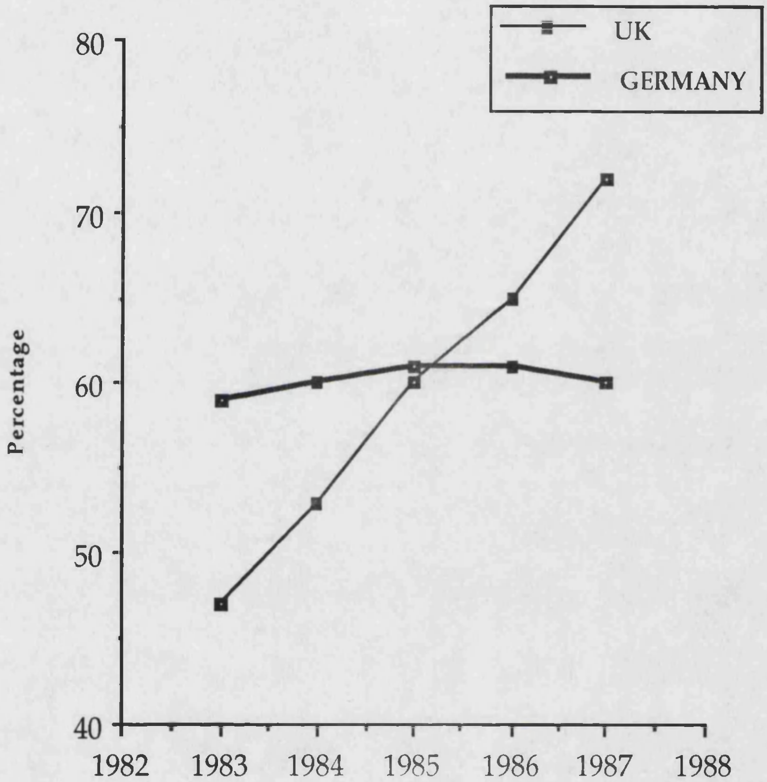
(Source: Economic Outlook)

Lawson and the officials were particularly dismissive of any suggestion that the Bundesbank operated effective monetary reserve requirements, a system in which banks are required to lodge a fixed percentage of their deposits as cash with the central bank. Lawson states:

> In essence the German system was little different from that operated in the UK by the Bank of England. ... The only substantive difference between Britain and Germany was that in Germany there were mandatory, and much larger reserve requirements - idle balances as far as the banks were concerned. The high German reserve requirement did not make German interest rates any lower: it merely

encouraged the Frankfurt banks to escape the impost by challenging business through offshore centres such as Luxembourg, to the annoyance of the Bundesbank. This explanation had, in fact, been given numerous times in the *Bank of England Bulletin*. But the myth was so much more attractive than the bleak reality that it seemed indestructible.[102]

Figure 4.10: Household Debt to Disposable Income Ratio in Germany and the UK 1983-1987



(Source: The Guardian, October 9, 1992)

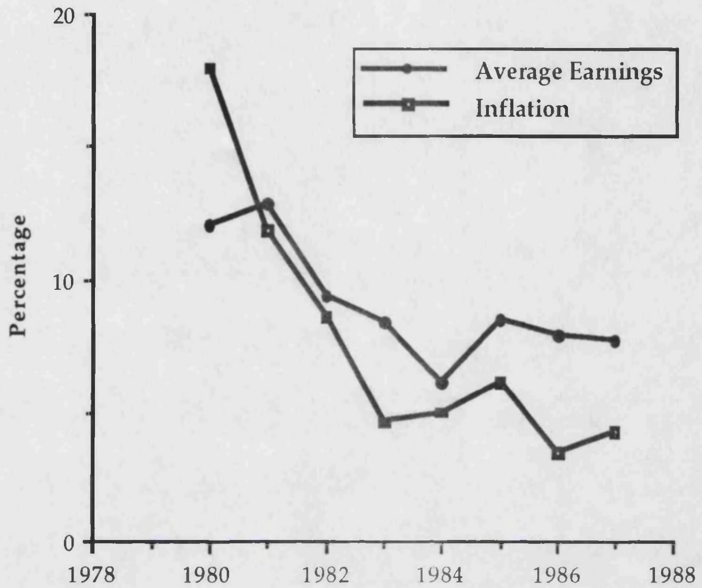
However, Lawson and the Treasury's position on the relationship between UK membership and credit controls was based on two fallacies. First, whilst it is true that the Bundesbank ceased to attach much operational significance to its monetary reserve requirements in the 1980s, this did not mean that Germany shared the UK government's laissez-faire attitude towards credit. As the utility of its monetary reserve requirements declined, the Bundesbank turned to open market policy instruments. It used short-term purchases and sales of government bonds and other securities to regulate liquidity in the banking system.[103] At the same time, Germany maintained a broad money target to measure credit after the UK government decided that such targets were not reliable.[104] When the outcome of German and UK policy towards credit expansion is compared, it is very difficult to sustain Lawson's argument that 'the German system was little different than that which operated in the UK.' As figure 4.10 (page 186) shows whilst the German ratio of household debt to income remained relatively stable between 1983 and 1987, the UK ratio increased dramatically.

Second, whatever Lawson's and the officials' assessment of German credit policy, in terms of ERM membership, it would have been more appropriate to compare UK policy with ERM states other than Germany. To sustain their currencies, these states needed to reduce inflation to as near German levels as possible by whatever means they could. Certainly, all the other ERM states controlled credit practising both monetary reserve requirements and continuing to set a broad money target throughout the decade.[105] Since credit expansion was an inflationary problem for the UK, it was rather irrelevant as to how low inflation Germany did or did not control credit. Inside ERM, the onus would be to reduce inflation whatever its cause.

Wage Control and ERM membership

Wage rises were a further source of inflationary pressure in the UK economy in 1986 and 1987 which the government did not seek to control. Figure 4.11 (page 188) shows that in these years the differential between increase in average earnings and inflation in the UK was significantly higher than between 1981 and 1984. At the same time, the UK neither achieved the steady low level percentage increase in wage costs of Germany or the reductions secured by other states notably France. As figure 4.12 (page 189) shows, whilst the annual increase unit labour costs fell from 1985 to 1987 by 3.15 per cent in France and 5.05 per cent in Italy, they fell only 0.5 per cent in the UK.

Figure 4.11: Increases in Average Earnings **Compared to Inflation** 1980-1987

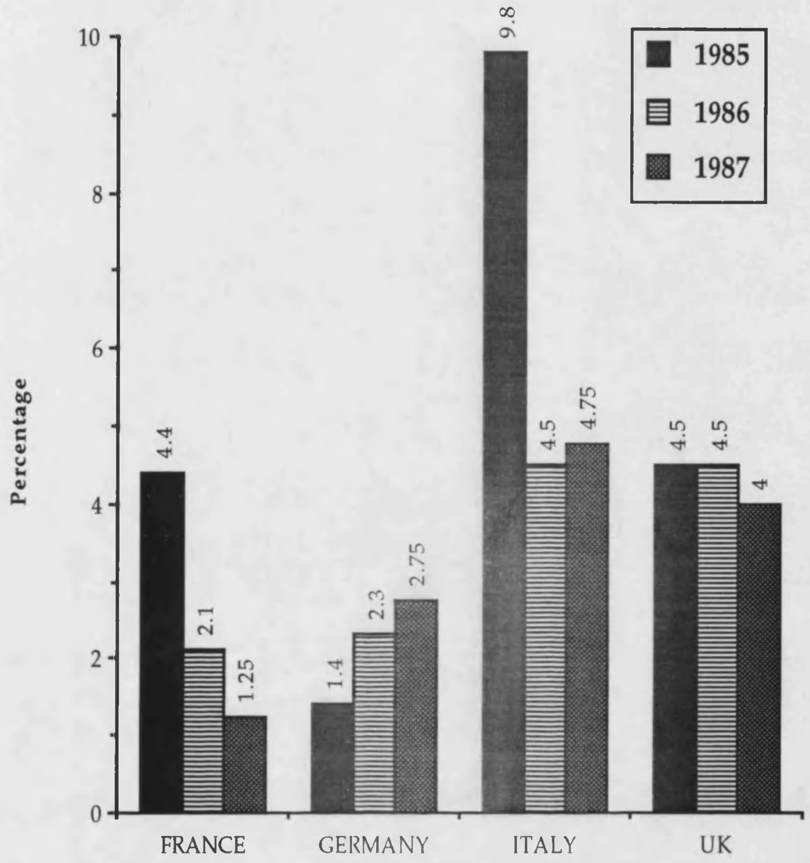


(Source: Annual Abstract, Monthly Digest of Statistics)

Unlike the ERM states, the UK government did not have a policy to control wage increases, having renounced any form of incomes policy on its entry to office in 1979. With the Heath government's statutory incomes policy blamed for its defeat in 1974, formal wage restraint was an unthinkable option for the Thatcher government. One Treasury official recalled:

> Wage restraint was certainly not on the agenda. ... The whole history of the 1970s led to the view that incomes policies had been singularly ineffective for two reasons. Firstly, they just led to a wage explosion as soon as they ended. And secondly, that, a wage policy would lead to inflexibilities in the economy. ... The only time I ever heard incomes policy seriously mentioned was in the Cabinet in 1981.[106]

Figure 4.12: Comparative Percentage Annual Increase in Unit Labour Costs 1985-1987



(Source: Economic Outlook)

The Treasury was just as opposed to formal wage restraint as ministers. They too regarded the 1970s experience as an unmitigated failure.[107] In the view of one Treasury official, the only cure possible cure for rising wage increases was recession:

> We tried it [an incomes policy] and it does not seem to have succeeded. If it works, you don't need it and if you need it, it doesn't work. ... It is a tragedy of the British economy that it appears to require quite deep recession to check even to 'check' whatever that means, wage inflation.[108]

To the extent that Lawson and the Treasury did recognise that the level of wage increases in 1986 and 1987 would translate into inflation, they believed that ERM membership itself was the most effective policy instrument to combat the problem. One Treasury official commented:

> We seem to be stuck with earnings increase of 7 per cent plus. ... It [the wage problem] led back to the need to have a more competitive labour market and I think it led back to the ERM too. We were impressed by the wage experience of France and Germany and we felt that membership of the ERM had had an impact on wage negotiations. In the sense that wage negotiations were helped when there was not a devaluation option to override an inflationary wage settlement.[109]

However, such an attitude stood in contrast to the actual experience of France and Germany which had institutional structures designed to restrain wage increases independent of ERM membership. In effect, Germany practised, what Johnson describes as 'a covert form of voluntary incomes policy.'[110] The Bundesbank and the Council of Economic Experts (CEE) set implicit parameters for wage bargaining. The CEE was specifically charged with the means of maintaining price stability, and made wage restraint the central objective of its policy recommendations. Meanwhile, at the end of each year the Bundesbank announced a rate at which the money supply would be allowed to expand over the subsequent year and what this entailed for wage settlements. Through a network of informal and collaborative business-labour forums. the exhortations of the CEE and the Bundesbank were generally accepted by wage bargainers on both sides.[111] In France, the government concentrated on a public sector pay policy.

One senior CBI official commented on the intellectual incompatibility between Lawson's support for ERM membership and the absence of formal wage restraint:

> I don't think they properly understood just what convergence involved. I think they thought that by being in it [ERM] that itself would impose the [wage] discipline. Because clearly if our costs went up quicker than the exchange rate in a fixed parity would allow us to go up, then those companies would lose their profitability, they would be in decline and jobs would be lost. ... I think they were putting in the end result with the hope of controlling one of the inputs.[112]

Fiscal policy, credit controls and wage restraint all raised questions about how Lawson and the Treasury believed they would be able to match the counter-inflationary performance of the ERM states in the medium to long term whilst renouncing the means they used to achieve it. Indeed, in the face of rising inflation, the only option the government left for itself was to allow sterling to appreciate to reduce import prices - which was the one counter-inflationary policy ruled out *per se* by ERM membership. Whilst revaluation remained possible within ERM, it is difficult to see how a relatively inflationary currency would come under enough appreciatory pressure to warrant an upwards realignment. In sum, for all the support within the core executive for ERM entry, inside the counter-inflationary ERM the government would be left with a bare counter-inflationary cupboard.

Thatcher's View of Non-Membership

Was Thatcher aware of the difficulties in counter-inflationary policy which the government would have faced in ERM in 1986-1987? And did such an awareness of them form any part of her opposition to ERM membership? Did Thatcher's conception of sovereignty on ERM membership involve the wish to hold onto a peculiarly British approach to counter-inflationary policies? Such an explanation of Thatcher's position would be dependent on her possessing a better understanding of the ERM's operation than Lawson, the Treasury or the Bank of England. In the case of fiscal policy, this argument is hard to sustain at least if Lawson is to be believed that Thatcher was less committed to fiscal expansion than himself. If Thatcher preferred a more restrained fiscal policy than Lawson, then it can hardly stand as a reason for her rejecting Lawson's case to enter the ERM with its emphasis on fiscal restraint.

Only in the case of credit controls is there evidence that Thatcher saw a contradiction between ERM membership and government policy. Asked about whether Thatcher was aware that ERM membership might be a backhand path to credit controls, a close adviser replied:

> Yes, very much so; nannying she called it. I don't think it was a major part of her objection to it. I think she took the view that if we went in we wouldn't have credit controls, they would have to change to our way.[113]

Alan Walters in an article in the *Evening Standard*, in April 1991 said that he had been expecting Lawson to raise credit controls ever since 1985-1987 since all the other ERM states practised them.[114]

Clearly,Thatcher's views on credit controls are not enough to explain her opposition to ERM entry. However, it is not difficult to conceive that Thatcher's view on credit controls fitted into a general belief that there was 'our way' and a 'continental way' of running the economy. For example, in her *Financial Times* interview in November 1986, she railed against the exchange controls of certain ERM states in comparison to the absence of controls in the UK. It is similarly easy to understand how Thatcher could see electoral benefit in presenting the government as preserving 'our way' of economic management against outside forces.

Conclusions

In 1986 and 1987 the core executive was only really forced to confront ERM membership as an issue of economic policy. Although the pressure for entry from the ERM states remained, non membership imposed no significant costs on the government's EC policy. After the initial ambivalence about monetary policy in 1986, the government took full advantage of Thatcher's veto of ERM membership to stimulate the economy in preparation for the general election. In so doing, the government demonstrated the short term flexibility of non-membership which the Prime Minister wished to preserve. However, once the government wanted to stabilise sterling in September 1986 the benefits of non-membership in terms of monetary and exchange rate policy diminished. Divisions re-emerged between Thatcher and her senior Cabinet colleagues, the Treasury, the Foreign Office and the Bank of England. With Thatcher loath to concede defeat on membership but unable or unwilling to provide an alternative, the economic policy making process broke down. Lawson was left to operate a monetary and exchange rate policy which because of its perceived proximity to ERM membership was never openly discussed within the core executive. As a result, the Prime Minister-Chancellor axis was not re-established and the Bank of England was marginalised from the decision making process.

As a compromise policy, shadowing could not provide a long term solution to the government's problem over ERM membership. Indeed, Lawson was likely to resume battle with Thatcher as soon after the general election as possible. Yet without new alliances there was no reason to suppose that he would be any more successful than in 1985 and 1986. At the same time, renewed public divisions between the Prime Minister and Chancellor would in the medium term make operating any kind of exchange rate policy difficult Even if Lawson were to be successful, fundamental questions remained about how actually the UK government was going to act as a viable member of ERM.

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11. Keegan, *Economic Gamble*, 186.

12. Keegan, *Economic Gamble*, 186; *Economic Outlook*, June 1990, Table R1.

13. Non-attributable interview with Treasury official.

14. Non-attributable interview with Treasury official.

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16. Lawson, *Memoirs*, 653.

17. *Financial Times*, April 17,1986; *Financial Times*, April 21, 1986; *Financial Times*, June 7, 1986; *Times*, June 7, 1986.

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19. Lawson, *Memoirs*, 654; Smith, *Boom to Bust*, 72-73; *Times*, September 4, 1986.

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21. Lawson, *Memoirs*, 654-656; Keegan, *Economic Gamble*, 187.

22. Lawson, *Memoirs*, 656.

23. Lawson, *Memoirs*, 656; Keegan, *Economic Gamble*, 186-192; McKie ed., *Election*, 73; Smith, *Monetarism*, 128; Johnson, *Economy Under*

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34. Lawson, *Memoirs*, 663; *Financial Times*, October 21, 1986; *Times*, October 21, 1986.

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37. Non-attributable interview with MAFF official.

38. Non-attributable interview.

39. Non-attributable interview with Treasury official.

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41. *Financial Times,* November 19, 1986.

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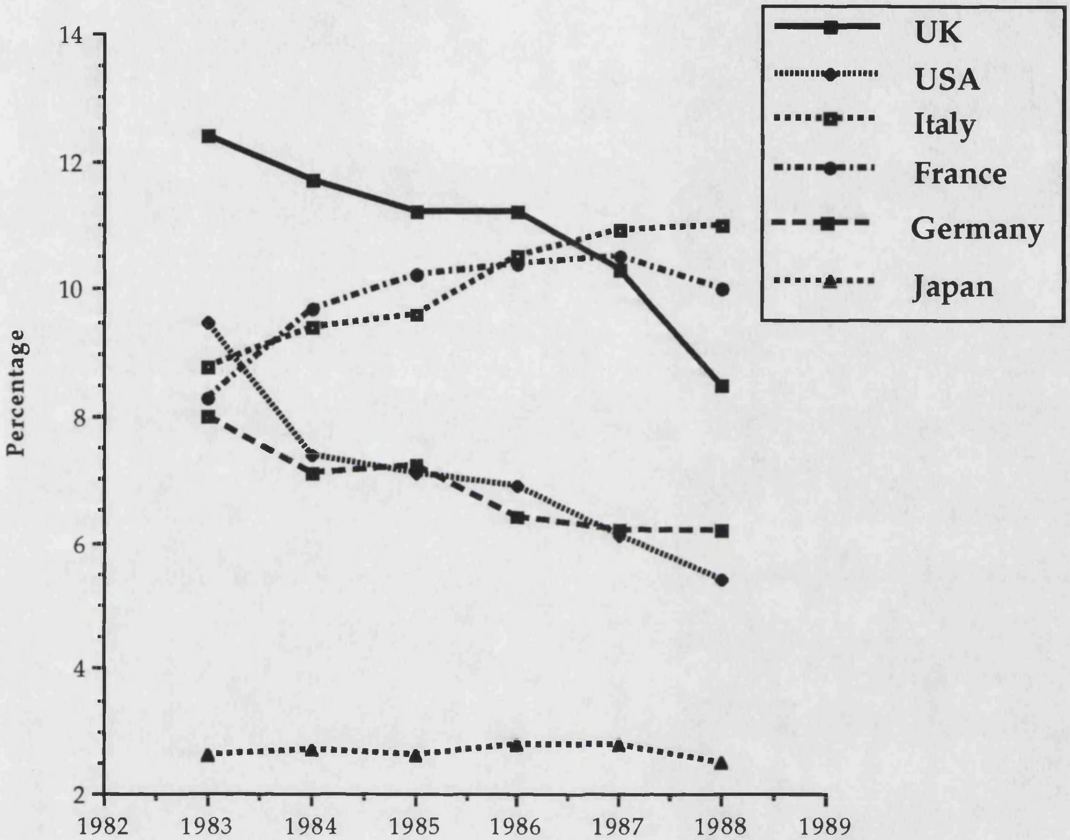
CHAPTER 5
ECONOMIC DIVERGENCE AND MONETARY UNION

This chapter traces the evolution of policy from the Conservatives' general election victory in June 1987 to the Madrid European Council in June 1989. Section 5.1 examines the operation of the ERM during the period and the growing dissatisfaction of some ERM states with German dominance of the system. Section 5.2 looks at developments in the UK economic and EC policy from June 1987 to June 1988. Specifically, it considers how ERM membership remained dormant within the core executive despite a new imperative for entry in order to have influence in the EC's debate on monetary union. Section 5.3 analyses the period from July 1988 to March 1989 primarily covering the UK's participation in the Delors Committee on monetary union. Section 5.4 examines a renewed round of ministerial conflict on ERM membership from the publication of the Delors Report in April 1989 to the Madrid European Council.

5.1: ERM DISSATISFACTION

Between June 1987 and June 1989 the ERM operated with a greater commitment to fixed rates than ever before and no realignments took place. In circumstances which previously produced realignments, the member states were determined to maintain existing parities. For example, in October 1988 during a bout of dollar weakness which boosted the Deutschmark, the franc fell to the bottom of its band. The French government would not countenance an end to its *franc fort* policy and raised interest rates despite the consequences for the sluggish French economy. With unit labour costs relative to Germany moving in France's favour, the French government was determined to reap the credibility rewards in the exchange markets of its counter-inflationary policy.[1]

Figure 5.1: Comparative Annual Unemployment Rates 1983-1988 (Standardised OECD figures).



(Source: Economic Outlook)

Most ERM states incurred significant economic costs in the post-1983 effort to maintain their currencies with counter-inflationary monetary and fiscal policies. During 1987 and 1988 the costs in terms of both competitiveness and unemployment increased. First, for states with higher inflation than Germany, to maintain a roughly stable nominal exchange rate against the Deutschmark was to accept a currency appreciation in real terms. The majority of ERM states now faced a deteriorating external account as the German trade surplus with the rest of the EC increased from DM30 billion in 1986 to DM46 billion in 1988. From 1986-1987, the French manufacturing trade deficit with Germany increased from DM15.1 billion to DM16.3 billion. Although the French external account started deteriorating as early as 1985, the fall in the dollar from its mid-1980s peak now reduced the opportunity to balance the deficit with Germany with surpluses with the USA.[2] Second, as inflation converged among the ERM states towards German levels, figure 5.1 (page 204) shows that unemployment in France and Italy rose to and remained at the highest levels within the G6. By contrast, unemployment in the USA and the UK fell.From June 1987 some member states led by France and Italy began to suggest that these costs were unnecessarily imposed by the particular nature of German leadership of ERM. So long as German monetary policy remained tight in the face of low inflation, high unemployment would continue. Similarly, whilst German fiscal policy remained restrictive, the other ERM states would face a further deterioration in their current accounts if they were to unilaterally expand their economies to reduce unemployment. Neither was there any provision for co-ordinated fiscal action to achieve successful collective expansion. At the same time, it was impossible for France, for example, to maintain the *franc fort* without high interest rates unless the balance of payments looked sustainable in the long term which would only be possible with devaluation.[3]

In the second half of 1987 the French government started making public calls for a new power sharing arrangement in ERM. Backed by Belgium and Italy, it initiated a series of negotiations which led to reform of the system. The reforms were agreed by central bank governors in Basle in September and endorsed by finance ministers later in the month at Nybourg. The most important change was to licence the financing of non obligatory intra-marginal intervention through recourse to a Very Short Term Financing Fund. The Fund allowed weak currency states to borrow reserves from other member states subject to certain quantitative limits and other conditions. In practice, this created a presumption that the Bundesbank would lend Deutschmarks to weak currency states before its currency reached its fluctuation margins. Previously the Bundesbank only lent Deutschmarks when the fluctuation margins were breached. The aim of the reforms was to share the burden of intervention more equitably between member states and to save the reserves of weak currency states.[4]

Even as the agreement was signed, there was little evidence that the reforms could resolve the tensions between Germany and the weak currency states. The head of the Banque de France, Larosière, spoke of the agreement as being 'presumably automatic'. Similarly, the Belgian Finance Minister said that creditor central banks would bear 'the burden of proof' should they at any time refuse the necessary credits. By contrast, Pöhl asserted the creditor central bank's right to assess the monetary situation, including its own domestic environment, before giving any funds for intervention.[5]

In the aftermath of Basle-Nybourg, monetary co-operation did increase. For example, in November 1987 Germany and France jointly announced interest rate changes in opposite directions. Nevertheless, the fundamental issue of restricted growth within a Bundesbank-dominated system remained. France soon tried a bilateral approach to increase its influence on policy. During November 1987, the German and French governments negotiated a draft treaty which would create a new policy co-ordinating mechanism between the two states known as the Franco-German Council. The Council which was expected to meet four times a year placed both central banks on an equal footing and bound each to co-ordinated objectives to be determined by the Council. This was an apparent success for France because the Council could decide for itself the yardstick for co-ordination rather than simply accept the primacy of price stability as defined by the Bundesbank.[6]

However, the Bundesbank, excluded from the pre-treaty negotiations, was able to blunt the effect of the treaty. Under Bundesbank pressure, the German government ultimately amended the treaty so that it explicitly stated that the autonomy of the Bundesbank and its legal commitment to the maintenance of price stability was protected. With the eventual Franco-German council placing no constraint on the actions of the Bundesbank, the

French problem with ERM remained.[7]

In January 1988 faced with the limitations of the Basle-Nybourg reforms and the Franco-German council, the French government made a series of calls for the development of a single European currency and a European central bank. It believed that there was no solution to its problems of high interest rates, unemployment and the external account deficit within the existing ERM. Monetary union would be a means of retaining the credibility of ERM membership and the *franc fort* while reducing the power of the Bundesbank in monetary and fiscal policy. [8]As Ellen Kennedy comments:

> Policy-makers [in France], chafing at limitations imposed by the Bundesbank standard on their national economic policy, hoped to achieve through inter-European co-operation what they had not secured alone or in bilateral negotiations: access to policy-making in the Bundesbank itself. [9]

At one level, monetary union was not new to the EC agenda. The issue was first discussed in the late 1960s as Bretton Woods weakened. In 1970, the EC states agreed to the Werner plan for union by 1980. However, the plan quickly died amidst the exchange rate instability of 1971-1973 and was formally abandoned in 1974. In 1977, the Commission President, Roy Jenkins, rekindled the issue in a lecture which proposed a common currency and a European central bank. There was little response from the member states. Schmidt and Giscard later used Jenkins initiative as part of the presentation of their own proposals for ERM but the original ERM was far removed from any idea of monetary union. Only with the French initiative did monetary union become a serious medium to long term proposition as a proposal rooted in the experience of the existing Community monetary institution. France was supported by Italy. Unsurprisingly, the German government and the Bundesbank, did not welcome the proposal. However, with Germany holding the EC presidency, Kohl and Genscher ensured that the issue remained a serious item on the agenda over the next six months.[10]

5. 2: THE END OF SHADOWING AND THE RISE OF MONETARY UNION

During the first half of 1987 Lawson believed that a general election victory would translate shadowing the Deutschmark into ERM membership. Four days after the election, Lawson told EC finance ministers that the debate within the government was more open. Lawson hoped that the government could take advantage of the proposed Basle-Nybourg reforms and enter ERM in the autumn. In a bilateral meeting with Thatcher on 27 July, Lawson declared that he wanted further discussions on membership after the summer break. Thatcher refused and stated that she would not countenance further discussions before January 1988 and, then, there would be no broad core executive discussion of the kind which took place in 1985.[11]

Faced with another Thatcher veto, Lawson was left to continue to shadow the Deutschmark. The shadowing compromise remained until March 1988 when the tensions between Thatcher and Lawson became impossible to contain. As a result, the government was again left with a vacuum in its economic policy. Combined with a new imperative to examine ERM membership because of European monetary union proposals, further discussion of the ERM option would have seemed inevitable. However, the issue was barely discussed. To understand the non-decision on ERM membership in the second quarter of 1988, it is first necessary to examine the government's economic and EC policy in the period from June 1987 to March 1988.

The End of Shadowing

In July 1987 the upward pressure on sterling abated after the re-elected government announced a significant current account deficit for May. With inflation rising, on 7 August the government used the opportunity to raise interest rates from 9 to 10 per cent. In the subsequent months, the upward pressure on the currency returned and the Bank of England used substantial intervention to stabilise sterling.[12]

The continuity in post-election policy could not mask increasing divergence between Thatcher's and Lawson's positions. Lawson was still pre-occupied with the pursuit of international exchange rate stability. During the summer assisted by Terence Burns, he developed a proposal to institutionalise the Plaza and Louvre Accords into a permanent world-wide regime of 'managed floating.' To Thatcher's annoyance, he presented the proposal to the annual IMF meeting in September 1987.[13]

Meanwhile, Thatcher was growing uneasy with the pursuit of international exchange rate stability. After September Thatcher expressed increasing concern at the level of Bank of England intervention necessary to sustain the policy. She now believed that intervention was causing extra liquidity and would lead to renewed inflation.[14] Lawson comments:

> During the first half of the period of shadowing the Mark, up to my September 1987 IMF speech, she positively loved the steady accumulation of reserves. Alan Walters, however, who deeply disapproved of my IMF speech got on to her about it and thoroughly put the wind up her; as a result of which she completely changed her tune.[15]

After the stock market crash of 20 October and further upward pressure on sterling, the government cut interest rates on 26 October, 5 November and 4 December leaving them at 8.5 per cent. The aim was to maintain both the DM3.00 target and liquidity in the wake of the crash. Despite the rate cuts, by December defending the target was becoming increasingly difficult. Lawson concluded that intervention would be more effective in Deutschmarks rather than dollars as hitherto. Leigh-Pemberton refused the request after the Bundesbank reacted angrily to the proposed development on the grounds that it contravened the EMS agreement on purchases of other member states currencies.[16]

On 8 December Thatcher took up the general issue of intervention with Lawson. Both recall in their memoirs that Thatcher expressed deep concern about the scale at which the Bank was intervening. Nevertheless, they agreed to order the Bank of England to intervene in Deutschmarks irrespective of the EMS agreement. With the Bundesbank, Pemberton and now the Banque de France still unhappy, a compromise was reached whereby the Bank of England intervened in a range of currencies including

Deutschmarks but not dollars.[17]

The new intervention was not initially sufficient to curb the flow of capital into the UK. On the 11 December sterling traded at DM2.997. Lawson states that he and the Treasury considered abandoning the policy but before any decision was taken, sterling started to fall. A further respite in sterling's appreciation came in February and allowed the government to raise interest rates to 9 per cent.[18]

At the start of March, the upward pressure on sterling returned. Despite massive intervention, sterling hovered slightly below DM3.00. The financial markets convinced of the DM3.00 ceiling now believed that they possessed a one way bet on sterling's appreciation. In his memoirs, Lawson states that he hoped that the ceiling could be maintained at least until the budget on 15 March. However, on Friday 4 March Thatcher demanded that Lawson abandon the sterling target and end intervention when the markets re-opened on the following Monday. Lawson accepted Thatcher's principal demand and Thatcher agreed that some limited intervention to smooth the markets could continue on the condition that she was given half-hourly reports on developments. On Monday 7 March, sterling surged and within days stood at DM3.10.[19]

Thatcher was backed in ending shadowing by both the Treasury and Bank of England officials who believed that the policy was now unsustainable. [20]As Lawson himself comments, he was in no position to resist:

> It was an unpleasant meeting, and I particularly resented her manner on the eve of a Budget that was to achieve so many of the objectives we shared. Equally, there was no way in which I could contemplate resigning then: I was determined to introduce the 1988 budget for which I had laboured so long and hard. And Margaret knew this.[21]

Yet neither was Thatcher in a position to sack him:

> The question arises whether at some point now or later I should have sacked Nigel. I would have been fully justified in doing so. He had pursued a policy without my knowledge or consent and he continued to adopt a different approach from that which he knew I wanted. On the other hand, he was widely - and rightly - credited with helping us

win the 1987 election. He had complete intellectual mastery of his brief. He had the strong support of Conservative back-benchers and much of the Conservative press who had convinced themselves that I was in the wrong and that only pettiness or pig-headedness could explain the different line I took.[22]

Lawson and the Treasury hoped that sterling could be restabilised at a level around DM3.08 with further intervention and interest rate cuts if necessary. Whilst Thatcher was unrelenting on the former she was prepared to accept the latter to limit sterling's appreciation.[23] Lawson states:

> The rows I had with her at the end of 1987 and in the early part of 1988 were entirely about intervention....She at no time suggested that interest rates should be higher, which she should have done if she had really wanted a strong counter-inflationary stance. Indeed, she made it clear that, if we stopped intervening and let the pound rise, one of the attractions for her was that this might enable interest rates to come down.[24]

On 17 March the government did indeed cut interest rates from 9 to 8.5 per cent and left itself with half an exchange rate policy.[25] The end of shadowing created a new public row between Thatcher and Lawson with the media reporting that Thatcher forced Lawson to abandon a policy to which he was committed. On 8 March Thatcher told the House of Commons that 'there is no way in which one can buck the market' and hammering home a very public wedge between herself and Lawson. Two days later, with sterling at DM3.06, Lawson responded by warning against any further rise in sterling.[26] He then told the Treasury Select Committee: 'Any further significant rise in the exchange rate, certainly against the DM would, in my opinion, be unlikely to be sustainable.'[27]As Smith comments: 'The markets were therefore faced with the bizarre situation of a Chancellor trying to talk his currency down, while the Prime Minister appeared to be relishing its rise.'[28] To add to the conflict, on 24 March Howe made a speech firmly backing Lawson's case for exchange rate stability and praised 'the increasingly valuable experience of stability in the ERM.'[29]

Although the 1987 autumn statement planned for a fall in public expenditure, the government's fiscal policy in 1987-1988 continued to be expansive. The 1988 budget provided a big boost to demand. The government introduced income tax cuts totalling £6 billion per annum reducing the basic rate from 27 to 25 per cent and the top rate from 60 to 40 per cent. For the future it set a target of a 20 per cent base rate. By limiting mortgage tax relief to one allowance per household from August 1988, the government inadvertently gave a further huge stimulus to the housing market as people rushed to take advantage of the old regulations.[30]

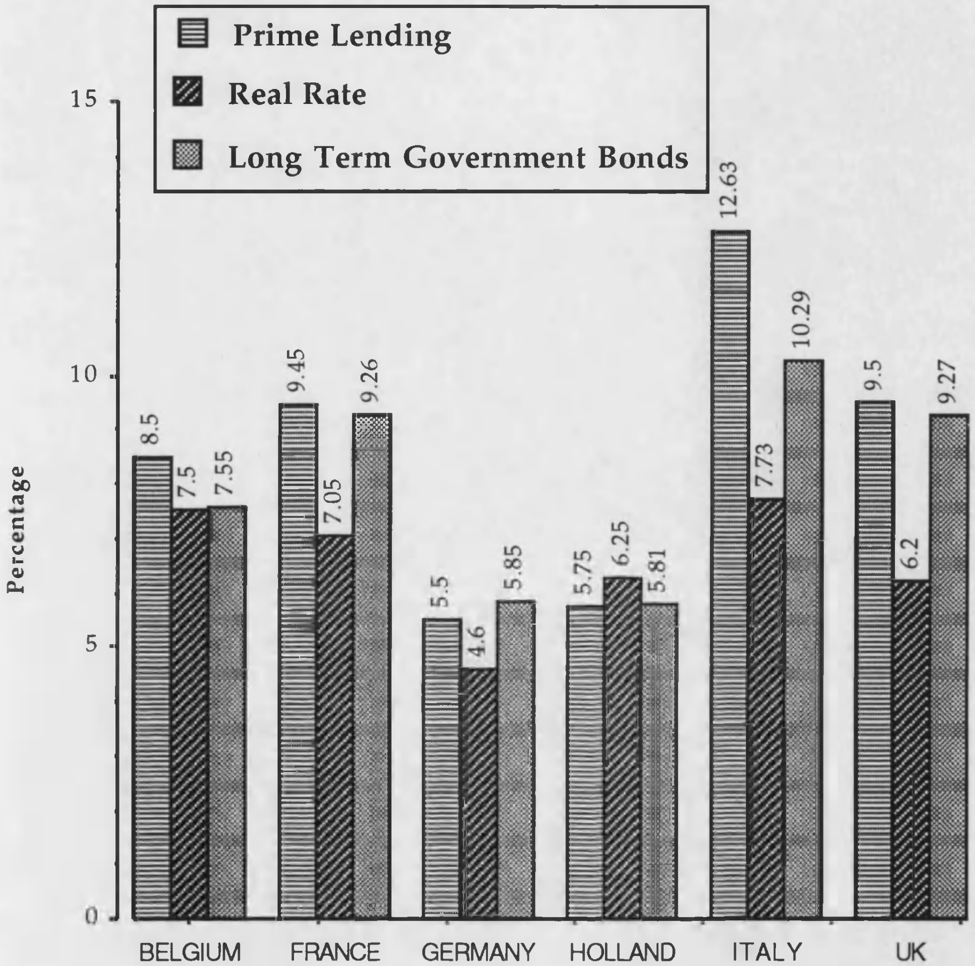
Expansion was possible because revenue was flooding into the Treasury through increased tax payments, a reduced social security budget and, primarily, privatisation. For 1987-88, the government possessed a budget surplus of £3.2 billion and the budget projected a surplus of £14.4 billion for 1988-89. Lawson used the Public Sector Debt Repayment, as he dubbed it, to deny that fiscal policy was expansive:

> The budget was in no way an attempt to give the economy a boost. Nor, in any strict economic sense did it.... The purpose of the 1988 budget was simply and solely to improve the supply side performance of the economy through tax reduction and reform, which is what Budgets ought to be about.[31]

In reality Lawson was denying the most elementary relationship between taxation and demand.

In terms of ERM membership Lawson could certainly have pursued his monetary aims more successfully within ERM since the ambivalence in exchange rate policy only made stabilising sterling more difficult. However, with sterling strong and nominal and real interest rates low in comparison to previous years, membership no longer offered the clear monetary benefits that it did in November 1985 and autumn 1986. As figure 5.2 (page 213) shows, UK nominal rates were now lower than those in Italy and real rates were lower than those in Belgium, France, Holland and Italy. Only on long term government bonds was the UK in a relatively poor position.

Figure 5.2: Comparative Interest Rates March 1988

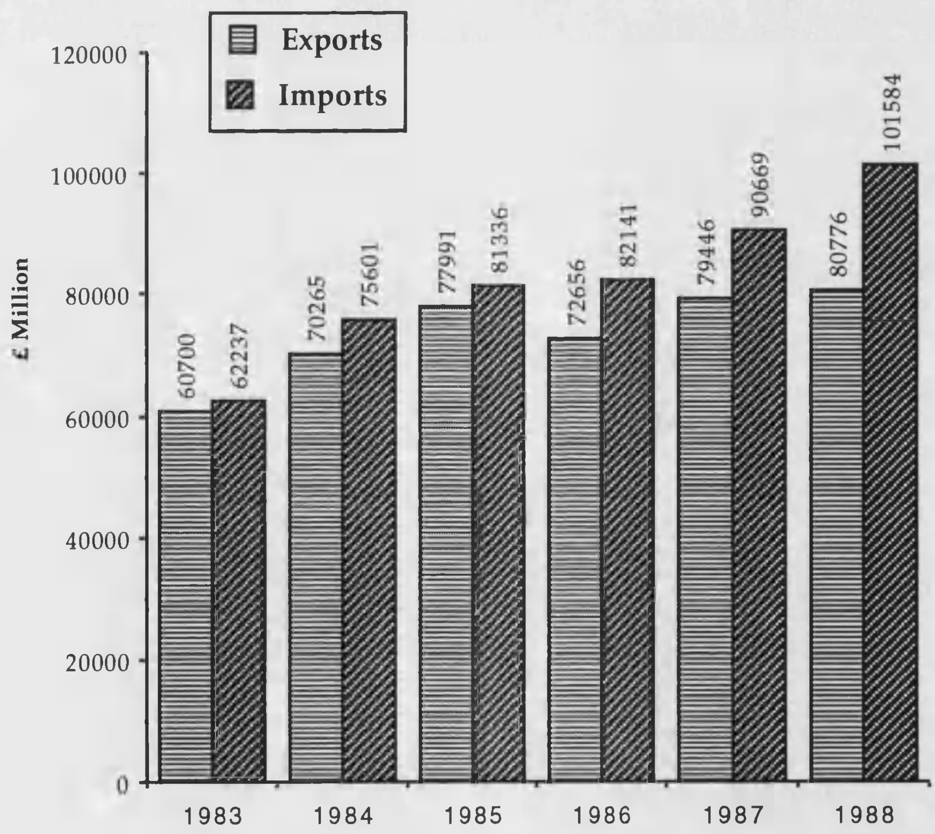


(Source: Economist Economic and Financial Indicators, March 26, 1988

Unwilling as it was to accept the causal relationship between domestic demand and inflation, the government's fiscal policy remained incompatible with ERM membership. With fiscal and monetary policy both expansive, the UK was taking inflationary risks in comparison with its ERM competitors. As Johnson comments, 'what ERM rules would have required to offset easier monetary policy was not just static but tighter fiscal policy.'[32]

By March 1988, ERM membership posed a new difficulty for the government in that a large balance of payments deficit loomed which would make it hard to sustain sterling at a fixed rate in the medium to long term. In July 1987, the government announced a £500 million balance of payments deficit for May and by the end of 1987, there was a deficit of £4.182 billion. The 1988 budget optimistically forecast a further £4 billion deficit for that year.[33] The deficit appeared to be structural rather than temporary. Imports were growing at twice the rate of exports and the UK's manufacturing base was nowhere near strong enough to provide for domestic demand. Figure 5.3 shows that the manufacturing trade deficit expanded from £3 345 million in 1985 to £11 223 million in 1987 and £21 078 million in 1988.

Figure 5.3: Exports and Imports 1983-1988



(Source: Annual Abstract of Statistics)

New Isolation

In June 1987 the UK government entered into a new conflict with the other EC member states. At the European Council in Belgium, the UK alone opposed the Delors plan for the reform of the budgetary process, CAP, and regional and social policy. The other member states were more irritated than usual over the UK's intransigence since they believed that the proposals accommodated more of the UK's demands than those of any other member state. For the remainder of 1987, the Thatcher government refused to reach a deal without tough limits on farm expenditure, a guarantee that the UK would not be worse off in any new budgetary arrangement than under the existing rebate system and a detailed plan on farm price stabilisers. However, in February 1987 the government was forced to accept a reform plan with major UK concessions on Community spending, budgetary procedures and increased regional and social expenditure.[34]

At the same time, during the second half of 1987 and the first quarter of 1988, monetary and financial affairs moved to the forefront of the EC's agenda and the other member states put renewed pressure on the UK to enter ERM. As the final Basle-Nybourg agreements were drawn up in September 1987, the other EC finance ministers pressed Lawson for UK entry. They argued that the UK was free riding on the benefits of the ERM system without accepting the cost of membership. In public, the Irish government repeated its earlier criticism of sterling's non-membership as particularly damaging to Ireland.[35]

After the Basle-Nybourg reforms, capital liberalisation emerged as the next monetary issue on the EC agenda. In November, the Commission presented comprehensive proposals to liberalise capital movements which the Council of Ministers considered over the following months. The other member states believed that it was illogical to create a more cohesive financial area without UK participation in ERM.[36]

With the advent of the monetary union debate, the pressure for UK membership mounted further. When the French Prime Minister, Jacques

Chirac, first proposed a European Central Bank in January 1988 he urged UK entry to ERM so that the EC could move forward monetarily. In February the Italian and German governments, the Dutch and German central banks and the Commission all made similar calls. Italy said it would give up its uniquely wide six per cent bands within ERM if the UK were to join. In March, the German Finance Minister, Stoltenberg made two unusually strong calls for UK membership. He argued that the government's intransigence was delaying the general process of European integration and the development of pooled reserves within EMS. In sum, the government already lacking allies faced a European summit in Hanover at which its non-membership of ERM was likely to further isolate the UK from the mainstream of EC debate.[37]

Non-Membership as Economic Policy

With Lawson and the Treasury operating a monetary policy which could not loudly speak its name, there was a reduced scope for any broad debate in the core executive about overall macro-economic strategy. The Bank of England was uneasy with the government's fiscal policy since, unlike Lawson, it believed that the expansion of demand was dangerous. In its February 1988 *Quarterly Bulletin* it implicitly called for a cautious budget:

> There must, however, be some question about the sustainability of growth of domestic demand in this country at a rate above that currently being achieved by most other major countries....It will also be important for the preservation of both internal and external balance that the anti-inflationary burden continues to be shared between monetary and fiscal policy.[38]

However, it was difficult for the Bank to make its case that with monetary policy loose, fiscal policy should be tighter when Lawson and the Treasury would not openly discuss monetary policy with them. As a result, the Bank was marginalised from the decision making process. One former bank official commented:

> It was clear that the Bank of England was at the end of its tether at what Lawson was doing.... The Bank felt they were put in an impossibly compromised position by the inflationary boom. It was a disastrous policy. Some of them may have come close to resigning ,I

think.[39]

With the Bank marginalised and Thatcher, Lawson and Howe feuding in public, Thatcher called a meeting of herself, Lawson and Leigh-Pemberton for 25 March to hammer out future monetary and exchange rate policy. In preparation for the meeting, Lawson and the Treasury produced a paper laying out three options for the future conduct of policy: first, that sterling be a factor among others in monetary policy; second, to announce an explicit commitment to exchange rate stability but within an unpublished band; third, to enter ERM. Lawson still believed that ERM membership was the most preferable option. However, he did not press the case.[40] He comments:

> There was no point in exploring the ERM case in depth since there was no chance at that time of persuading Margaret to accept it. The immediate purpose of including the third option was to try and persuade her to reinstate the second option, an informal target range supported by both interest rates and intervention.[41]

At the meeting the onus was on a compromise between Thatcher and Lawson. Thatcher accepted that exchange rate stability was desirable with some role for intervention and Lawson accepted that there would be no exchange rate target as the objective of policy. In no way did this arrangement constitute a formal monetary framework. The net result was a cap on sterling's appreciation with future interest rates cuts if necessary. The concordat effectively excluded Leigh-Pemberton who was firmly against any further loosening of monetary policy whatever sterling's position. It also removed any possibility of ERM entry in the short to medium term.[42]

In the second quarter of 1988, the government's economic objectives moved ever further away from ERM membership. On 11 April Thatcher and Lawson agreed to cut interests rates to 8.5 per cent after sterling rose above DM3.12. A month later a new public row broke. On 12 May, responding to a question from Kinnock, Thatcher failed to support Lawson's view that any further appreciation in sterling would damage industry. The next day, Howe departed from his press released text to say that the government could not 'go on for ever' discussing ERM adding the qualification of 'when the time is right' to the underlying commitment to enter the system. [43]

Thatcher recalls that after his comments Howe asked her to meet Lawson and himself to discuss their conflict. Thatcher refused and she met Lawson alone on 16 May.[44] Their discussion at this meeting is a matter of dispute. Lawson states that they agreed an answer for Thatcher to give at Prime Minister's question time if pressed again on sterling. Then, Thatcher suggested a half per cent interest rate cut to strengthen the appearance that they were both committed to an exchange rate policy:

> To my eternal regret, I accepted this poisoned chalice. While nothing had been farther from my mind than a further interest rate reduction, I could see when Margaret suggested it that it would clearly demonstrate that we took sterling into account in our interest rate policy; and I was confident that I could reverse it fast enough to prevent it from bringing about a reduction in mortgage rates.[45]

By contrast, Thatcher claims that Lawson proposed the interest rate cut:

> I had been told by the Treasury in advance of the meeting that Nigel wanted a further interest rate cut. ... I had got part of what I wanted ... in that sterling had been allowed to rise to DM3.18. So I was not unhappy to have the suggested interest rate cut I knew he wanted. ... Above all, however, this reduction of the interest rate on Tuesday 17 May by half a point to 7.5 per cent was the price of tolerable relations with my Chancellor, who believed that his whole standing was at stake if the pound appreciated outside any 'band' to which he might have semi-publicly consigned it.[46]

Certainly, others saw the third interest rate cut in two months as part of Lawson's effort to circumvent Thatcher's refusal to allow any significant intervention to stabilise sterling. Smith comments:

> The Chancellor having lost the battle to keep the pound below DM3, refused to accept that he had lost the war over managing sterling. Colleagues say that this, and pride, offer the only explanations of why in the weeks after the 15 March budget, he again embarked on a policy of cutting interest rates to restrain the pound. 'It became an obsession with him', said one adviser. 'He believed he was right and he was determined to prove it.'[47]

In her next appearance in the House of Commons, Thatcher agreed that there was 'utter unanimity' between herself and Lawson over economic policy. Yet beyond the rhetoric, the conflict remained. Thatcher's former economic adviser, Alan Walters started to give interviews and write newspaper articles criticising Lawson's monetary management and arguing for an increase in interest rates. Rather than renounce Walters criticism, Thatcher asked him to return as her adviser to start in May 1989.[48]

By June 1988, the inflationary pressure created by the government's policies since 1985 translated into rising inflation. Having stood at 3.3 per cent in January, inflation rose to 4.6 per cent in June. House price inflation was running at 30 per cent and the growth of narrow and broad money was accelerating. Demand was growing much faster than domestic supply and wages were rising far above prices. At the same time, the balance of payments was plunging further into deficit, standing at £12 billion for the first half of the year.[49]

In the space of a few days at the end of May and the beginning of June, sterling fell from DM3.19 to DM3.09. Thatcher and Lawson united to raise interest rates again to 8 per cent on 3 June, 8.5 per cent on 6 June, 9 per cent on 22 June, and 9.5 per cent on 29 June. Their apparent aim was not simply to stabilise sterling but to encourage its appreciation as a counter-inflationary weapon. In so doing they rejected the alternatives of curbing the housing market, controlling credit, encouraging wage restraint or increasing taxes - all of which would have directly addressed the sources of inflation.[50]

By choosing a tight monetary policy and an appreciating exchange rate as its sole counter-inflationary tool, the government rejected the whole approach of the ERM states to economic management and made its monetary as well as fiscal policy incompatible with ERM membership. A year earlier Italy faced a similar problem of rising demand, a deteriorating current account, and pressure on the lira. After a rise in interest rates to try and stabilise the lira, the Italian government introduced a package of tax measures which included a rise in VAT and then imposed additional qualitative controls on bank lending. In 1988, it raised taxes again, in sharp contrast to UK policy. [51]

Such further divergence from the ERM states raised a fundamental question for Lawson and other ERM supporters: if the UK were to enter ERM, how would the government control inflation? At the same time, the balance of payments was likely to make it difficult for the government to pursue its new counter-inflationary policy beyond the short term. Such a large deficit would put a limit on sterling's appreciation, however high interest rates went, because the markets would ultimately expect that the government would allow sterling to depreciate to restore competitiveness.

Nevertheless, Lawson and the Treasury were now as prepared to ignore the threat to successful ERM membership posed by the balance of payments deficit as the incompatibility of their counter-inflationary framework. In a speech to the IMF in 1988, Lawson declared that the balance of payments was no longer an important economic indicator and it was not necessary for it to be in equilibrium for policy to be successful. He comments:

> In today's world, [by contrast], an advanced industrial country that can maintain a reasonable degree of confidence in its currency can finance a current account deficit for a considerable number of years - as for example the United States did - by importing capital from overseas. At any given period, those countries whose capacity to generate savings exceed their indigenous investment opportunity will experience a capital outflow, which will finance the current account deficits of those countries whose capacity to generate savings falls short of their indigenous investment opportunities.[52]

Only if a balance of payments deficit reflected excessive government borrowing and spending was corrective action necessary otherwise a deficit would correct itself:

> The main source of fluctuations in net savings is changes in the amount of borrowing by the private sector. There is a limit to the amount of debt which the private sector will be willing - or can afford - to undertake. Once that limit has been reached, the savings ratio will rise again. Moreover, higher debt means higher interest payments in the future, which will reduce disposable income and consumption. ... It is only in the unlikely event that the self-correcting mechanisms threaten to stretch over so long a period that the creditworthiness constraint to which I have alluded comes into

> play [so] that it would be appropriate for the government to run a large budget surplus in order to offset the lack of private sector savings.[53]

What Lawson's doctrine ignored was how the UK could maintain a reasonable degree of confidence in its currency given its balance of payments deficit. International investors were not being asked to use their savings to finance domestic investment as much as domestic consumption. Beyond the short term, this situation was a disincentive to export capital to the UK. At the same time, investors could only believe that the UK government would not allow sterling to depreciate to the extent to which they could believe that the government would accept the consequent costs in interest rates, lost output and employment. Without that confidence, it would ultimately prove difficult to pursue exchange rate stability.

Non-Membership and EC Policy

In the same period, there appears to have been little discussion about ERM membership as an issue of EC policy in the run up the Hanover summit. Whilst Thatcher does not discuss the subject, Lawson claims that little debate took place because Thatcher refused to consult him due to their conflict over economic policy. Instead, she chose to rely almost entirely on Charles Powell, her Private Secretary on foreign affairs.[54]Thatcher and Powell decided that the government could not oppose the establishment of a committee on monetary union even though no-one in the government supported the idea of a single currency. Indeed, one person close to Thatcher commented on the proposed committee:

> There was no option. The trouble was always with these things in the Community, you get carried along step by step. At each stage you try to minimise it, but there was always enough there to get to the next stage.[55]

Rather, the Thatcher-Powell strategy was to try and expunge any mention of a European central bank from the terms of reference and ensure that the committee was comprised of central bank governors rather than experts.[56] A Thatcher adviser recalled that Chancellor Kohl assured her that a committee of central bankers would oppose monetary union: 'We were told

- "Push these guys in there. They'll all hate it. They'll kill it stone dead."[57]

Lawson describes it as 'extraordinary' and 'innocent' that Thatcher and Powell believed that monetary union was possible without a European central bank. In his view, it was a disastrous decision for which they alone bore responsibility:

> I claim no great prescience in recognizing the reality of Hanover as I did. What amazed me was that Margaret, and those to whose advice she chose to listen, could have got it so wrong....She simply failed to understand what she was about.[58]

However, Lawson's account is open to serious dispute. Certainly the Foreign Office was involved in the decision-making process. In 1989 Thatcher told one minister that the only reason that she agreed to a committee on monetary union was because the Foreign Office assured her that its conclusion would be of little consequence. Whether this was a genuine Foreign Office position or whether it hid its true views from Thatcher is difficult to assess. At least in public Howe did not draw any link between his economic policy case for ERM membership and any new imperative in terms of EC policy.[59]

A senior Treasury official asked about Lawson's claim responded that Thatcher did in fact take Treasury advice in the run up to Hanover.[60] Rather, it appears that Lawson and the Treasury did not believe that the other member states were serious about monetary union. If the Bank of England thought differently, then it did not impose its view on the Treasury. One Treasury civil servant commented:

> I don't think in mid 1988, we [the Treasury] were taking it [monetary union] very seriously. I don't think we began to take it very seriously until we actually got to the Delors report.[61]

According to another official there, the Treasury was in a weak position to assess the monetary union debate because Delors kept the issue out of the Economic and Finance Council (Ecofin) meetings:

> One of the problems in the early stages was following discussions. Jacques Delors worked extremely hard to keep it out of financial circles. He did his utmost to mobilise the Foreign Affairs Council so that we in the Treasury were actually finding it quite difficult to

discern what was going on.[62]

The Treasury tended to believe that other finance officials and central banks were not interested in monetary union. The same Treasury official commented that Delors 'knew that the monetary committee would not be enthusiastic.'[63]

The Treasury did not believe it was isolated within the EC monetary committee on either monetary union or because of non-membership of ERM. It saw itself as part of an inner group on the committee comprised of the UK, Germany, France, Italy, Holland and the senior commission official, and selected for technical expertise. According to one Treasury official: 'The UK representative played a suitably important role and was never kept out of the evolution of the Community's monetary affairs.'[64]Another senior official commented:

> We negotiated all the financial side of the directives leading up to 1993 and I always reckoned we got much more than our fair say. It isn't true that people said 'you're not in ERM so we're not going to listen to you.'[65]

The Treasury believed that Delors and his Commission colleagues were forcing the debate as part of their own integration compulsion. One Treasury official commented that he could not recall any interest among the member states for monetary union until April 1989. Rather, 'it was a Commission dream.'[66] Another senior official stated that the initial push for monetary union came from Delors putting political pressure on Mitterrand as the 'big statesmanlike thing to do; I'm sure Delors put it to him on that basis.'[67] In his view, France did not become dissatisfied with the ERM's operation until 1990. Another respondent recognised France's enthusiasm for monetary union but did not link it to the costs of ERM membership: 'The French motive was basically to tie Germany into the EC. They detected that it might just move off to the East.'[68] The Treasury apparently failed to understand that monetary union was primarily on the EC agenda because France and other member states were dissatisfied with the operation of ERM. Although Delors certainly played a significant role in persuading Mitterrand that a European solution was the only answer to France's economic problems, this active role in the debate was totally dependent on the French government's, in particular support for monetary union.[69]

The Treasury's view was shared by those who directly advised Thatcher. One Number Ten official commented:

> I think that Delors concluded that after the Single Market, this would be the next big step, not principally for economic but for political reasons. He saw this as the key to political union and a federal Europe. That's why he pursued it so vigorously ... Delors was absolutely central to the pressure for economic and monetary union. Now, we all know that the French developed their own reasons for favouring, it principally because they got fed up being dependent on the Deutschmark and the Bundesbank determining their economic policy, and wanting to grab a share of that themselves through Europe. But that I think was a rationalisation, quite frankly, an exploitation of a policy stance that Delors originally took.[70]

Overall, the evidence suggests that many actors in the UK core executive inaccurately assessed the position of the ERM states on monetary union and ignored the question of how the UK could pursue its interests on monetary union outside ERM.

Hanover

In mid-1988, the pressure to enter ERM mounted. In May Lord Cockfield, the senior UK Commissioner, declared that UK entry to ERM was a necessary part of the Single Market and capital liberalisation. On 10 June Mitterrand pressurised Thatcher in bilateral talks without success. Two days later France and Germany issued a joint threat to block the capital liberalisation directive, to which the UK government was committed, unless the UK reversed its position. It was the first effort by other EC states to impose a direct cost on the UK for its non participation in ERM. However, with France already starting to remove some of its exchange controls, the threat carried little actual power. On 24 June, the EC finance ministers reached a final agreement on the directive with the provision that Ireland would have until 1992 to comply and Spain and Portugal possibly until 1995. Lawson successfully struck down a draft declaration which called for 'equal participation by 1992 of all countries in the EMS.'[71]

At the Hanover summit on 27 and 28 June, the EC states unanimously agreed that an objective of the EC was the 'progressive realisation of monetary union' as set out in the SEA. To outline 'concrete steps towards this union,' the Council set up the Delors committee composed of EC central bank governors and co-opted experts with Jacques Delors as chairman.[72]

Before Hanover, Thatcher told the House of Commons that a European central bank could only exist when there was a sovereign EC government.[73] Since this was undesirable, there was no point in discussing the issue. On her return, Thatcher presented the omission of any explicit mention of a European central bank from the Delors committee's terms of reference as a victory for the UK. She told the House of Commons:

> With regard to the European Central Bank, we have taken part in the SEA which went through the House and which said that we would make progressive steps to the realisation of monetary union, and we have set up a group to consider that. Monetary union would be the first step, but progress towards it would not necessarily involve a single currency or a European central bank.[74]

Thatcher's statement was in stark contrast to Mitterrand's post-Hanover comment that a European Central Bank followed from monetary union.[75] The contrast suggested that Thatcher believed she had agreed to something less than the ERM states envisaged for the Delors committee. One former Foreign Office official commented: 'I am completely amazed that Thatcher agreed to the terms of reference of the Delors committee.'[76]In the words of one Commission official, 'Thatcher did not realise what she signed up for at Hanover.'[77]The net result was that the UK was committed to the goal of monetary union whilst pursuing an independent monetary policy from the states with which it would monetarily unite.

The City and Monetary Union

The establishment of the Delors committee renewed City enthusiasm for ERM entry. One week after the Hanover summit, the chairman of the Stock Exchange, Nicholas Goodison, told a group of MPs that outside ERM the

UK's interests would not be considered in the debate on monetary union. As a result, London's position as the leading financial centre in Europe could be threatened. The International Financial Outlook of Lloyds Bank similarly warned that non-membership would now run the risk of isolating the City. In these circumstances, Frankfurt would be the likely host of any European Central Bank and would displace London as the operational centre of exchange and money markets in the EC.[78]

Isolation within the EC was likely to strike at the heart of London's position as a financial centre. Compared to New York and Tokyo, London was without a large economic hinterland. It succeeded in transcending that weakness through its liberal rules of operation and its claim to the whole EC as its economic backyard. However, capital liberalisation within the EC was likely to reduce the singular attraction of the City in regulatory terms. At the same time, any move towards further EC monetary development without UK participation made it less tenable to assert that the EC functioned as London's economic hinterland. With the City now criticising non-membership as a direct threat to its own interests, the government could expect more vociferous pressure on ERM entry in the future.

The City's anxiety increased dissatisfaction with non-membership in the Conservative party. Most significantly, the City's position gave Michael Heseltine an issue on which to focus his latent leadership challenge. In an article in the *Financial Times* in July 1988, he declared:

> Technically, the ERM and our attitude to the Delors committee are not linked. Britain could leap a stage and without joining still play a positive role in the arrangements which will flow from Delors. But such clinical simplicity ignores the cause of the controversy over EMS. ... Europe believes we have dug in. Psychologically and politically, 'they've heard it all before.' We will never play our full role if we stay outside the institutions of Europe and complain of their discrimination. It is almost surrealist to look at Europe's leading economies today with lower interest rates and lower inflation than ours and suggest that German rigidity underlying the ERM is incompatible with Britain's economic self-interest.[79]

5. 3: THE DELORS COMMITTEE AND NON-MEMBERSHIP OF ERM

During the period of the Delors committee, the government's monetary and fiscal policy remained incompatible with ERM membership. After the four interest rate rises in June 1988, the government raised interest rates to 10 per cent on 5 July, to 10.5 per cent on 19 July, to 11 per cent on 8 August and to 12 per cent on 26 August. As a result, sterling steadily appreciated. When sterling came under downward pressure in November after the announcement of the worst monthly balance of payments deficit on record, the government raised interest rates again to 13 per cent. During the first quarter of 1989 sterling averaged DM 3.23, reaching a peak of DM 3.27 in February.[80]

Although inflation continued to rise, reaching 7.9 per cent in March 1989, the government still refused to countenance any additional counter-inflationary policies. In September 1988 an IMF report recommended that the UK government consider raising taxes if the growth in demand did not slow down, and warned that otherwise inflation would continue to rise and the current account would deteriorate.[81] Lawson dismissed the report saying: 'We must continue to resist those siren voices who want to use fiscal policy in a vain attempt at short term demand management.'[82]Indeed, rather than tightening fiscal policy, in the 1989 budget the government gave the economy a further stimulus, with £2 billion worth of tax cuts through change to National Insurance.[83]

The Delors Committee

The UK was represented on the Delors committee by Robin Leigh-Pemberton. The Governor and officials at the Bank of England were sceptical about any monetary union in the EC which did not emerge through natural convergence. In the words of one Bank official:

> I don't think the Bank of England was or is opposed to monetary union in principle. Many of us would feel that if that is a destination which we reach as a result of having had a really meaningful Single Market which over a period has brought our economies increasingly

closer together, so that they are practically integrated ... then at a certain point in that process, you lose very little and potentially gain quite a bit more, by locking in to a monetary union. It's the notion that that process is one that can be used as a driving engine for economic integration that I think some of us are pretty sceptical of.[84]

Nevertheless, they believed that it was necessary for the UK to play a full role in the Delors committee:

> I think we thought it would be absolute folly not to take the debate seriously. I think that most of us felt in our bones that the terms in which the debate was being conducted were a little bit removed from reality. But nevertheless one had to go through the debate, and as necessary inject doses of reality when we thought it was lacking.[85]

Thatcher, Lawson and the Treasury were more resolutely opposed to the whole principle of monetary union. Lawson comments on his and Thatcher's position:

> The irony is that this was an issue on which our views were very similar...My own opposition to the idea of a single currency for Europe went back a long way...My idea of Europe was that of de Gaulle's Europe *des patries,* a Europe of nation-states, rather than the single federal superstate, or United States of Europe, which some espoused. The implications [of the Werner Report] appalled me, since it clearly implied doing away with the Community in favour of a single European superstate.[86]

In their accounts of the Delors committee's operation Lawson and Thatcher both stress that they sought to use Leigh-Pemberton to secure a report which they could accept. The Prime Minister and the Chancellor saw the papers from the start of the committee in September on a *sub rose* basis and felt that the likely report would make recommendations to which the government was firmly opposed. On 14 December 1988 Thatcher held the first of a series of meetings with Leigh-Pemberton, Lawson, Howe, Charles Powell and Brian Griffiths. Leigh-Pemberton explained that the Delors report was likely to fall into three parts. The first would describe the operation of ERM. The second would define monetary union and outline the institutional changes necessary to achieve it. The third, and as yet unfinished section, would examine the case for early EC constitutional change as a first step to monetary union. The others agreed that Leigh-

Pemberton's tactics should be to assemble the widest possible opposition within the committee both to an early EC treaty amendment and to recommendations of any particular course of action. They believed that Leigh-Pemberton should concentrate on an alliance with Pöhl and hoped that if these two stood together some of the other governors would eventually join them. [87]

According to Lawson, the tactics were unsuccessful because after promising Leigh-Pemberton his support, Pöhl refused to seriously engage himself in the committee's negotiations. As a result, when a draft of the Delors committee's report was circulated in February 1989, the UK government regarded it as totally unacceptable. Lawson and Thatcher then tried unsuccessfully to persuade Leigh-Pemberton to submit a minority report stressing that it was beyond the committee's competence to pronounce upon the shift in political sovereignty which monetary union would entail. Instead, Leigh-Pemberton concentrated on removing some of the prescriptive language from the report. [88]

Lawson's and Thatcher's accounts are contradicted on several counts all of which suggest that the government did not take the Delors committee seriously. Lawson states that the committee started meeting in September. Whilst it is true that the formal meetings did indeed start on 13 September, informal discussions appear to have begun on 12 July.[89] According to one Treasury official: 'The way the committee started was a bit confusing and it was difficult to get hold of what was actually going to be discussed.'[90] On this basis, there was no consultation between Leigh-Pemberton and the government until some five months after the committee began its effective work. One Treasury insider admitted that the department had no discussions with Leigh-Pemberton about a strategy for negotiation until some months after the committee began. Another Treasury official said that Leigh-Pemberton was very much left on his own in the committee.[91] One former Foreign Office official went further:

> Robin Leigh Pemberton did not have any instructions of any kind in all that year of the Delors Report. ... He never saw Mrs Thatcher after

he signed it to discuss it. I mean she just went around saying that he was a bloody idiot to go along with it.[92]

Without instructions in the formative stages, Leigh-Pemberton and the Bank simply informed Lawson and the Treasury about the proceedings of the committee. A senior Bank official who briefed Leigh-Pemberton for the committee commented:

> The Treasury were kept in touch with what was happening but more by way of letting them know what had happened at each meeting. And then Governor-Chancellor level to some extent, and to a much more detailed extent as a somewhat more junior level, we were sensitised to Chancellor-Treasury thinking.[93]

In this context, the government was in a weak position when it pressed Leigh-Pemberton to submit a minority report. Rather than acquiesce to government pressure, Leigh-Pemberton believed that it was preferable to have a unanimous report with some compromises to his scepticism than a stronger majority report.[94]

The government's apparent detachment from the Delors committee was not matched by the other EC member states. Certainly, Pöhl remained, in the words of one Bank official, 'pretty autonomous' from the German government but this was the result of the Bundesbank's independence rather than the government's lack of attention to the committee's work. The French government had a similar institutional relationship to the Banque de France as the UK government to the Bank of England but French ministers looked to its representative Larosière to pursue its interests.[95] One Bank of England official close to the negotiations commented:

> I don't know how much prior[French] consultation, preparation and instruction went on. I would suspect quite a lot, mitigated only to the extent that Larosière is a fairly powerful figure. Nevertheless, to my mind, it is *inconceivable* that he would have argued a line on any particular aspect of the [Delors] report that was not deemed by the Treasury [ie Finance Ministry] to be consistent with French government thinking.[96]

When a draft Delors report to which the government was opposed was released, the government apparently blamed Leigh-Pemberton's personal weakness for the situation.[97] One Treasury official commented:

> He was a bit out of his depth in central banking circles. ... He saw being Governor as a part-time job in his spare time from being Lord Lieutenant of Kent.[98]

Another official commented:

> I think Nigel Lawson was pretty fed up with the way that Robin Leigh-Pemberton allowed himself to be carried along .... He spoke scathingly of the inability of the Governor to stop it.[99]

Thatcher, Lawson and the Treasury apparently did not believe that the UK's non-membership of ERM reduced Leigh-Pemberton's influence in the committee. Leigh-Pemberton and senior Bank officials believed otherwise. As one commented:

> He did not go into those discussions with the best hand. Our non-participation was a weakness in the hand certainly. ... If you want to be arguing that the Community should not be advancing as fast down the EMU road as some of the more ambitious institutional developers might be seeking, it is very difficult to argue that footdragging, a *non-Communitaire* card as seen by those who want to rush ahead if not only are you not wanting to run the next race as far or as fast as the others but you haven't actually finished the race before.... We were not deemed to be a full-time professional player.[100]

The Bank's view was shared by the Foreign Office. According to a Foreign Office official: 'We were very aware that the revival of the EMU objectives revived also the political, as well as the economic disadvantages of non-membership of the ERM.'[101] Outside ERM, Leigh-Pemberton was in no position to make alliances within the Delors committee. Again a Foreign Office official commented about the monetary union debate:

> I do not recall that we saw the Germans as particular allies on issues of monetary union. In some things they were helpful, for example, in favouring economic convergence, but not in others. In some areas we had more scope for making deals with the French who always hoped to have us on their side to exert concerted influence on the Bundesbank. But with either country our absence from the ERM was a deterrent to striking alliances. [102]

Certainly, during the period of the Delors committee, the pressure from within the EC for UK entry continued. Although in August 1988 the government announced that it would create a unique market in short-term Treasury bills denominated in Ecus, the other member states doubted the UK's monetary credentials. In January 1989 Leon Brittan became the UK's senior Commissioner and almost immediately started to make regular calls for UK entry. On economic grounds, he argued that ERM membership would reduce inflation and provide the discipline necessary to create a framework in which UK business could flourish. In EC terms, he declared that the UK could put at least a temporary break on further institutional monetary development by entering ERM. Brittan's calls were matched in February 1989 by interventions from the Deutsche Bank and the Spanish government, which said that it might delay its own entry to ERM until the UK was also a member.[103]

Capital liberalisation placed further indirect pressure on the government. Whilst Thatcher professed that liberalisation would destroy the ERM, practice was increasingly suggesting otherwise. Through the second half of 1988 Italy started to remove some of its capital restrictions whilst maintaining the lira parity: its first attempt to this in May 1987 was abandoned after the lira came under pressure. The progress now being made towards a single financial market made the UK's non-membership an increasing anomaly. [104]

Outside the Delors Committee, Thatcher, Lawson and the Treasury addressed the monetary union debate in political rather than economic terms. As in the first half of 1988, they ignored the link between the ERM's operation and support for monetary union. Thatcher, in particular, saw monetary union as part of an alien plot for a federal Europe and the abolition of nation-state sovereignty rather than as a means of reducing the power of the Bundesbank. On 18 September 1988 Thatcher declared that a central bank would mean that:

> Each country would have to give up control over the future of its own economy, over its own currency so that neither Parliament, nor government would have a say in what happened, in what steps had to be taken to uphold the value of the currency.[105]

Two days later in Bruges, Thatcher delivered what became both a celebrated and notorious speech attacking monetary union in even more forthright terms:

> We have not successfully rolled back the frontiers of the state in Britain, only to see them reimposed at a European level with a European superstate exercising a new dominance from Brussels.[106]

Similarly, on 25 January 1989, Lawson declared:

> It is inevitable that there are those who tire of [completing the internal market] and flutter towards the flame of economic and monetary union, or other great ideas. And others who have never much liked hacking at regulation and bureaucracy anyway and are only too keen to escape with dreams of EMU instead.[107]

Thus, by failing either to make a connection between ERM membership and the monetary union debate or to engage with the integration issue on the same terms as other states, the UK government left itself in a very weak position to pursue its interests on monetary union.

An Independent Bank?

During the period of the Delors committee, Lawson and Howe apparently did not put any pressure on Thatcher over ERM membership. Rather Lawson pursued an alternative counter-inflationary option with Thatcher. In September 1988 he instructed his officials to devise a proposal for an independent but accountable Bank of England. In Lawson's plan, the Bank would operate under a completely new legal framework with a similarly explicit statutory obligation to maintain price stability as that of the Bundesbank. The Bank would be accountable to Parliament through the select committee system. On 25 November Lawson sent a memo to Thatcher outlining his proposal and recommending a white paper publication on Budget Day 1989 and legislation in the following November. When Thatcher and Lawson subsequently discussed the proposal, Thatcher displayed little interest. She stated that the proposal could only be considered when inflation was low and coming down, since otherwise it would look as if the government could not reduce inflation itself. For the remainder of his Chancellorship, Lawson neither took up the issue again with Thatcher nor place it on the public agenda.[108]

In terms of ERM membership itself, Thatcher and Lawson continued to spill their differences in public. On 9 October Thatcher stated that she believed that with capital liberalisation, the ERM would break up. On 23 January Thatcher used Ingham to declare that she was virtually ruling out ERM membership during the remainder of the government's term in office and that she did not believe that a further term would change her mind. The next day, Lawson responded by saying that the obstacles to entry were diminishing and the Single Market would make exchange rate stability increasingly important.[109]

5. 4: THE ROAD TO MADRID

The Delors Report was published on 17 April as the unanimous findings of its seventeen members. It outlined three stages necessary to reach monetary union and argued that a decision to enter upon the first stage should be a decision to embark on the entire process. Stage One was to begin in July 1990 and would entail closer coordination of monetary policy, the abolition of remaining exchange controls and the participation of all member states in ERM. Stage Two was to be a transition period and would create a European System of Central Banks (ESCB) composed of a central institution and individual national banks with limited power. The ESCB would be independent from member states and community institutions and be committed to price stability. In Stage 3 the ESCB would assume sole responsibility for monetary policy and exchange rate management vis a vis non-EC currencies. There would be a final fixing of member state currencies and a single currency issued. [110]

The report further stated that to make monetary union successful, economic convergence between member states was necessary. To this end, the report recommended increased regional aid, improved macro-economic policy coordination and binding rules on the size of member states' budget deficits. Finally, the report recommended immediate preparation for an IGC to negotiate the necessary changes to the Treaty of Rome.[111]

Whilst all other member states publicly welcomed the report, the UK government vociferously condemned it. Immediately after the report's publication, Lawson said that the UK could not accept the massive transfer of sovereignty into a political union which monetary union would entail. He declared that the UK could only accept Stage One and would seek to block any proposal to proceed with an IGC. Unlike ERM membership, all core executive actors were generally united on the Delors report. Lawson's expressed opposition was shared by Thatcher, Howe and the Foreign Office, the Treasury and the Bank of England.[112]

Although the UK was isolated in its response, the other member states were not unanimous about a timetable for Stages Two and Three. One group of states led by Germany envisaged a long period of economic convergence and institutional consolidation before Stage Three was reached. By contrast, France, Italy and Spain wanted to move rapidly towards a single currency. For its part the Bundesbank as the institution most threatened by monetary union, aimed to emphasise the importance of economic convergence to an extent that would jeopardise the whole project.[113] In his book on the Bundesbank, Marsh comments:

> Realising that outright opposition to EMU would be sterile and counterproductive, the Bundesbank opted for a more subtle line of assault. If the bank could not bring down the EMU from outside, it had to try to disable the edifice from within...The Bundesbank's chosen method was to give ostensible backing to the aim of monetary union, but to seek to obstruct it by posing conditions which would simply not be acceptable to the other countries.[114]

Turning to Lubbers.

The UK government was now left to decide how to maximise its influence in the run up to the Madrid summit in June where a formal decision would be taken about how to proceed with the Delors report. Initially, it appeared very unsure how to act. One senior Treasury official commented:

> It was quite difficult after the Delors report was actually published to discover what the government's attitude actually was and as we were supposed to be working for the government, it was a period of some confusion.[115]

For their part, Lawson and Howe believed that any successful strategy to halt the momentum towards monetary union was dependent on entry to ERM. Howe decided to pressurise Thatcher on the issue again. He believed that the person most likely to convert Thatcher to ERM membership was the Dutch Prime Minister, Ruud Lubbers with whom she was personally and politically close.Whilst Lawson remained unconvinced that Lubbers could change Thatcher's mind, Howe arranged a mini-summit with the Dutch government under the auspices of discussions on NATO modernisation.[116]

The summit took place on 29 April with defence first on the agenda and the Delors Report second. To pre-empt Howe and Lawson's effort to use Lubbers on ERM, Thatcher made clear to Lubbers her opposition to membership before the formal discussions began. According to Lawson, she then berated Lubbers and his ministers over modernisation and tried to delay any discussion on the Delors Report for as long as possible. When the Delors Report was finally discussed, Lawson and Thatcher rowed over shadowing leaving Lubbers and his Finance Minister, Ruding, with little opportunity to participate in the discussion let alone influence Thatcher.[117]

Lawson took the issue up again with Thatcher himself in a bilateral meeting on 3 May. Thatcher told Lawson that ERM entry would not strengthen the government's hand against monetary union and that a deadline for entry as Ruding suggested, would be particularly damaging. Moreover, as far as she was concerned, ERM membership was a dead issue. [118]Lawson comments:

> It was evident to both of us that the discussion was getting nowhere; but the terms in which she brought it to a close were particularly revealing. 'I do not want you to raise the subject ever again,' she said; 'I must prevail.' It was those last three words that said it all. The economic and political arguments had become an irrelevance. Joining the ERM, as she saw it, had become a battle of wills between her and me; and it was to be her will that prevailed.[119]

Lawson quickly came back to the issue on 20-21 May at an Ecofin meeting to discuss the Delors Report. The ministers agreed to a quick start to Stage One and to a future decision about whether to call the IGC necessary to proceed with Stages Two and Three. With UK membership of ERM a necessary part of Stage One, Lawson assured his fellow finance ministers that entry 'is not a question of whether, it is a question of when.'[120]

In sum, ERM membership now confronted the government as a central issue of its EC policy. Other member states were not prepared to co-operate with the UK government over a range of issues and in particular on monetary union so long as it remained outside ERM. If the government's own policy aim was to minimise the Community's future monetary development, then it faced a considerable incentive to enter ERM.

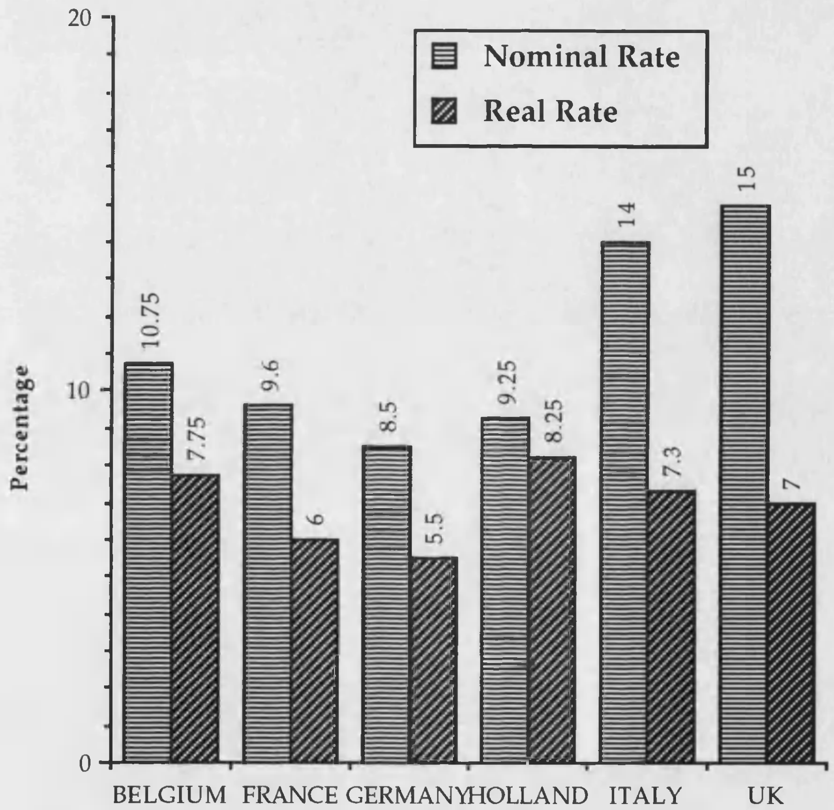
The Price of Conflict

Against this background the government's effort to maintain an appreciating exchange rate as a counter-inflationary weapon failed. In May, sterling came under sustained downward pressure as the balance of payments deficit mounted and the dollar rose. The Bank of England began to intervene heavily. On 17 May, with Lawson and Howe's support for ERM membership well known, Thatcher declared in a radio interview that inflation not ERM membership was to remain the overriding priority. As a result, sterling weakened.[121] Two days later, in another radio interview, Thatcher publicly blamed Lawson's shadowing of the Deutschmark for rising inflation, and questioned whether the ERM could survive capital liberalisation. She then remarked: 'I do not know any serious commentator who at the moment has suggested that we go in until we have tackled our inflation and got it down.'[122]Again, sterling weakened.[123]

Furious with Thatcher, Lawson considered resigning. However, the two reached another accommodation after Thatcher apologised to Lawson, saying that her remarks were taken out of context. Although Thatcher's apology was widely reported, it did not dispel the impression of a divided Prime Minister-Chancellor axis nor stabilise sterling. Indeed, on 22 May, Thatcher attacked ERM again and stated that the UK would not become a member until inflation was under control and 'maybe not even then.' Two days later, Thatcher and Lawson were forced to raise interest rates to 14 per cent to defend sterling against the selling caused by market uncertainty.[124]

ERM membership now offered the government more limited economic benefits than at any time since 1985. As figure 5.4 (page 239) shows, although UK nominal interest rate were significantly higher than the ERM states, real rates were lower than those in Belgium, Holland and Italy.

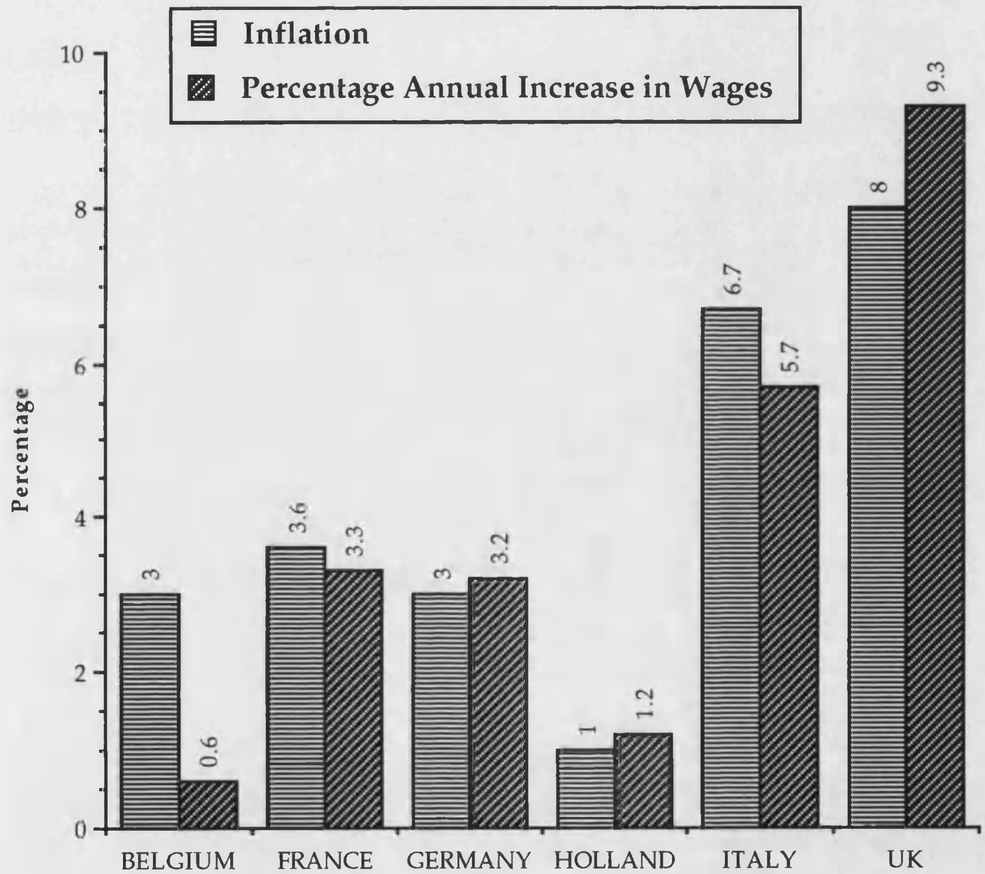
Figure 5.4: Comparative Interest Rates May 1989



(Source: The Economist Economic and Financial Indicators, May 27, 1989)

However, reduced interest rates were now of dubious benefit to the government with UK inflation rising. After sterling stopped rising, high interest rates became the government's only counter-inflationary tool. Inside ERM, interest rates were likely to have to be reduced to keep sterling in its band given the premium of UK rates over those of the ERM states. Yet as Figure 5.5 (page 239) shows, by May 1989 UK inflation and annual wage increase were much higher than those achieved by the ERM states. Without other counter-inflationary polices than high interest rates, particulary some means of controlling wage rises, the government could not achieve the inflation convergence necessary to maintain a sterling parity inside ERM. At the same time, the continuing current account deficit raised a further question-mark over whether the government could sustain sterling in the medium term without a devaluation.

Figure 5.5: Comparative Rates of Inflation and Wage Increases May 1989



(Source: The Economist Economic and Financial Indicators May 27, 1989)

The City and the Delors Report

After the Delors Report was published, the pressure on the government from business groups to enter ERM mounted. Both manufacturing and the financial sector companies and organisations supported monetary union and believed that ERM membership was essential to minimise the UK's isolation. One Treasury official commented on the atmosphere:

> You could not meet an industrialist who didn't think that it was the answer to the world. ... It [ERM membership] was just there all the time, day after day after day so the line of saying we'll join some time was becoming increasingly untenable.[125]

For its part, the CBI saw three main advantages to monetary union: it would reduce the costs of hedging on exchange rate volatility; it would reduce transaction costs; and it would demand of member states the inflation convergence which the CBI sought. Given these advantages, the CBI believed that it would seriously damage UK industry if it were forced to embrace costs that its competitors were avoiding.[126]

Most of the City welcomed the idea of monetary union as a means of strengthening the position of European companies and as a necessary component of a single financial market. The City believed that the UK's non-participation in any union represented a direct threat to its most fundamental interests as a financial centre. In the words of one City official:

> If the others went ahead with economic and monetary union, and it looked as though the UK were going to stay out, then a whole lot of companies, both EC and non EC banks and insurance companies, would start thinking if they should still regard London as the financial centre of Europe and where the centre of gravity would move to. They would start hedging their bets by putting some of their operations in Paris or Frankfurt.[127]

Within this context, non-membership of ERM assumed a new meaning for the City. In March 1989, a senior National Westminster Bank official wrote in *Banking World:*:

> The uncertainty relating to future UK membership of ERM may limit the ability of London, in the future, to claim its rightful place as the premier financial centre of Europe. It would be easy to be complacent and point to the enormous strength of the City and the size of the markets, but the success of the EMS and ERM in particular, is now being accepted by many observers. Increasingly, the UK looks out of line on this topic.[128]

Later, Barclays Bank told the House of Lords Select Committee on the European Communities:

> The pace of change now facing the EC makes it vital that the UK plays its full part in the reshaping of Europe in the 1990s. This it can only do effectively as a full participant in the EMS.[129]

The publication of the Delors Report coincided with a general anxiety in the City about its future competitiveness. The competitiveness of any financial centre is primarily determined by the regulatory framework in which it operates. During the 1980s London established itself as the financial centre of the EC through a process of deregulation which culminated in the Financial Services Act. However, the advent of the Single Market and capital liberalisation meant that the other EC states were now moving towards UK style deregulation. By April 1989, many of the directives for the single financial market were already in place and other countries centres were well advance in their preparation. Increasing numbers in the City believed that the Financial Services Act now left the City over-regulated in comparison to its competitors. The City was threatened in two specific ways. First, some European business which was previously driven offshore to London could now be repatriated. Second, harmonisation could give the potential for each financial market to make use of other advantages to become an international centre.[130] In Robin Leigh Pemberton's words:

> We can no longer class London as a cheap place to do business; and we must be sensitive to the cost of operating here. We start with great natural advantages, not least that we have achieved that 'critical mass' which enables a market to function effectively as a major international, as well as a domestic, financial centre. But it may be that only a small shift in the balance of advantage would be enough to start a process of attrition. And I am well aware that other centres - in Europe and elsewhere - are far from devoid of attraction or potential.[131]

As in 1985, City organisations generally did not concertedly lobby the government. Rather, individual members of the City expressed their support for ERM entry to ministers and officials. One exception was the City European Committee of British Invisibles chaired by Michael Butler, a former Permanent Representative to the Community. The European Committee was created in May 1988 at the instigation of the Bank of

England to examine all EC issues affecting the City from monetary questions to Single Market banking directives. The Bank believed that such a committee was needed for the City to increase its collective input into the UK's EC policy. The committee operated primarily as a policy consultation body with members joining in a personal capacity from all main areas of the City's activity.[132]

Although in 1988 the European Committee lacked coherence, during 1989 it established a collective identity and a voice for itself largely through the monetary union issue. After the Delors Report, Michael Butler went to Thatcher with a mandate from the committee to try and persuade her to take a more constructive position on monetary union and ERM. Although the committee considered that immediate ERM membership was not appropriate in view of economic conditions, it believed that the UK could not have influence on monetary union unless it was regarded as making a serious effort to create the conditions necessary for entry.[133]

By 1989, the financial service sector was the engine of growth of the UK economy employing 2.6 million people. It represented 19.8 per cent of GDP in 1989 compared to 11.6 per cent in 1979. In the 1985-1989 period, the financial sector grew at an annual average of 8.9 per cent compared to 4.1 per cent for manufacturing industry and 4.2 per cent for the non-financial service sector. As a result, with the City now believing that non-membership represented a direct threat to its interests, the government faced a stronger pressure to enter ERM in terms of its capital accumulation priorities than ever before.[134]

The Lawson-Howe Axis

By the start of June 1989 and with the Madrid summit looming, the question of ERM membership posed a direct or indirect problem for the government in terms of economic management, EC policy and the future of the City. The changing costs and benefits of membership across these three areas of policy redefined the core executive debate. One City official close to Thatcher believed that she was very worried about the City's position outside any monetary union, but was still instinctively reluctant to accept

ERM membership as a means of strengthening the UK's position. 'She was a funny mixture of realism and rationality and prejudice on the subject of the EC and particularly on the ERM.'[135]

For its part, the Bank of England was more concerned about the City's position in relation to monetary union than any other part of the core executive and prepared an internal report on the subject. [136]According to one Bank official 'the whole question about London's position as a financial centre had been preoccupying the Bank.'[137] Another policy official described the Bank's position:

> London's position as a financial centre is a factor which clearly does weigh quite strongly with everybody in the Bank. We consider the City to be a major economic asset and we're therefore concerned lest there be any development that undermine that, prejudice it in anyway. And I think most people would agree that the financial community, particularly financial institutions from elsewhere, happening to locate their European institutions here, or considering whether to locate their European institutions here would take into account the question of whether we were in a single currency union or outside it. ... How important it would be, different people inevitably take slightly different judgments. Yes, in principle, it would be prejudiced but is it just a marginal consideration or is it a fundamental one.... I think probably most people feel short term, either uncertainty as to whether we would join or even knowledge that we weren't going to join wouldn't have much significant adverse effect. But that over time particularly if associated with our not being part of the union, other policy decisions were taken at a Community level by members of the union, our influence over events is likely to be eroded. If financial institutions see that, or expect that to be the outcome, then that in turn will affect whether they locate themselves in the decision-making centre or in somewhere which is clearly outside the union.[138]

Outside ERM, the Bank believed, the other member states would not listen to the Bank's concerns. Their view was:

> 'If you want us to listen to your view of the way forwards to further monetary integration, you at least have to come up to where we all are at present.' ... It puts one at some disadvantage in all negotiations about things which change permanent arrangements. And there's always the potential that we will not be able to carry as much weight in deciding the outcome as we would wish and as another member state with our economic and historical weight, if you like, would expect to achieve. [139]

However, whilst the Bank believed that ERM membership was vital to secure influence on monetary union, it now believed that it could not be justified on economic grounds. Leigh-Pemberton reversed his position to oppose membership.[140] In his view expressed in the *Bank of England Quarterly Bulletin*:

> It would be a mistake to enter the mechanism in circumstances where our anti-inflationary policy might be compromised or undermined. This could happen if we wished to keep interest rates high for domestic reasons but ... we were pushed towards lowering interest rates to keep sterling within its band. It would therefore be unwise to enter the mechanism with the UK economy significantly out of balance with other major member countries.[141]

The 1985 Treasury-Bank axis on membership was now broken. The Treasury was far less concerned than the Bank of England that the City would be penalised outside a monetary union. Asked about the extent of the threat to the City, a senior Treasury civil servant observed: 'it's not very obvious that it is true.'[142] Neither did the Treasury share the Bank's view that rising inflation made ERM membership untenable. The Treasury still supported membership as a means of achieving exchange rate stability and as a counter inflationary monetary framework. At the same time, the Treasury believed that membership was necessary to halt the Delors Report.[143]

These developments took the Treasury closer to the Foreign Office position than ever before. According to a Foreign Office official: 'there was no difference of view between the Treasury and the FCO on these matters.'[144] The Foreign Office similarly considered that progress on the Delors report would be impossible outside the ERM. Like the ERM states, in the view of one Treasury official: 'The Foreign Office regarded it [ERM membership] as a litmus test of whether we were serious about Europe.'[145]

With the Treasury now allied with the Foreign Office rather than the Bank, Lawson and Howe moved to act in partnership against Thatcher. At the start of June Howe proposed to Lawson that they send a joint memo to Thatcher outlining the case for ERM membership in the context of the decisions to be taken on monetary union at the Madrid Summit. Lawson states that he was sceptical about its utility but agreed that Treasury and Foreign Office officials should draft a paper. The draft memo argued that it would be very damaging simply to oppose monetary union at Madrid and that the government's aim should be to avoid an agreement to an IGC. To this end, the government should give a non-legally binding undertaking that sterling would enter ERM by the end of 1992 on the condition of a reduction in UK inflation and the abolition of all EC exchange controls. The government could then seek the postponement of any decision on Stage Three until work was carried out on how it would operate. [146]

Whilst the memo was being drafted, Lawson returned to a public offensive. On 11 June Lawson denied that shadowing caused inflation and claimed that Alan Walters was wrong about ERM membership. The next day, giving evidence to the Treasury Select Committee, Lawson declared that if the other member states believed that the UK would enter ERM within a reasonable time period, then the UK's influence on the monetary union debate would increase. For the first time he specified a set of conditions for ERM entry. The conditions differed slightly from those outlined in the draft joint memo. Whilst the inflation condition remained, the exchange control condition was now restricted to the *major* EC states. With France and Italy due to abolish controls by mid-1990, the press interpreted Lawson as stating that entry would occur sometime in 1990.[147]

On 13 June Lawson and Howe met to discuss the joint memo. Lawson remained sceptical about its likely effectiveness. Nevertheless, the next day he agreed to sign the memo subject to a number of amendments and it being sent on Foreign Office paper.[148] According to one Treasury official who worked on the memo, it was a step into new territory:

> What was extraordinarily unusual was something that comes out in the Lawson memoirs that he and Geoffrey Howe signed a joint minute. That is very, very, rare in Whitehall.[149]

The memo was sent to Thatcher on 14 June. She viewed the memo as an ambush but reluctantly agreed to see Lawson and Howe on 20 June.[150]

In the intervening period events conspired to apparently strengthen Lawson and Howe's hand. On 15 June in the elections to the European parliament, the Conservatives slumped to their worst performance in a national election in the post-war period receiving just 34.7 per cent of the vote and losing 13 (out of 81) seats to Labour. In part, the poor performance reflected a growth in the government's general unpopularity. In the *Guardian* average monthly poll, the government fell from a six per cent lead over Labour in January to an eight per cent deficit in June. At the same time, the party paid the price of a public perception that the government was too negative in its approach to Europe. Already isolated on monetary issues, in May 1989 the government unilaterally dismissed a Commission plan for a social charter to protect worker rights in the EC. With other member states wanting to act on an issue with which Labour was identified, Labour effectively presented itself as the united and pro-European party working for UK interests and the Thatcher government as petty isolationists. Labour's task was made easier by a Conservative campaign which stressed the government's nationalist and anti-European credentials.[151]

Throughout the campaign the government's strategy left many people in the Conservative party unhappy. Both Henry Plumb, leader of the Conservative MEPs, and Heath made blistering attacks on the style and substance of Thatcher's EC leadership. At the end of May, Michael Heseltine strongly criticised policy in a book entitled, *The Challenge of Europe: Can Britain Win?* Meanwhile, increasing numbers of Conservative backbenchers believed that the UK could not retain its European credentials outside ERM and that business was suffering as a result.[152] One Conservative opponent of membership, commented that backbenchers 'believed the UK's problems would be ameliorated by a German fixed rate regime; their was a very powerful mood disposed to membership of the ERM.[153]To add to their case, on the day of the election, Gallup published a poll showing that 93 per cent of chief executives of large UK companies and City institutions believed that the UK should enter ERM.[154]

The election result only compounded the belief in the party that the government needed to pursue a more constructive EC policy. Lawson comments on the situation:

> It was no surprise that the results of the [European Parliament] elections... were an unmitigated disaster for the Government. While the unpopularity caused by the inexorable rise in interest rates had probably been the main factor, the nature of the Euro-campaign itself had clearly not helped.
> Margaret did not see it that way at all. I suddenly realised, with a shiver of apprehension, that she saw the Euro-campaign as a trial run for the next General Election; and that, with the short term economic outlook unpromising, she saw a crude populist anti-Europeanism as her winning strategy. It was a strategy that would undoubtedly have evoked a considerable response: xenophobia always does. But it would have been a disaster for the Party, splitting it from top to bottom and making no sense to the voters.
> It was always clear to me that the Conservative Party could be successfully led only by someone who took their stand in the centre of the spectrum on this issue, where the silent majority dwelt. Margaret's evident determination to lead the Party from one of the two extremes of that spectrum spelled nothing but trouble.[155]

Lawson and Howe's hand was additionally strengthened as direct pressure from the other member states on ERM membership mounted. On 16 June, Spain announced that it would enter ERM three days later. With Spain similarly suffering from above average inflation, the decision drew attention to the validity of the UK's economic justification for non-membership. Spain also gave voice to the growing view in the other member states, including Germany, that if the UK did not act quickly on ERM entry, monetary union could be achieved without it. On 19 June France and Germany issued a joint communique calling for decisive progress on the Delors Report at the Madrid summit.[156]

On 20 June Thatcher, Lawson and Howe met to discuss the joint memo. Thatcher rejected their case for setting a timetable for membership as putting an unwelcome constraint on monetary policy and stated that it would achieve no concessions on the Delors Report. Unable to agree, the three agreed to give the matter further consideration. [157]

What happened next is a matter of dispute between the protagonists.

Lawson states that the next day Howe received a memo from Charles Powell outlining an alternative set of conditions for ERM entry to use at Madrid, seemingly devised by Alan Walters. Those conditions were a reduction in inflation, exchange control abolition, the creation and successful implementation of a level playing field in Europe on the monetary front and the final completion of the Single Market to the UK's satisfaction. Lawson and Howe regarded the conditions as totally unacceptable. On 23 June, Lawson and Howe sent another joint memo to Thatcher stating that they believed the open-ended nature of the 'Walters' conditions would be counter-productive at Madrid and requesting a further meeting. They also agreed that if Thatcher did not adopt these conditions, then they would resign. [158]

By contrast, Thatcher makes no mention of any memo from Powell and implies that the second Lawson-Howe memo came out of the blue.[159] Thatcher reluctantly agreed to see her Chancellor and Foreign Secretary on Sunday 25 June before she and Howe left for Madrid in the evening. [160] In Lawson's description of the meeting:

> The atmosphere was unbelievably tense. As before, Geoffrey opened, and spoke briefly along the lines of the minute. Margaret was unmoveable. Geoffrey then said that if she had not time for his advice, and was not prepared to make the sort of forward move at Madrid necessary to avoid the disastrous outcome he feared, then he would have no alternative but to resign. I then chipped in, briefly to say, 'You should know, Prime Minister, that if Geoffrey goes, I must go too.' There was an icy silence, and the meeting came to an abrupt end, with nothing resolved.[161]

Thatcher comments:

> I would never, never allow this to happen again. I refused to give them any undertaking that I would set a date. Indeed, I told them that I could not believe that a Chancellor and a former Chancellor could seriously argue that I should set a date in advance: it would be a field day for the speculators, as they should have known. I said I would reflect further on what to say at Madrid. They left, Geoffrey looking insufferably smug. And so the nasty little meeting ended.[162]

Later in the day, Spain warned that it might call an IGC whether the UK would accept it nor not.[163]

The Madrid Summit

When Thatcher and Howe arrived in Madrid, the conflict between them remained unresolved. During the evening, Thatcher met for discussions with Powell on how to proceed without Howe. When the summit started, Thatcher deployed a conciliatory tone to set out a series of conditions for UK entry to ERM: the convergence of UK inflation with other EC states; the abolition of all exchange controls; further progress towards the completion of the Single Market; free competition in financial services; and the strengthening of European competition policy. However, it was not sufficient to defer action on the Delors Report beyond Stage 1. The summit concluded with an unanimous agreement by member states to proceed with the Delors Report as the means to achieve monetary union. They agreed that Stage One should start by 1 July 1990, to be followed by an IGC when adequate preparation was completed. [164]

The media hailed the summit as a major shift in Thatcher's position on ERM membership. Yet with Thatcher claiming that the Madrid conditions were based on a paper Alan Walters had given her in May 1989, this was open to dispute.[165] For his part, Lawson rejected Walters' claim to the conditions:

> Irrelevant though the last three conditions were to the objective question of ERM membership, it was clear that they were as long as a piece of string: they could be interpreted as having been satisfied at any time. By contrast the original Walters/Powell formulation had implied that there could be no ERM membership for some four years at the earliest - the single market was not due for final completion until the end of 1992, which meant that even in the unlikely event of everything going to plan, it would have been well into 1993 before the monitoring period had been completed.[166]

Walters' claim would seem more tenable. Whilst conditions 'as long as a piece of string' could be interpreted 'as having been satisfied at any time,' they could also be interpreted as never having been satisfied. Moreover, the Madrid conditions contained no deadline for membership as demanded by Lawson and Howe.

Officials who worked on the joint memo saw the Madrid conditions as a defeat for Lawson and Howe. One Treasury insider felt:

> It was a slight movement. But at the time it seemed to those of us who had been working on it all as a grave disappointment. ... I'd worked on the joint paper and the purpose of the paper was to persuade the Prime Minister that ERM membership at an early stage, not with the Single Market, but within a matter of months would be appropriate. It seemed to set up hurdles which meant we would not be able to join for quite a while. I think those of us who were closely involved regarded it as a set back.[167]

In the words of a former Cabinet minister, 'she gave sufficient ground to make everyone believe she had given more ground than she had done.'[168] A Thatcher confidant observed:

> I would argue that the conditions for our joining ERM were made more difficult by her statement in Madrid, not brought closer and that was a deliberate act of defiance of them. [Lawson and Howe] In effect they had to climb down when she came home and pretend to be satisfied with what they'd done ... What we did was spell out the conditions which would have to be met if sterling were to join the ERM and when you actually spelled out the conditions, it became quite clear that the hurdles were a good deal higher than the rather vague general formulation that we'll join when the time was right.[169]

Indeed, Lawson himself admits that overall Howe and himself were outmanoeuvred:

> I saw Geoffrey .... to discuss with him where we stood on the resignation question. The media, rightly or wrongly, were without exception hailing Madrid - which Margaret was felt to have handled with unaccustomed skill - as a major breakthrough on the ERM, and our backbenchers, particularly those in the ERM camp, were echoing the chorus. He understandably felt that, although she had rejected our deadline proposal, a resignation in those circumstances would have been bizarre and incomprehensible.[170]

A Thatcher confidant remarked: 'I think their bluff was called. I don't think they intended to resign or expected to have to.' [171] In effect, Lawson and Howe were little closer to persuading Thatcher to accept ERM membership than before forging their alliance.

Conclusions

After 1988 the government was forced to face ERM membership as a significant issue of both economic and EC policy, and the external pressure on it to enter ERM mounted. On economic policy, the government faced a continuing of problem about how to operate a monetary and exchange rate policy outside ERM which was acceptable to both Thatcher and Lawson and which could be presented as such. At the same time, the government moved further away from an economic policy which could easily translate into ERM membership if it so wished. In EC terms, both Thatcher and Lawson initially ignored the question of how to effectively oppose monetary union outside ERM. They failed to take the debate seriously and to understand the economic interests shaping the impetus towards monetary union. When Lawson did finally join forces with Howe to tackle Thatcher on ERM as an issue of EC policy, they were not able to achieve any significant concession from the Prime Minister and the momentum towards monetary union increased.

After the Madrid summit much the same problems remained. In EC policy, the dilemma was how to influence an accelerating debate on monetary union and ultimately an IGC without any tangible commitment to ERM entry. The Madrid conditions did potentially offer a reduction in costs to the government's economic policy and presentation. Since Thatcher was commonly believed to have given ground on ERM membership, whatever the reality, the exchange markets could consider that Thatcher and Lawson had reached more than a temporary accommodation on the issue.

Nevertheless, the underlying question remained of how the government could act as a viable counter-inflationary member of ERM if it were to enter the system. When Spain decided to enter ERM, it abandoned its previous counter-inflationary policy based on a tight monetary policy and an appreciating exchange rate. In May 1989 Spain faced rising demand and a deterioration in the balance of payments. In response, the government cut public expenditure and increased and brought forward corporate withholding taxes to tighten fiscal policy. Shortly after it entered ERM, it reintroduced credit ceilings, raised the Bank of Spain's intervention rate and increased withholding taxes on personal incomes. Yet there is no evidence that Lawson or the Treasury believed that any parallel shifts in UK policy would be necessary should they finally prevail over Thatcher.[172]

ENDNOTES TO CHAPTER FIVE

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44. Thatcher, *Downing Street Years*, 704.

45. Lawson, *Memoirs*, 836.

46. Thatcher, *Downing Street Years*, 705.

47. Smith, *Boom to Bust*, 137.

48. Lawson, *Memoirs*, 842; Smith, *Boom to Bust*, 139-140.

49. McKie ed., *Election*, 72; Keegan, *Economic Gamble*, 227; Smith, *Boom to Bust*, 130-131.

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52. Lawson, *Memoirs,* 956.

53. Lawson, *Memoirs,* 858.

54. Lawson, *Memoirs,* 902.

55. Non-attributable interview.

56. Lawson, *Memoirs,* 902-903.

57. Non-attributable interview.

58. Lawson, *Memoirs,* 904.

59. *Financial Times,* June 26, 1989.

60. Non-attributable interview with Treasury official.

61. Non attributable interview with Treasury official.

62. Non attributable interview with Treasury official.

63. Non attributable interview with Treasury official.

64. Non attributable interview with Treasury official.

65. Non attributable interview with Treasury official.

66. Non attributable interview with Treasury official.

67. Non attributable interview with Treasury official.

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72. *Financial Times*, June 27, 1988; *Financial Times*, June 28, 1988.

73. *Financial Times*, June 25, 1988.

74. Lawson, *Memoirs*, 904.

75. Lawson, *Memoirs*, 904.

76. Non-attributable interview with Foreign Office official.

77. Non-attributable interview with Commission official.

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82. *Financial Times,* September 26, 1988.

83. McKie, *Election,* 72; *Financial Times,* September 26, 1989.

84. Non-attributable interview with Bank of England official.

85. Non-attributable interview with Bank of England official.

86. Lawson, *Memoirs,* 892.

87. Lawson, *Memoirs,* 906-908; Thatcher, *Downing Street Years,* 708.

88. Lawson, *Memoirs,* 908-909; Thatcher, *Downing Street Years,* 708; Non-attributable interview with Bank of England official.

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90. Non-attributable interview with Treasury official.

91. Non-attributable interviews with Treasury officials.

92. Non-attributable interview with Foreign Office official.

93. Non-attributable interview with Bank of England official.

94. Non-attributable interview with Bank of England official.

95. Non-attributable interview with Bank of England official.

96. Non-attributable interview with Bank of England official.

97. Non-attributable interview with Foreign Office official.

98. Non-attributable interview with Bank of England official.

99. Non-attributable interview.

100. Non-attributable interview with Bank of England official.

101. Non-attributable interview with Foreign Office official.

102. Non-attributable interview with Foreign Office official.

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106. *Financial Times*, September 21, 1988.

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114. Marsh, *Bundesbank*, 245.

115. Non attributable interview with Treasury official.

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117. Lawson, *Memoirs*, 915-916.

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120. Lawson, *Memoirs*, 920; *Financial Times*, May 22, 1989.

121. *Financial Times,* May 18, 1989.

122. *Financial Times,* May 20, 1989.

123. *Financial Times,* May 20, 1989.

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137. Non-attributable interview with Bank of England official.

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145. Non attributable interview with Treasury official.

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147. Lawson, *Memoirs,* 923-924; *Financial Times,* June 12, 1989; *Financial Times,* June 13, 1989; *Financial Times,* June 14, 1989.

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155. Lawson, *Memoirs,* 922-923.

156. *Financial Times,* June 8, 1989; *Financial Times,* June 17, 1989; *Financial Times,* June 20, 1989; *Times,* June 20, 1989.

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158. Lawson, *Memoirs,* 930-931.

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CHAPTER SIX
THE ROAD TO ENTRY.

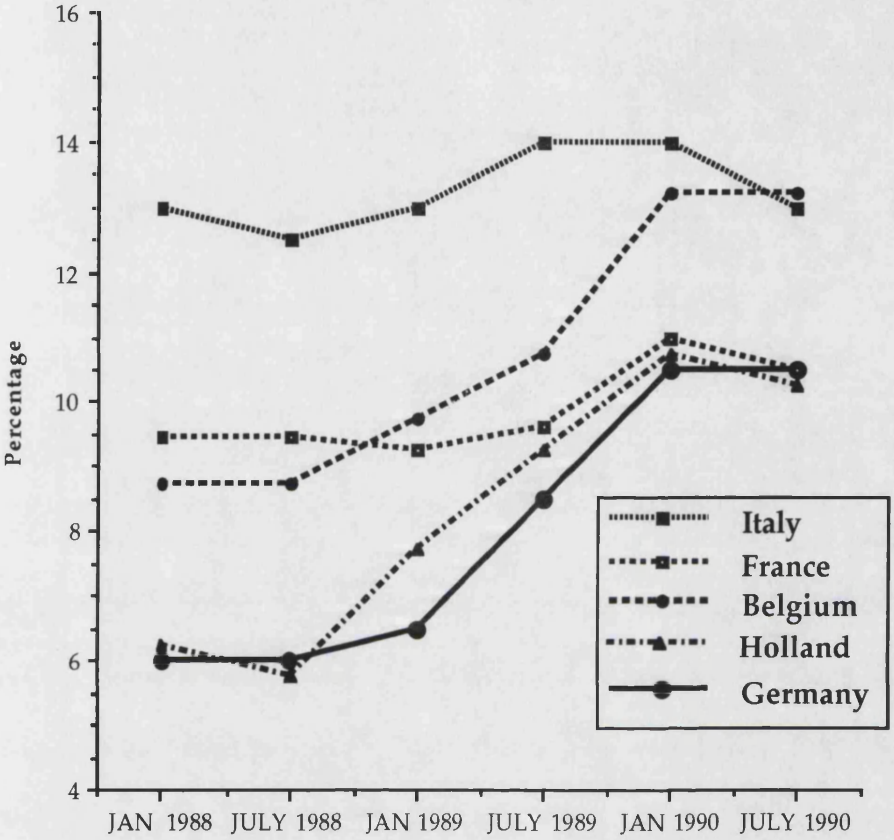
This chapter traces the evolution of policy from the aftermath of the Madrid summit in June 1989 to the UK's entry to ERM on 8 October 1990. Section 6.1 examines the operation of ERM during the period in view of the ERM states' commitment to monetary union and the prospect of German reunification. Section 6.2 looks at how Lawson's and Howe's departure from office and the European momentum towards monetary union in the second half of 1989 affected the UK debate on ERM membership. Section 6.3 considers the government's problems in economic and EC policy between January and April 1990 which resulted in ministers making a public commitment to ERM membership. Section 6.4 examines the actions of core executive actors from May to early September 1990 in view of the public commitment to ERM membership. Section 6.5 analyses the government's decision to enter ERM in autumn 1990 given ministers' policy priorities at that time. A final epilogue reviews the UK's membership of ERM, the Maastricht treaty and the suspension of the ERM's narrow bands in August 1993.

6.1: ERM, MONETARY UNION AND GERMAN REUNIFICATION

During the second half of 1989 and 1990, the ERM states saw impending monetary union as an added incentive to maintain their currency parities against the Deutschmark. With the financial markets believing that there was a clear path to monetary union, interest rates within ERM started to converge towards the German level. Since the financial markets believed that currencies would ultimately be irrevocably fixed, less premium was required to persuade them to hold currencies other than the Deutschmark.[1] Figure 6.1 (page 267) shows that from January 1988 to July 1990 the differential between Italian and German nominal rates fell by 4.5 per cent and between French and German rates by 3.45 per cent. Similarly, as figure 6.2 (page 268) indicates, the differential between French and German long term government bonds fell by 3.19 per cent and between Belgian and

German bonds by 1.22 per cent.

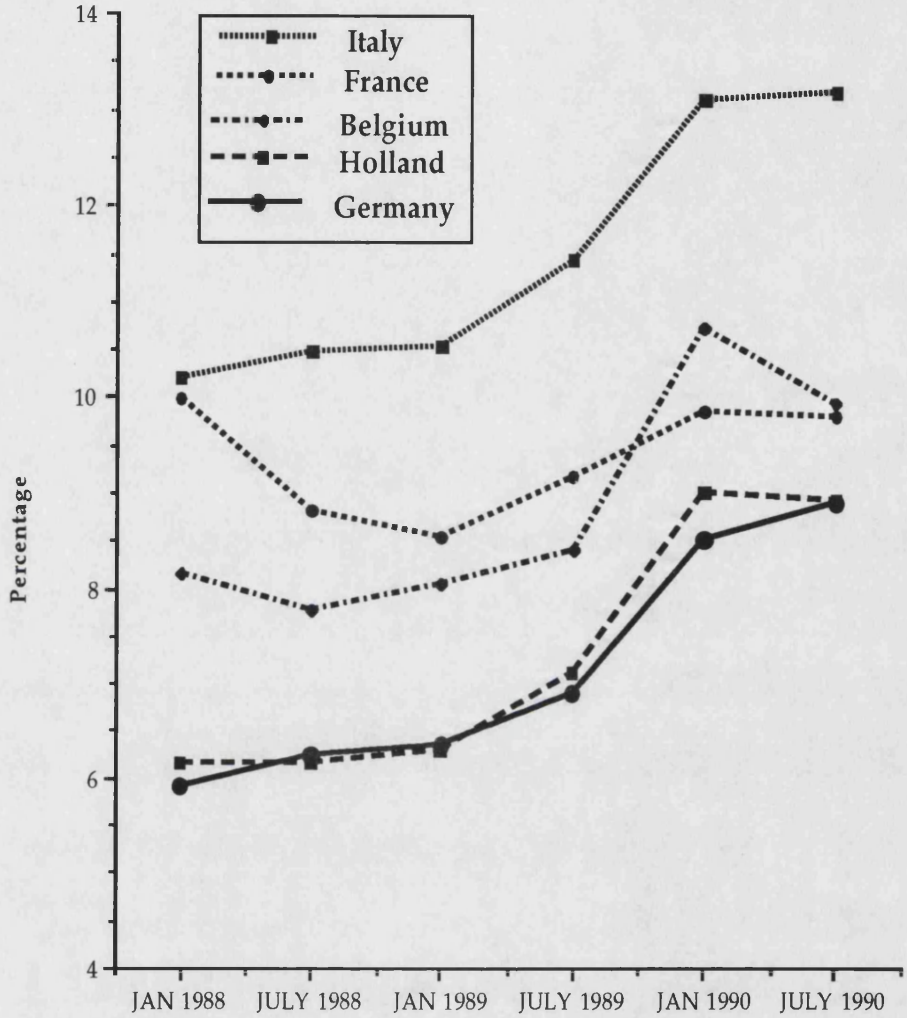
Figure 6.1: Comparative Nominal Prime Lending Rates 1988-1990



(Source: Economist Economic and Financial Indicators 1988-1990)

With monetary union operating as an insurance policy, the major ERM states were able to fully liberalise capital. In January 1990 France scrapped its remaining exchange controls six months ahead of schedule and Italy dismantled some more of its controls. Four months later Italy removed all remaining restrictions. In both cases, the process was accomplished without any pressure arising on the respective currencies.[2]

Figure 6.2: Comparative Long Term Government Bond Rates 1988-1990



(Source: Economist Economic and Financial Indicators)

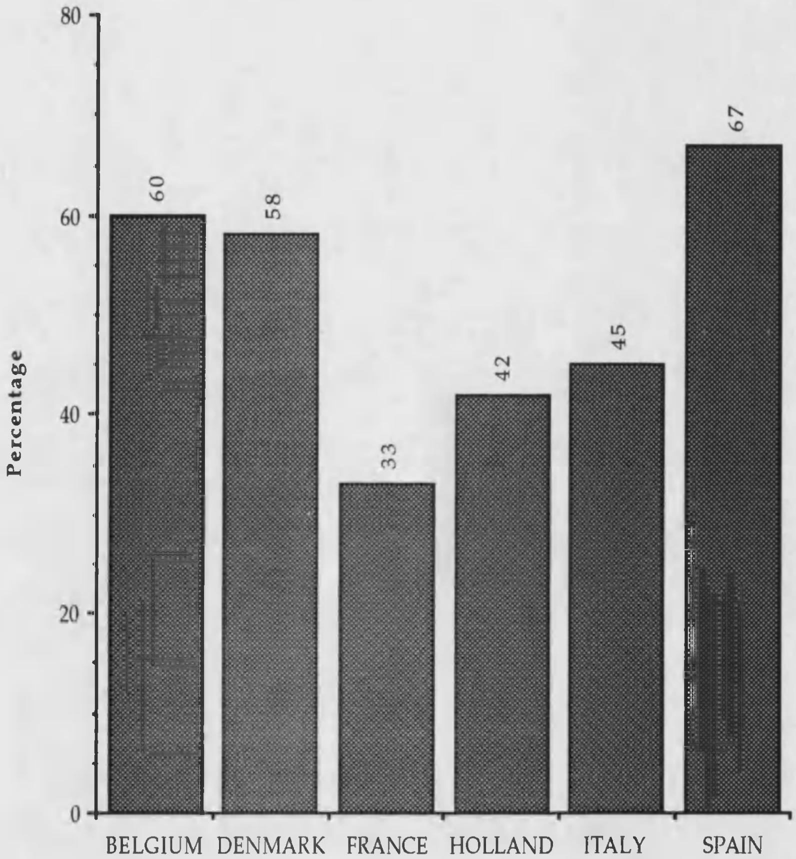
In November 1989 the ERM faced an external shock when the destruction of the Berlin Wall created a momentum towards German reunification. The likely cost of reunification was DM200 billion per annum. Rather than increase taxes to pay for it, the Kohl government retained its commitment to DM725 billion worth of income tax cuts. Given the inevitability of increased borrowing, and with West German workers demanding higher wages to protect themselves from the two thousand East Germans crossing the border daily, Germany faced rising inflation.[3]

In response the Bundesbank raised interest rates. It also sought an appreciation in the Deutschmark against the other ERM currencies as a further counter-inflationary tool. Without such an appreciation, the Bundesbank would continue to tighten monetary policy to a level which would have serious deflationary consequences for the ERM states forced to follow suit. Between the fall of the Wall and the start of 1990 the Deutschmark gained nearly 11 per cent against the dollar and yen due to rising German interest rates and a financial market view that reunification would create a new economic superpower. As a result, all the ERM currencies except the Dutch guilder came under sustained downward pressure against the Deutschmark.[4]

By January 1990 the Bundesbank was publicly expressing its view that a general realignment was necessary. The French government refused to countenance the possibility, committed as it was to the *franc fort* whatever the circumstances. It strongly appealed to the German government to commit itself to the maintenance of the parity and to suppress discussion of the subject by the Bundesbank. Kohl backed the French government and ruled out any realignment. As a result, on 5 January, Italy alone devalued the lira by a marginal 3.7 per cent against the Deutschmark at the same time as it moved into the 2.25 per cent ERM bands. Later Holland and Belgium started to operate unofficial 0.5 per cent bands to further consolidate their currencies parities. [5]

Although the monetary policy of the ERM states remained deflationary for the rest of the year to match the Bundesbank, German reunification did provide some economic stimulus for the ERM states. In 1990, the German economy grew at a rate of 4.5. per cent which was higher than at any other time during ERM's existence. With demand rising in West Germany and surging in East Germany after monetary union between the states on 1 July, the ERM states made spectacular gains in export volumes to Germany as figure 6.3 (page 270) indicates. By dramatically cutting their trade deficits with Germany, the ERM states were able to acquire Deutschmarks without deflationary action. The situation weakened the Deutschmark and with high Spanish interest rates the peseta started to become the strongest currency in the system.[6]

Figure 6.3: Comparative Percentage Growth of Imports into Germany Fourth Quarter 1989-Fourth Quarter 1990



(Source: The Guardian, April 15, 1991)

6.2: WHITHER THE MADRID CONDITIONS?

The potential benefit of the Madrid conditions to the government's EC policy were undermined within days of their inception. Whilst Thatcher was still in Madrid, she declared that the UK rejected the Delors Report, and would be putting forward its own alternative proposals for monetary union even though none existed. Lawson comments:

> The first I and my senior officials knew of this proposal was a report on the radio from Madrid which stated that the Treasury was already

working on alternatives to Delors. Peter Middleton subsequently told me that he heard the news when driving his car, and was so astonished that he nearly crashed into a tree. About twenty four hours later came the request from Number 10 to validate the Prime Minister's promise. [7]

On her return to the House of Commons, Thatcher again speculated that the ERM might not survive France and Italy abolishing exchange controls.[8]

On 24 July, evidently angry at Howe's behaviour in the run up to the Madrid Summit, Thatcher removed him as Foreign Secretary and made him Leader of the House with the honorific title of 'Deputy Prime Minister.' In replacing Howe, Thatcher overrode the most obvious candidate Douglas Hurd, and chose the less European-minded John Major. Major came to the Foreign Office without any apparent conviction on ERM membership and was unlikely to pressurise Thatcher on fulfilment of the Madrid conditions.[9]

At the same time, the Madrid conditions offered the government little benefit as it sought to develop and sustain a credible alternative to the Delors Report. Left by Thatcher to devise a proposal, Lawson decided upon a scheme of competing currencies within the EC. Rather than proceeding to Stages 2 and 3 of the Delors Report, the member states would make all EC currencies fully legally interchangeable. National central banks would remain responsible for currency creation and would act within the framework of ERM. Good currencies would threaten gradually to drive out the bad until eventually the EC might theoretically find itself with a single currency.[10]

Lawson presented the idea verbally to an informal Ecofin meeting in Antibes on 8-9 September. Whilst the press reported that the other finance ministers and central bank governors were very hostile to the suggestion, Lawson later recalled that they 'regarded it with polite scepticism and would reserve final judgement until they had read the paper.'[11] The government's problem was that the plan did not offer the benefits that the other member states wished to secure from monetary union, especially France. Since competing currencies did not address the question of how to reduce the power of the Bundesbank, there was little chance of the scheme attracting future interest.[12]

Neither did the other member states or the Commission regard the Madrid conditions as a sufficient substitute for ERM membership. According to one official: 'The Madrid conditions were received with all the enthusiasm of Crystal Palace on a wet afternoon.'[13] Immediately after the summit Leon Brittan expressed scepticism about the validity of the inflation and exchange control conditions and called for early entry. In October he declared that there could be no justification for delaying entry beyond the summer of 1990. In the same month the Commission's annual economic report expressed concern about high inflation in the non-ERM states. Specifically, it concluded that the UK would be better off inside ERM and ending its 'excessive reliance' on high interest rates to curb inflation.[14]

In terms of economic policy, the government was not able to use the Madrid conditions to create certainty in the markets about its attitude towards exchange rate management. During July and August, the press reported that Alan Walters was criticising Lawson's monetary policy at City lunches. Walters vigorously denied this and claimed that Lawson planted the stories himself. Whatever the truth, it was impossible to dispel the impression of conflict between the Prime Minister and Chancellor.[15]

At the start of October, the government announced a £2 billion trade deficit for August and sterling weakened despite considerable Bank of England intervention. Sterling now hovered just above the DM3.00 level for the first time since shadowing was abandoned. On 5 October, the Bundesbank raised its interest rates by one per cent. Immediately, Lawson secured Thatcher's consent to a similar rise in UK rates to try and maintain sterling above DM3.00. With the Conservative conference due to start on 9 October, the *Sunday Times* published a story that Walters opposed the rise in interest rates and that Thatcher had 'reluctantly sided with Lawson.' It further implied that Thatcher would not sanction any further increase in rates to defend sterling. Although Walters professed ignorance about the source of the story, Thatcher herself did not deny its contents. [16]

If indeed Thatcher was prepared to accept Walters advice to decouple monetary policy from the exchange rate again, with the ensuing inflationary consequences, then the Madrid conditions for membership were effectively compromised. Lawson now faced a threat in economic policy in regard to ERM membership at the same time as he was completing the paper on competing currencies which stated that sterling would become a member of a 'hard' ERM.[17]

On 18 October the *Financial Times* published extracts from an article by Walters due for publication in an American academic journal in which he stated that the ERM was 'half baked' and that the arguments for entry 'have never attained even a minimum level of plausibility.'[18] Having at the beginning of October fully committed itself to early ERM entry, Labour was in a stronger position than ever to exploit the differences between Lawson and Walters. On 19 October the Labour front bench called for Thatcher to distance herself from Walters' stance, declaring that the credibility of the UK's exchange rate policy was 'being fatally undermined.'[19] With Thatcher silent, Lawson concluded that the situation was untenable:

> The problem, as I saw it, was not the difference between Margaret and myself over sterling's membership of the ERM. I had been living with that during most of my six years as Chancellor, and although it was far from ideal, I could have continued to do so. What made my job impossible was Number 10 constantly giving the impression that it was indifferent to the depreciation in sterling. I cannot recall any precedent for a Chancellor being systematically undermined in this way.[20]

Indeed, on 25 October, Lawson succeeded in securing Thatcher's agreement to the formal publication of the competing currencies proposal. Lawson comments:

> My officials, who had been apprehensive of Margaret's reaction to a paper whose proposals assumed sterling's membership of what would ultimately become an unequivocally 'hard' version of the ERM felt that I had achieved something of a coup.
> ... In the short term the paper's value was largely domestic. It contained for the first time, a firm Government commitment that sterling would join the ERM when the Madrid conditions, which were clearly spelled out in a perfectly acceptable form, were satisfied.

> This definitive statement meant that when Margaret subsequently sought to add further conditions as and when they entered her head it was easier to ignore them as apocryphal.[21]

The next day Lawson told Thatcher that he could no longer continue in office so long as Walters remained in his position. After Thatcher refused to sack Walters, Lawson resigned declaring in his resignation letter:

> The successful conduct of economic policy is possible only if there is *and is seen to be* full agreement between the Prime Minister and the Chancellor of the Exchequer. Recent events have confirmed that this essential requirement cannot be satisfied so long as Alan Walters remains your personal economic adviser.[22]

In the short time left for trading that day, sterling plummeted by seven pfennigs against the Deutschmark despite repeated intervention from the Bank of England. Later in the evening, Walters too resigned.[23]

The End of the Madrid Conditions

Despite Lawson's success in securing a new commitment to eventual ERM membership from Thatcher prior to his resignation, his departure effectively removed membership from the government's agenda. For his part, Howe soon declared that it was essential that the government quickly reaffirmed the Madrid conditions in order to maintain the confidence of its EC partners. However, although nominally 'deputy Prime Minister,' Howe was now excluded from the *ad hoc* meetings of senior ministers where influence on the issue lay. Although the new Chancellor, John Major, did publicly back the conditions on 1 November, neither he nor the new Foreign Secretary, Douglas Hurd, showed any signs of wanting to push the issue with the Prime Minister as their predecessors had.[24] One Treasury official commented:

> I don't think Mr Major was ever pro-ERM, in the sense that he came with a strong conviction that that was the way we should run our affairs.[25]

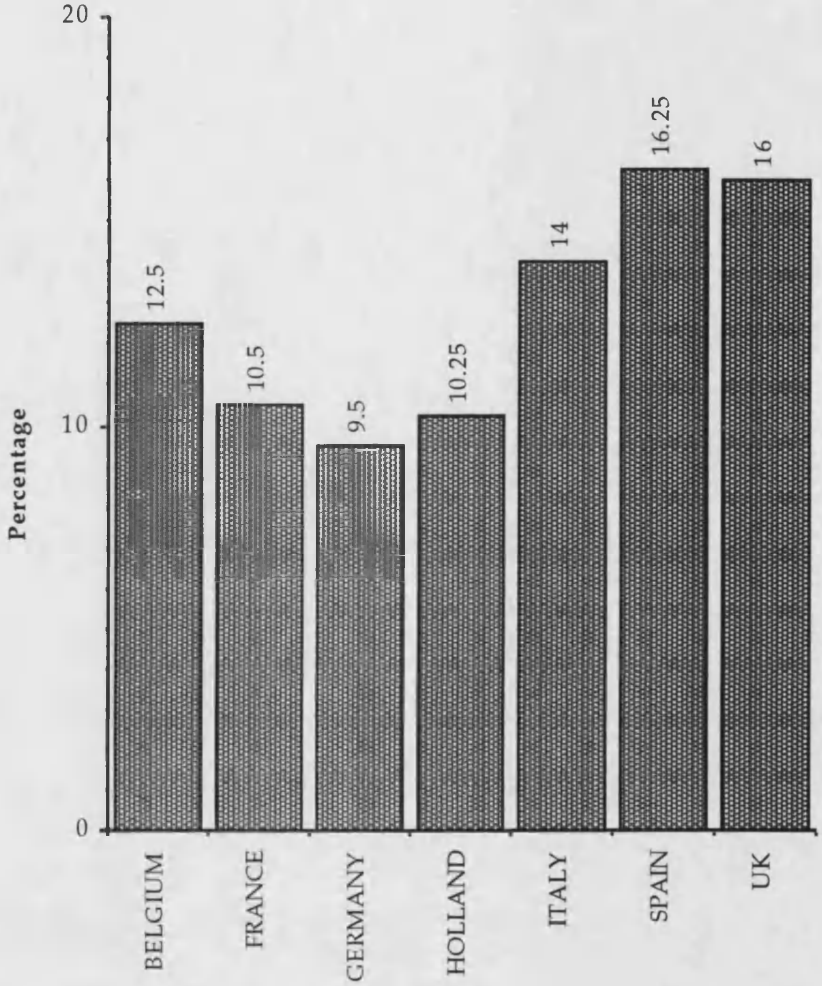
Unthreatened by Major and Hurd, Thatcher felt free to publicly express her instinctive opposition to membership in an interview with Brian Walden:

> The various countries in that particular exchange rate play by different rules. That is nonsense. When you join any system, you must all play by the same rules....
> You just simply can't have system with a currency like sterling, which is a big currency, which has London as the most open market, freest market in the world, playing under that higgeldy-piggeldy set of rules.[26]

Asked by Walden if it was true that 'the UK shall not be going into ERM for quite some time,' Thatcher replied: 'That depends on them, on the gap between what they say and do.'[27]

In terms of economic policy, the government now abandoned the pursuit of exchange rate stability and inflation convergence, as prescribed by the Madrid conditions. The government did not raise interest rates to defend sterling after it slumped in the aftermath of Lawson's resignation. After stabilising at the start of November, sterling to fall again in mid-November trading below DM2.80 by the end of the month. Thatcher responded by saying that fifteen per cent interest rates were not there to defend sterling. Meanwhile, Major told the Bank not to intervene to protect the currency. When asked in the House of Commons about his attitude to sterling's sharp fall, Major refused to respond and simply warned that inflation might now rise and that there was 'much to be done' on ERM membership.[28] The financial markets concluded that the government was not committed to a floor for sterling or to reducing inflation.[29]

Figure 6.4: Comparative Nominal Interest Rates November 1989



(Source: Economist Economic and Financial Indicators November 4, 1989.)

As Goodhart states, there was now 'in effect a ceiling on any further use of monetary policy as an additional deflationary phase'.[30] Thatcher and Major did not want any further damaging increases in the mortgage rate, and more importantly, they wanted to avoided a recession with an election drawing closer.[31] Paradoxically, ERM membership would have offered them the interest rate reductions which they wanted. Outside ERM, the government was not reaping the full counter-inflationary benefit of high interest rates because there was not a credible floor for sterling. By contrast, the ERM states enjoyed exchange rate stability for a lower rate of interest. As figure 6.4 (page 276) shows UK nominal interest rates were significantly higher than in the ERM states with the exception of Spain. (The Spanish government was using its wide ERM margins to keep interest rates deliberately and unnecessarily high to reduce inflation.) However, with inflation higher in the UK than in all the ERM states, a reduction in interest rates would have had to have been accompanied by the kind of counter-inflationary measures categorically ruled out by ministers.

The government's policy embraced the risk both of increased inflation through a depreciation in sterling and of a recession through tight monetary policy. The policy was based on two premises. First, that the means by which inflation was reduced was of more important than reducing inflation itself. High inflation could remain until 15 per cent interest rates started to reduce it. Again, the government was not prepared, to trade a reduction in interest rates, for example, for an increase in taxes. Second, the policy assumed that with 15 per cent interest rates, sterling could not come under indefinite downward pressure. Ultimately sterling must rise and would act as a counter-inflationary influence on the economy. Neither premise was relevant to the Madrid conditions.[32]

Whilst the government moved away from the Madrid conditions, pressure from business interests for ERM membership mounted, since sterling's depreciation increased the problem of exchange rate volatility. A poll published on 18 November showed continuing overwhelming support for membership among company directors. In the same month, the CBI declared that unless the UK entered ERM by July 1990, it would not be an effective participant in the monetary union debate. At the CBI conference a significant minority indicated that they would now prefer immediate membership rather than waiting until inflation convergence was achieved.[33]

Similarly, backbench dissatisfaction with non-membership increased. Most importantly, Heseltine now stepped up his criticism of the government on the issue.[34] On 20 November he told a meeting of the European League of Economic Co-operation:

> Britain's absence from the ERM makes less likely a positive response by our partners to our more Atlanticist, free-trade objectives. The more we have prevaricated, the longer we have denied ourselves a leading and influential role.

Strasbourg

The government was implicitly repudiating the Madrid conditions as another EC summit approached in December. It was likely that the Strasbourg summit would be dominated by discussions about whether to hold an IGC on monetary union and the government faced further isolation. Certainly common ground did exist between the UK government and other member states on monetary matters. On 1 November the UK and German governments joined forces to impose changes on the Commission's proposals about how finance ministers and central bank governors should co-ordinate policy during Stage One. However, on more fundamental issues, other member states continued to view the UK's non-membership of ERM as a deterrent to allying themselves with the Thatcher government.[35]

On 2 November the Treasury published 'An Evolutionary Approach to Europe', detailing its competing currencies alternative to the Delors Report, but no other member state showed any serious interest in the proposal. On 20 November Leon Brittan declared that ERM membership was 'the only way for Britain to have a significant influence on the next steps to economic and monetary union'.[36] In the same month, Onno Ruding said that Holland would only be prepared to pay attention to the UK's concerns on monetary union if it were inside ERM. Similarly, Kohl argued that whatever its potential economic problems with membership, the UK could not expect to influence the monetary union debate outside the system.[37]

If the government's aim at Strasbourg was to avoid the creation of an IGC, then Germany was its most promising ally. By the start of December, the German government faced the prospect of absorbing 17 million East Germans into its state and economy. As a result, it viewed the prospect of monetary union less favourably than previously, which weakened the Franco-German axis. It appeared that if the UK were to improve its monetary credentials, then an Anglo-German alliance might be possible. On 1 December, Howe tried to strengthen the government's position by stating that there was a 'real possibility' that the UK would enter ERM before the next general election. However, no similar gesture of intent came from either Thatcher, Major or Hurd. Thatcher and Hurd went to Strasbourg simply hoping for the best.[38]

When the summit opened on 7 December, Thatcher was unable to exploit the pressure placed on Kohl by the Bundesbank to oppose an IGC. The next day, the other member states agreed to set up two IGCs on monetary union and political union respectively, despite Thatcher's opposition to the proposal. The conferences were scheduled to begin in Rome in December 1990. Casually dismissed by the other heads of government, Thatcher was simply left to confirm that the UK would attend the IGCs.[39] As at other summits, Thatcher failed to find means to pursue her government's policy.

A Shift in Presentation

After the summit, Douglas Hurd began to assert himself on the issue since he believed that it would be impossible for the UK to influence the IGC outside ERM. He quickly persuaded Thatcher and Major to modify at least the presentation of their stance on membership. On 12 December, the *Financial Times* published an interview with Thatcher and reported:

> It was possible to detect a change of nuance, perhaps an important one. For the Prime Minister would not give way on which if any of her well known conditions had to be met, to what extent and by when 'There'll be no difficulty, for example, in France getting rid of her controls on foreign exchange', she said ...'We are obligated to join the ERM', she said, adding for a 'when', when the terms and conditions laid down at Madrid were 'broadly met...' She went on, ... 'I'm not looking at it as taking a whole page of graph paper and making a dot in each little square. Life isn't like that.' Was it her view that the ERM would break down with the end of exchange controls?

'No, she didn't think so'.[40]

On the same day, Major told the Conservative backbench finance committee that he was persuaded that the UK would benefit from ERM membership but now was not the right time for entry. However, in private there was no evidence that either Thatcher or Major were committed to entry in the foreseeable future. Indeed, whilst Thatcher professed that the Madrid conditions obliged the UK to enter ERM, the government's economic policy was not designed to achieve inflation convergence.[41]

Elsewhere in the core executive, the Bank of England was determined that the Madrid conditions be retained. On 13 December Leigh-Pemberton declared that 'premature' entry into ERM would damage both the UK economy and the system itself. He argued that although the UK had much to gain from membership, there would be considerable economic risks if entry occurred before UK inflation and interest rates were more in line with those prevailing in the ERM states. In the Bank's view, the economics of membership should not be sacrificed to the imperative of entry before the start of the IGC.[42]

6.3: THATCHER PUBLICLY RELENTS

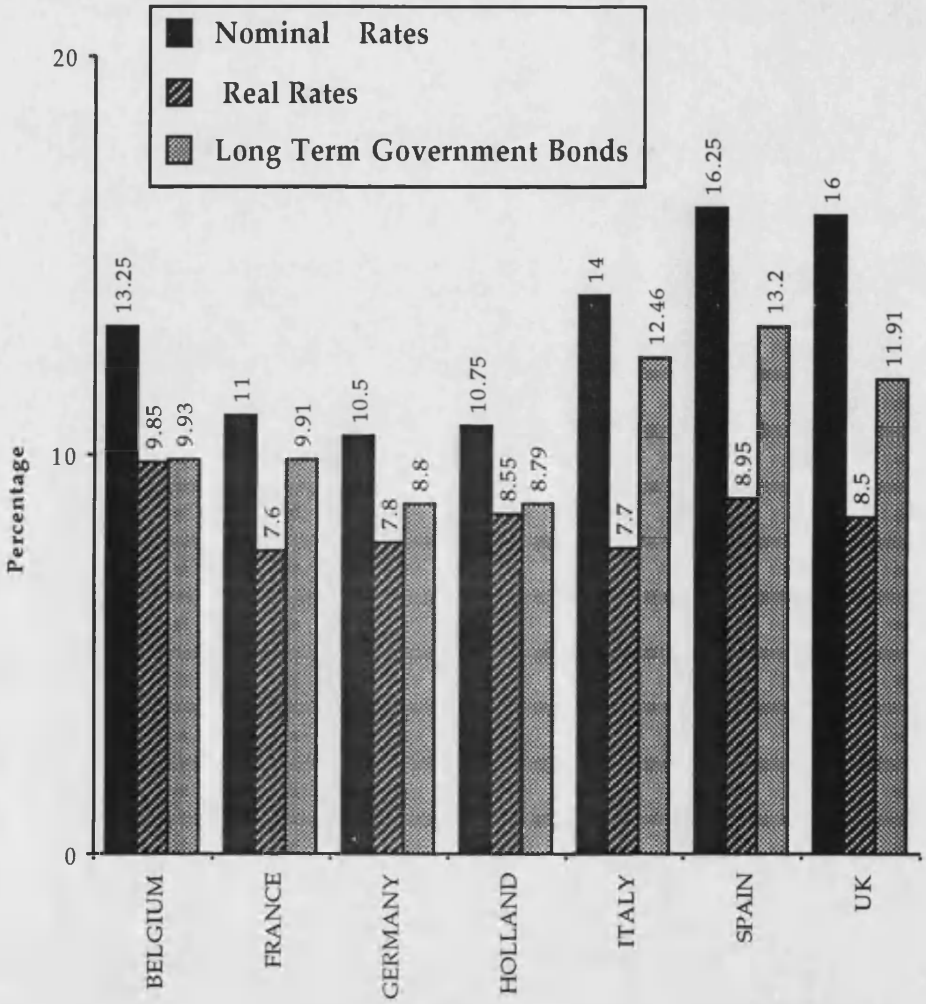
In January 1990 sterling finally stabilised without the government having to raise interest rates. By February, it was again trading between DM2.80 and DM2.90 but it was not strong enough for the government to now cut interest rates. Neither was sterling's new stability sufficient to reduce inflation. Although inflation fell from 7.7 per cent in January to 7.5 per cent in February, other government policies were creating further inflationary pressure. In the 1989 budget, Lawson broke with previous practice and did not index excise duties, to try and prevent inflation from rising. Unless Major did likewise in the 1990 budget, inflation would automatically increase. If the government were to freeze duties again, then consumer spending was likely to increase. At the same time, the government was due to introduce the poll tax in April 1990. With poll tax bills on average 30 per cent higher than the previous year domestic rates bills, the new tax alone would increase inflation by more than 1 per cent .[43]

From the start of March, sterling started to depreciate again. In the first two weeks of the month, it lost more than 4 per cent on its trade weighted index. The government was left to hope that its budget on 20 March would stabilise sterling. Yet when the budget came, the government simply increased excise duties and so added 0.5 per cent to the inflation rate and created new Tax Exempt Special Savings Accounts.[44] As the *Economist* commented: 'When the City looked at the gap where macro-economic policy should have been, it took fright. Sterling slumped. '[45] The financial markets concluded that the government did not posses a coherent monetary framework and was not committed to sterling. Meanwhile, Lawson publicly warned that sterling would remain weak so long as the government delayed ERM membership and that sterling's weakness was putting the government's entire anti-inflationary strategy at risk. After the poll tax riots of 31 March, which were indicative of the government's now massive unpopularity, sterling depreciated further, 15 per cent interest rates notwithstanding. To compound the government's economic problems, unemployment rose in March for the first time since 1986.[46]

ERM membership at this time still offered the government the benefit of lower nominal interest rates for maintaining exchange rate stability. Figure 6.5 (page 282) shows that whilst the strongest ERM states were able to maintain a rate differential with Germany of less than one per cent, UK nominal rates were 5.5 per cent higher. Similarly, the UK suffered from high long term government bond rates in comparison to most of the ERM states (except Spain and Italy). As in the second quarter of 1989, UK real rates were around the average level.

The cost of membership would be that with lower interest rates yet inflation still rising, the government would have to use alternative counter-inflationary policies to reduce inflation to sustain sterling in the medium term. Although Spain continued to use high interest rates they were used to compeiment its overall counter-inflationary stance. At the same time, after a final balance of payments deficit of £23.9 billion, the question remained of how the government could sustain a sterling parity given the deficit and how the deficit could be alleviated within the constraints of membership.

Figure 6.5: Comparative Interest Rates March 1990



(Source: The Economist Economic and Financial Indicators March 24, 1990)

By contrast, a credible commitment to membership offered the government overwhelming monetary benefits. With the government unwilling to raise interest rates or turn to alternative policies, a credible commitment to ERM membership to strengthen sterling was the government's sole counter-inflationary option. If the markets believed that the government was committed entry and, hence, a floor for sterling, then it was highly probable that they would buy sterling to take advantage of high UK interest rates. The government would be delivered an appreciating exchange rate to bear down on inflation and then could enter ERM when inflation was reduced.[47]

Similarly, unless the government sacrificed its counter-inflationary objective, a commitment to membership was the only means to ultimately reduce interest rates and lessen the risk of recession. Once a floor for sterling was established, then it could probably be defended with lower interest rates as the ERM states achieved. To all intents and purposes, the government now possessed no means of achieving its macro-economic objectives without a genuine commitment to ERM entry in the foreseeable future.

Facing up to monetary union.

In the first months of 1990, Thatcher appeared to hope that the momentum towards monetary union was stalled. She believed that Germany was now procrastinating on the issue since it was preoccupied with reunification. In March Germany blocked a Franco-Italian attempt to bring forward the IGC by several months. In the same month, the Commission published its plan for monetary union. The only significant difference from the Delors report was that it dropped the latter's insistence on centrally set rules for member states' budget deficits and recommended 'binding procedures' instead. Governments would have to submit rules or guide lines on budgetary policy to Ecofin that would be written into national law. These would have to be stringent enough to ensure that states' borrowing did not put pressure on national or Community interest rates. The Commission hoped that peer group pressure would persuade member states to comply with Ecofin rulings on their budgetary plans which would be taken by majority voting. However, at an Ecofin meeting on 31 March-1 April, Germany, supported by Holland, opposed the plan. At the insistence of the Bundesbank, Germany wanted binding ceilings on budget deficits as prescribed in the Delors report. Overall, it was adamant that monetary union would only be feasible on Bundesbank style conditions.[48]

Against this background, the UK government did not directly act to strengthen its position before the IGC. Meanwhile, Michael Butler (from the City European committee), largely on his own initiative, meanwhile developed an alternative proposal for monetary union known as the Hard Ecu Plan. He proposed that the Ecu basket currency used in ERM be hardened into an international currency backed by a new EMF. The Hard Ecu would exist as a parallel currency alongside the existing EC currencies and would never depreciate against them. If there was a market for the currency, then in the long term it could become a common currency for Europe and ultimately a single currency if governments so chose. The EMF would manage the Hard Ecu eventually setting interest rates for it through normal central bank techniques. The Fund would also coordinate member states interventions against the dollar and the yen. At the end of March, Butler presented his proposal to Thatcher who took up the idea at least as a means of giving the UK a voice in the increasingly divisive monetary debate.[49]

In April the government's strategy of relying on divisions between other member states on the issue was jeopardised. Without the Bundesbank's knowledge, Kohl promised the French government that Germany would no longer prevaricate on monetary union. On 22 April Kohl and Mitterrand issued a joint communique calling for both monetary and political union to take effect from 1 January 1993. Thatcher dismissed the Franco-German initiative as 'premature and esoteric'. However, in practice the initiative recreated an onus for the UK to enter ERM before the IGC began in December 1990.[50]

The Hurd-Major Axis

In the first months of 1990 Douglas Hurd set out to recreate the Treasury-Foreign Office axis on membership and convince Major that entry before the start of the IGC would be extremely valuable. One official commented that Hurd 'never felt as strongly about it as Geoffrey Howe - I think he just believed in the inevitability of it.'[51] Over a serious of informal bilateral meetings, Hurd persuaded Major of his case.[52] One Treasury official described Major's conversion on the issue:

> He took a look at the position we were in and more or less decided we couldn't go on living this way. I think he was every bit as impressed by the politics as by the economics.[53]

For his own part, Major was keen to stress the economic case for membership:

> The more I realised, day after day, was that the most priceless gift you could offer British business over the medium term was a stable exchange rate and a stable inflation rate. And what was the best mechanism to achieve this, or the best and most proven mechanism to achieve it over the years would be the ERM.[54]

In March, Hurd and Major both publicly expressed their support for membership. Hurd declared that there were strong foreign policy reasons for entering and 'of course, it is conceivable that a decision could be taken during the present parliament.'[55]

In the budget, Major stated that entry was now a question of 'when' and not 'if'. Five days later, Major publicly reinstated the Madrid conditions. He noted that 'encouraging' progress towards their fulfilment was occurring. He then redefined the inflation convergence condition declaring that it was necessary for UK inflation to be 'proximate' to the inflation rates of the ERM states. On the same day, Howe stated that the other ERM states were fulfilling their side of the Madrid conditions.[56]

Major and Hurd now sought to convince Thatcher that the government should make a credible commitment to ERM entry within the foreseeable future. Rather than initiating another internal core executive debate with papers and a formal meeting of senior ministers and officials, Major decided to operate on a low key bilateral basis with Thatcher. Although there was an overwhelming majority within the Cabinet in favour of ERM membership, Major apparently did not believe that collective pressure would be productive. At the same time, he could no longer rely on support for membership from either the Treasury or particularly the Bank of England. Both institutions did share his view that outside ERM the UK would be in a weak position in the IGC. However, throughout the first half of 1990, officials were preoccupied with the concern that the economy was not responding sufficiently to high interest rates. They believed that membership would put an undesirable onus on interest rate cuts and that entry should be delayed until a sizeable reduction in interest rates could be justified on counter-inflationary grounds. On their own calculation, the earliest date for entry would be 1991.[57]

Largely by himself, Major persuaded Thatcher that the government should at least act as if it would enter ERM by the end of 1990. Thatcher appeared to accept that a credible commitment to membership would be a means of securing an appreciation in sterling and ultimately make interest rate cuts possible. It would also convince the ERM states that the UK wanted to be a full time player at the IGC. Whatever merit Thatcher saw in Major's case *per se*, Major was in a significantly stronger position than that which confronted Lawson and Howe in June 1989. The government was now trailing Labour by over 20 per cent in the opinion polls and could not offer voters more of the same on the economy at the same time as the first poll tax bills were arriving. Thatcher believed that Labour support for ERM membership now put the government at a direct disadvantage on the issue. First, it gave Labour credibility in the City at a time when the financial markets were showing little faith in the government. Second, it allowed Labour to claim that it could make cuts in interest rates which the government could not. At the same time, Thatcher's own position within the Conservative Party was weaker than in June 1989. She had been challenged for the Tory leadership for the first time in autumn 1989 by a 'stalking horse' candidate. Press and backbench speculation was now growing of a serious challenge to her leadership in 1990, which this time would involve Michael Heseltine. In the first months of 1990 Conservative dissent on European issues and ERM membership in particular coalesced into a new Positive Europe group. Since Lawson and Howe left office as a result directly or indirectly of their conflict with Thatcher over membership, she could ill-afford to lose another Chancellor or Foreign Secretary over the issue.[58]

Nevertheless what Thatcher actually agreed in March-April 1990 is open to dispute. Clearly, she agreed to let it be publicly known that she now supported membership. Thatcher herself ignores this fact saying only: 'When I saw him [Major] on the morning of Thursday 29 March I said that I did not believe that the conditions for our membership had yet been met.'[59] Smith suggests that Major further secured a genuine commitment from Thatcher to enter ERM 'at the earliest possible opportunity', presumably before the IGC began.[60] However, evidence from officials suggests that Thatcher agreed to far less. One Foreign Office official commented that Thatcher did not change her mind until far later in the year:

> I think that the Prime Minister was only convinced quite late, when it appeared that joining the ERM would allow us to control inflation at lower interest rates at a time when the government's economic policies were under attack.[61]

In the words of a Bank of England official, 'I don't think a decision was taken early in the year to do it specifically in the autumn.'[62] Similarly a Thatcher confidant stated that Thatcher did not change her mind on membership until September of that year.[63] In sum, it appears that Thatcher was prepared to economically exploit a commitment to eventual ERM membership without making any firm commitment to Major or Hurd.

6.4: WHAT STRATEGY?

The dilemma for the government in making a credible commitment to ERM membership was the onus on inflation convergence prescribed in the Madrid conditions. Since UK inflation was again moving further away from the levels of the ERM states, entry to the system within the foreseeable future would appear untenable on the terms of the Madrid conditions. To rectify the situation, the government redefined the conditions. At the Scottish Conservative Party Conference on 12 May, Norman Lamont, the Chief Secretary to the Treasury, noted that if UK inflation was measured on a properly comparative basis to other states, it was only 1.5 per cent above the EC average.[64] The following day, Thatcher declared that her conditions for membership were near to being fulfilled and made a similar point on inflation to Lamont:

> If we calculated our inflation as they do in most countries in Europe, it would be almost 3 percentage points lower. So, if you compare like with like, we are not so far above Europe's average for inflation.[65]

In the same week, Major told the IMF that UK inflation would significantly fall by the beginning of 1991 and went out of his way to show that this would narrow the inflation gap between the UK and the ERM states.[66] On 17 May, Major told the *Wall Street Journal*, that 'anyone who thinks we are playing with this as a gesture is wrong.'[67] The same day, he told the CBI that 'I am sure we will benefit from joining the ERM and join it we most certainly will when our conditions are met.'[68] A week later, Peter Lilley, the Financial Secretary to the Treasury stated that membership would serve as an anti-inflationary discipline.[69]

The government used its public commitment to ERM membership to try and recover the initiative on the issue from Labour. The government presented itself as the only party which was tough and credible enough to manage membership successfully. On 13 May, Thatcher declared that Labour lacked the financial discipline to make membership work:

> The ERM is no soft option. You agreed to keep your exchange rate within well defined limits. If it fails you have no choice but to raise interest rates, which is precisely what Labour attack us for doing.[70]

Later, Howe returned to the same theme:

> I detect an expedient advocacy by Labour of the ERM as a substitute to a counter-inflationary policy, not a complement to it. Labour believes that the ERM will bring Britain an economic margin for manoeuvre that can be used to finance higher government spending and lower interest rates and so fend off the need for tax increases [under its policies.][71]

Ministers' pronouncements produced the desired appreciation in sterling. After Major's comments on 17 May, sterling rose by 3 pfennigs against the Deutschmark. On 23 May sterling initially fell on poor trade figures but then recovered on speculation that membership was imminent. As the government hoped the financial markets believed that the commitment to membership provided a floor for sterling and so were prepared to take advantage of high UK interest rates. On 12 June Major told the press that the UK was looking to enter ERM in either September or October and sterling soared to a four month high in response. Overall from the budget to the end of June, sterling rose by more than 6 per cent against the Deutschmark.[72]

At the start of July at the Dublin Summit, Thatcher nearly condemned the whole policy when she attacked the 'folly' of fixed exchange rate systems. Nevertheless, through July and August, Major used carefully timed statements highlighting the government's commitment to ERM membership to sustain the sterling appreciation. For example, when sterling fell after a renewed attack on membership by Alan Walters, Major reasserted the government's support for entry. By the end of August, sterling was trading above DM3.00. The trouble for the government was that despite sterling's appreciation, inflation continued to rise. Even measured at the underlying level, UK inflation was still moving away from the ERM average in the wake of increased pay settlements and a surge in the price of oil after the Iraqi invasion of Kuwait. Between March and August 1990 UK inflation rose 2.5 per cent from 8.1 to 10.6 per cent.[73]

At the same time, during the third quarter of 1990, the economy moved into recession. From July to September GDP fell by 1.4 per cent, manufacturing output by 1.6 per cent, private sector investment by 7 per cent and retail sales by almost 1 per cent. Unemployment rose by approximately 20,000 a month. With bank lending falling and corporate profits tumbling, business confidence was shattered. These appeared to surprise Thatcher, Major and the Treasury, if not the Bank of England who were concentrating on the continuing rise in inflation.[74] One Bank of England official commented:

> I remember going down to a monthly meeting in the Treasury in May 1990 and finding our Treasury hosts saying 'Well look, we still can't see much evidence of the end and this boom actually turning down. Inflation is looking set for continuing acceleration. Have we really got policy tight enough?' I think in saying that they knew perfectly well that whatever they might recommend their political masters wouldn't contemplate tightening policy so it was a free

> option. But we found ourselves saying 'Well for heavens sake there must be one hell of a lot in the pipeline, surely it can't be right to be doing anymore now.' And of course in a couple of months, as we know, the whole thing had fallen off a cliff.[75]

According to one banker:

> As a clearing bank, we told the Bank of England to tell the Treasury that bad debts that started in an onslaught in the summer of 1990 were a bad omen, because normally bad debts don't get really going until the end of a recession. It was perfectly clear that something serious was happening but the Treasury didn't see it. They really didn't see it. The Bank probably did. The Bank got us into recession by design, the Treasury by accident. ... The Bank felt they were put in an impossibly compromised position by the inflationary boom... And now even though it was going to be very costly - they no doubt had a clear understanding of the costs - believed that we must sweat it out this time.[76]

Faced by the reality of the recession, the government publicly denied it. In part, this reflected the government's genuine ignorance of what was happening. At the same time, the denial was necessary since the government was not in a position to respond by cutting interest rates, given its commitment to reduce inflation through an appreciation in sterling.

The Ridley Affair

In terms of EC policy, the government wanted to use its public commitment to membership to strengthen its credentials before the IGC. During this period Major or one of his senior officials visited the finance ministers of all the other member-states to impress on them that the UK wanted to participate constructively in the monetary union debate. Although the diplomatic offensive earned Major a significant amount of personal good will, it did not secure the particular benefits he sought. First, some ERM states now believed that UK entry to ERM would impose costs on them given the problems of the UK economy.[77] On 31 May Pöhl declared: 'Under the present circumstances, I don't believe Britain can be a member of the ERM with its inflation rate and large balance of payments problem.'[78]

Second, the other states now believed that it would be possible for them to achieve monetary union even if the UK remained outside ERM.[79]

One Commission official privately commented: 'What makes the British think they will be doing the ERM such a favour by agreeing to join it?'[80] On 20 June the government published its Hard Ecu plan for monetary union. Although unlike the competing currencies proposal the scheme included the creation of a new independent monetary institution in the EC, it did not strengthen the UK's position. The Italian and Dutch Finance Ministers immediately denounced the plan as inferior to the Delors report. Meanwhile Pöhl declared that the proposals would not achieve a monetary union and were impractical. Having invested so much political capital in achieving monetary union, France and Germany were not prepared to see it downgraded to a possibility rather than a certainty. They believed that the IGC should accept the goal of monetary union as its starting point, not as its key subject of debate. In consigning a central bank to an unspecified future, the Hard Ecu plan did not address the French government's desire to reduce the influence of the Bundesbank. Neither did the proposal increase the possibility of an Anglo-Bundesbank alliance, since the Bundesbank tended to regard parallel currencies as inflationary and so unacceptable.[81]

Major and Hurd's ability to sell the Hard Ecu was further undermined from within the government itself. On 21 June Thatcher dismissed suggestions in the House of Commons that the Ecu could eventually replace sterling saying: 'It does not mean that we have approved a single European currency, it says specifically we have not.'[82] Then, the Trade and Industry Secretary, Nicholas Ridley, in a notorious interview with the*Spectator* condemned the monetary union project as:

> An all-German racket, designed to take over the whole of Europe. It has to be thwarted. This rushed take-over by the Germans on the worst possible basis with the French behaving like poodles, is absolutely intolerable. ... If Britain was going to give up sovereignty to 17 un-elected reject politicians we might just as well give it to Adolf Hitler frankly.[83]

When Thatcher only reluctantly accepted Ridley's resignation over the remarks, it was commonly assumed that she basically shared Ridley's view. A month later Thatcher commented that the substance, if not the style of some of Ridley's remarks were in tune with peoples feelings.[84] Indeed Lawson states:

> I have no doubt that the reason that Nick Ridley felt it was safe to make the anti-German remarks in his Spectator interview, which were to lead to his enforced and reluctant resignation in 1990, was that he had many times heard Margaret utter precisely the same sentiments in private - as, indeed, had I.[85]

Against this background, it was difficult for Major and Hurd to convince the ERM states that the UK wanted to be a serious player at the IGC.

No Strategy

Inside the core executive, the question is to what extent the public commitment to membership reflected a coherent strategy for entering ERM. Thatcher herself states that she told Major on 13 June that she would not resist sterling joining the ERM 'but the timing was for debate.'[86] In his account, Smith states that Major 'flirted briefly' with entry in July 1990 to coincide with the start of Stage One but Thatcher rejected the option. In the following weeks, Major and officials decided that entry would take place during the first weekend of October.[87] Smith comments:

> By the summer of 1990, however, Major and his advisors had a clear idea of the timing of ERM entry. There was one instance where, on a car journey to a political engagement Major asked one of his advisors to write on a piece of paper the best time to take the pound into the ERM. He did the same, and the papers were exchanged. Both had precisely the same timing, the weekend before the Conservative Party conference in October.[88]

However, evidence from officials suggests that contrary to Smith's and Thatcher's accounts respectively, no timetable for membership was established in the summer and that Thatcher's willingness to support membership at all was still open to question. One Bank of England official commented:

> I am not quite sure what was going on in 1990. I don't think there was a great deal of actual debate about ERM membership or the basis of ERM membership, though it is quite clear that the markets in 1990 were getting hold of the idea that the ERM was something we were clearly about to join. ... There were no set pieces that I could recall involving the official machine. Obviously in all the institutions with

an interest in the subject, including our own, we were doing our best to assemble our ideas. ... But we were not, as it were, concerting on a game plan such as would have produced this pretty blatant talking up of expectations of membership and thereby of the exchange rate at the other end of town. We got to know it was happening. But it was not something that I was ever involved in discussing whether it should be done, how it should be done, or whatever.[89]

The same official saw a continuing conflict between Thatcher and Major on the issue as the reason why no strategic discussion took place:

> There were really rather deep divisions within government which actually inhibited the proper process of open debate within the government and the official family that would desirably happen. Because those who wanted to move in this [ERM] direction did not want to show too much head above the parapet for her next door to sort of slide back. I suspect that was the position and so that made it rather difficult to get very close to what was going on.[90]

In the view of another Bank official:

> I get the impression, for example, the Spaniards when they entered the ERM had more of a strategy in the sense that they talked the exchange rate down. One could almost see them leading up and there was a fairly clear indication of when in the year they were proposing to go. They stage-managed it in a way we did not.[91]

Without a collective strategy, the respective parts of the core executive developed their own agenda on membership. During June, senior Treasury officials reversed their previous opposition to membership by the end of 1990. The department now believed that entry before the IGC was crucially important and that it could be justified on counter-inflationary grounds. If sterling were to use 6 per cent bands and enter at the bottom of that range, then sterling would have considerable room to appreciate before any obligation to cut interest rates arose. Indeed, with wide margins, holders of sterling would face a substantial downward risk which could justify a substantial interest rate differential with other ERM states. In this approach, the Treasury looked to Spain which in its first year of ERM membership successfully combined wide margins with high interest rates to bear down on inflation. In terms of a central rate for sterling, the Treasury did not believe that this level could be anything other than around prevailing market rate at the time of entry. Nevertheless, the Treasury considered that a central rate of around DM2.95 would be appropriate on the grounds that this was the average rate over the previous 10 years.[92]

At the Bank of England, senior officials remained sceptical about whether there was sufficient convergence between the UK and ERM states to justify entry. They were particulary concerned that UK inflation was too high. In the view of one sceptic at the Bank: 'If we were going to go in, it should be on the basis that going in was going to provided a strong anti-inflationary discipline.'[93]These officials believed that wide margins would be essential to avoid interest rate cuts. They further considered that entry should only occur with a central rate which would squeeze the economy, preferably around DM.3.20. At all costs, they wanted to guard against another inflationary boom.[94]

For her part Thatcher was certainly open enough to the idea of membership to consider how it might operate. If she was to accept membership, then she wanted wide margins for sterling. In the House of Commons on 1 May, she declared:

> It is one thing to join an exchange rate mechanism with certain quite wide margins within which the currency can fluctuate, as has been necessary. It would be much more unwise to go to locked exchange rates.[95]

After the June Dublin summit, Thatcher emphasised that there would have to be flexibility within ERM for sterling:

> You could have one of those weekend sessions when you altered the valuation of your currency. So there is no locking at all... and it would not work if there was.[96]

Thatcher appeared to believe that operating wide margins was a way of continuing to operate a *de facto* floating exchange rate but which allowed for interest rate cuts. It was the very opposite reason for which the Treasury and the Bank of England wanted wide margins and suggested that Thatcher did not see potential membership as any form of counter-inflationary discipline.[97] In sum, there is strong evidence that by September, there was no agreed timetable for ERM entry nor any consensus on how membership would operate. The government had created the expectation that entry was imminent but there was no coherent core executive debate about how to make membership a reality.

6.5: ENTRY TO ERM

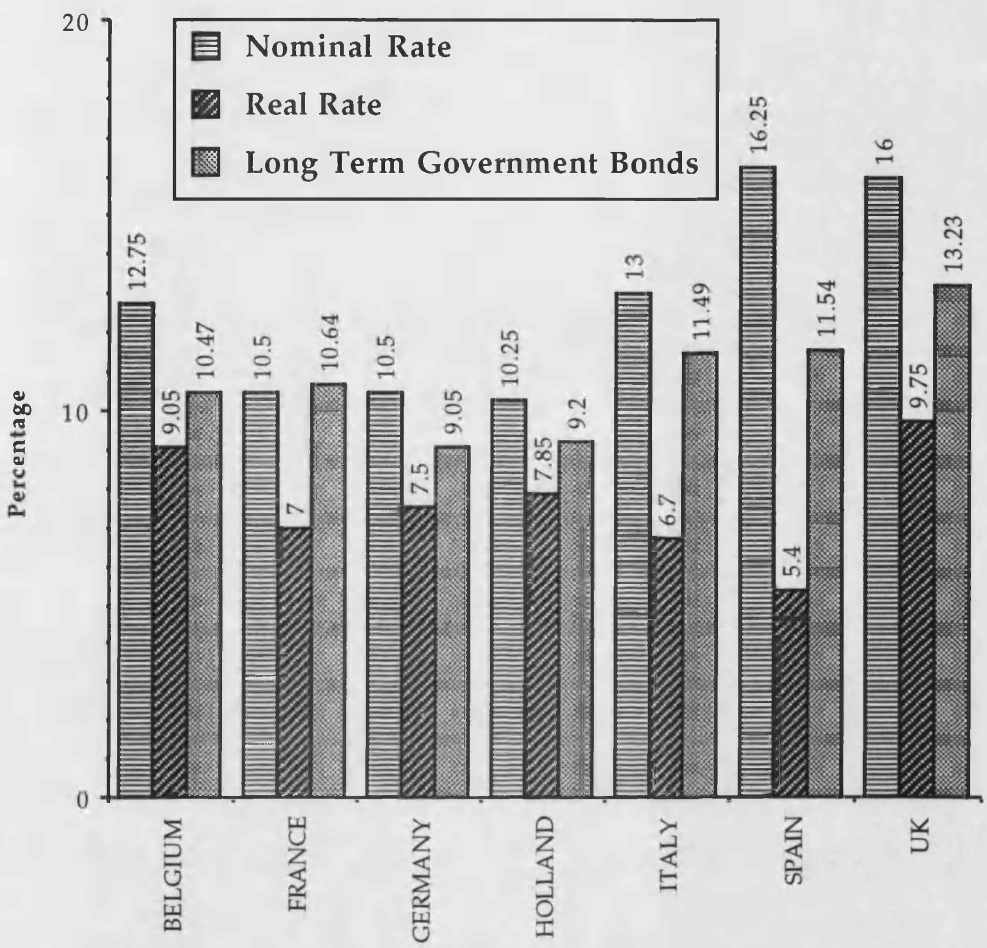
In analysing the government's decision in October 1990 to enter ERM, it is first necessary to consider the implications of membership in terms of ministers' economic, capital accumulation and European priorities. In economic terms, Thatcher and Major faced a crisis during September. With inflation rising above 10 per cent in August, the government was forced to redefine the Madrid conditions to maintain a credible commitment to membership to bolster sterling. On 7 September Major stated that entry could take place when UK inflation was 'proximate to that of its European partners'. However, the financial markets were now unresponsive to the government's announcements. Despite earlier speculation that membership was only days away, sterling fell on Major's comments. Within the next week, even the government's commitment to membership was thrown into doubt. On 19 September Pöhl suggested that UK entry to ERM was unlikely in view of rising inflation and sterling fell in response. Five days later, on a visit to Switzerland, Thatcher was quoted as saying that inflation would have to fall several points further before sterling could enter ERM. Her alleged remarks put sterling under further pressure. Unwilling to raise interest rates, Major effectively dropped the Madrid conditions to convince the financial markets that the government was serious about membership. In a speech to the IMF on 26 September, Major declared that the key factors in the decision were the prospective rates of inflation between the UK and its EC partners. However, his remarks were not sufficient to stabilise sterling. Indeed it took concerted intervention from the Bank of England, Bundesbank and the US Federal Reserve to stop sterling falling dramatically. It seemed that only membership itself could now convince the markets of the government's intentions and provide a floor for sterling.[98]

As a result, by the start of October, ERM entry offered the government overwhelming counter-inflationary monetary benefits. It alone could stabilise sterling and allow interest rates to be reduced. A simple public commitment to membership was no longer sufficient to achieve the government's objectives. Unlike the UK, after March 1990, most ERM states were able to reduce interest rates further towards the German rate and in Holland's case below it. As figure 6.6 (page 297) shows, UK nominal rates were now 3 per cer cent higher than Italy's compared to 2 per cent in March and 5.5 per cent higer than French rates compared to 5 per cent in March. UK real rates which were lower than those in Spain, Holland and Belgium in March 1990 were now higher than in any ERM state.

Nevertheless, the government would still be entering a fixed exchange rate system with inflation rising. Although Spain entered the system in a similar situation, it adopted the kind of counter-inflationary policies which the UK government had renounced. Inside ERM the biggest potential problem for the UK was with a level of wage increases growing by 10-11 per cent. By the end of 1990 unit wage costs in manufacturing industry were rising by twelve per cent a year. The Thatcher government would have to hope that the recession would soon dampen wage increases, and that previous tight monetary policy and appreciation in sterling would finally feed through into a lower inflation rate in 1991. Developments on these lines would make unnecessary any unpalatable policy changes.

In terms of the recession, membership offered the government short term benefit and long term problems. Since the government showed no willingness to sacrifice its counter-inflationary objective, it could not cut interest rates to respond to the recession by staying outside ERM. However, by entering the system the government would be tying monetary policy to the exchange rate at the same time as the consequences of high interest rates for the real economy were rising. ERM membership would make the ability to cut interest rates beyond the immediate future dependent on sterling's relationship with the Deutschmark. Whilst the recession would demand a reduction in UK interest rates, Germany interest rates were likely to continue to rise.

Figure 6.6: Comparative Interest Rates October 1990



(Source: The Economist Economic and Financial Indicators October 6, 1990)

Entry at the prevailing market rate between DM2.90 and 3.00 would compound the government's problems with the external deficit. Sterling's appreciation in the previous months further damaged the competitiveness of UK companies and contributed to the fall in output in the third quarter. By the end of 1990, the manufacturing trade deficit would stand at nearly £18 billion and the overall balance of payments deficit at £13.8 billion, making it difficult for the government to sustain a sterling parity in the medium to long term. The financial markets were likely to conclude that the government would ultimately have to devalue to deal with this problem. Without a credible central rate for sterling, there was a risk that interest rates would have to be higher than they would otherwise be.[99]

Entry and Capital Groups

The City still overwhelmingly supported ERM membership to reduce exchange rate volatility and provide a counter-inflationary discipline. Most importantly, membership would reduce the most immediate threat to London's long term future as the financial centre of Europe. By October 1990 it faced gloomy overall prospects. Banks, building societies, stockbrokers, fund managers and insurers, were all being squeezed by high interest rates and stagnant markets and faced cuts in capital spending and jobs. With ERM membership offering lower interest rates and likely to buoy up the stock-market, financial analysts believed that ERM membership could breathe new life into the securities business. Financial businesses which were driven by sentiment, like stockbroking and fund management, would benefit the most. The implications for the City of the central rate for sterling were mixed. Since the City does not export goods its competitiveness would not be directly affected. However, with London the most expensive financial centre in Europe a sustained high rate for sterling would make the City an increasingly expensive place for foreign institutions to operate in.[100]

Similarly, manufacturing industry remained in favour of membership too. Industry would benefit from exchange rate stability and the likely reduction in interest rates. However, the high central rate for sterling would impose costs on industry particularly those companies in the international sector. These companies would face the combination of falling domestic demand and competing abroad at a permanently difficult exchange rate, and with unit costs still rising faster than else where in the EC. In October, output was falling faster in services than in the manufacturing sector but the risk would be that exporters would reduce labour and investment and drag manufacturing industry further into recession.[101]

As relatively low exporters, the service sector would be less directly affected by ERM membership. Nevertheless, although cuts in interest rates would be beneficial, the high rate for sterling would be likely to have a damaging knock on effect on the services' performance. With output falling quickly in the service sector, it was looking to manufacturing industry to provide an up turn in domestic demand. If joining ERM dragged manufacturing industry further into recession, then demand for services would not be generated.

Selling the Hard Ecu

At an Ecofin meeting in September in Rome, the Franco-German axis on monetary union was again fractured. Only France, Belgium, Denmark and Italy still wanted a treaty commitment to move to Stage Two from January 1993. Indeed the Spanish Finance Minister presented a scheme for Stage Two to start in 1994 which incorporated some aspects of the Hard ECU plan and interested Ireland, Greece and Portugal. ERM entry might provide greater credibility for the government in pushing its option further.[102]

However, it did not offer the UK government particular reward in terms of improving its relationship with either France or Germany. The Bundesbank continued to oppose UK entry to ERM in 1990 on economic grounds. With the Bundesbank determined that monetary union could only take place when economic convergence was achieved, UK entry to ERM when its inflation was rising would not promote a UK-Bundesbank axis. By contrast on 24 September, Pierre Bérégovoy, the French Finance Minister urged UK entry as 'soon as possible.' According to Bérégovoy early entry would be good both for the UK and the building of Europe. However, although entry would strengthen the government's position with France, it had no desire to make common cause with France on monetary union in view of France's support for a speedy union.[103]

Entry at Thatchers whim

According to Smith, the government began October with the clear intention to enter ERM by the second week of the month. He states:

> The go ahead for entry came in a meeting between Major and Thatcher on Wednesday 3 October. Thatcher, however, had one condition. She wanted the decision to take sterling into ERM to be combined with a cut in interest rates, both because of the intense political pressure to reduce rates and because such a move would soften the objections to entry in the anti-European wing in the Conservative Party.[104]

Smith suggests that the government initially planned to announce entry on Friday 5 October, the final day of the Labour Party conference, after the financial markets closed for the weekend at 5.00pm. However, to squeeze Labour's successful conference off the early evening news and the weekend press coverage, Major announced at 4.00pm that the UK would enter ERM on 8 October at a central rate of DM.2.95 with 6 per cent margins. At the same time, he announced a reduction in interest rates from 15 per cent to 14 per cent.

However, if as previously suggested, the government did not establish a timetable for ERM entry over the summer, then an alternative explanation is needed for the decision to announce entry on 5 October. Thatcher herself makes no direct comment on the subject.[105] Other evidence indicates that at the start of October, Major and the Treasury concluded that early ERM entry alone could provide a counter-inflationary discipline and interest rate cuts. They now decided to actively push for entry with Thatcher before the IGC began. In this view, they were supported by Hurd and the Foreign Office. At the Bank of England, opinion was split. Senior officials were divided between those who positively supported entry and those who were reluctant but believed that continuing non-membership would prove inflationary given the expectations of membership already created by the government. One such sceptical Bank of England official commented:

> We suddenly found ourselves in the autumn of the year with the reality of a decision. Either you go in and validate those expectations. And if you go in, you go in at about the present exchange rate. Or you invalidate the expectations, because if you don't do it, prior to December, given the political focus of the IGC, no-one is going to expect it to happen for quite some time. You will get an enormous let down in the markets. All that premium will once again be demanded and in so far as the appreciating exchange rate has helped you on the road towards getting your inflation back under control, so that will be lost. And that really was an unappetising choice for those of us who still retained some misgivings as to whether this was a timely thing to be doing.[106]

On 4 October Major, and senior Treasury officials and Eddie George, Deputy Governor at the Bank of England, went to see Thatcher to seek her permission for entry sometime before the end of the year.[107] One senior Treasury official described the meeting:

> We went to the Prime Minister for an informal discussion about this, - she was going out to dinner somewhere; she had to get into a long dress so the whole thing was punctuated by this changing - with a view to joining later in the year. The party conference was coming up and none of us wanted to join close to the party conference. I'm totally allergic to doing things close to party conference, interest rate changes or anything. It was a Thursday night when we went to see her.
>
> She said: 'All right, do you think it will be all right?',
>
> 'It will certainly be alright for next six to seven months.'
>
> The Prime Minister said: 'Could you bring down interest rates at the same time?'
>
> We said, 'yes' because we wanted to bring down interest rates anyway.
>
> She then said: 'Well, can you do it [join ERM] tomorrow?'
>
> 'Well that would be extremely difficult.'
>
> So we then adjourned to see when we could assemble the monetary committee and we said, 'No, we can't do it tomorrow but we can have it done by the weekend.'
>
> And she said: 'Goodness knows how we are joining at 2.95.'[108]

The suddenness of the decision in this account is hinted at by others. One Bank of England official commented:

> Discussions most immediately associated with the decision itself were very closely focused on a short period of time. There had been quite a lot of fairly general discussion about it in the run-up. But then suddenly when things started to coalesce, [and] move very fast, it was really a *very* short period of discussions about things like [the] appropriate rate and [the] precise moment.[109]

A Foreign Office official recalled: 'the Prime Minister's view on ERM entry changed only *very* shortly before we joined in October 1990.'[110] Another official remarked that 'I think that one of the reasons why no decision was taken until the very last minute is because a decision is in itself a highly market sensitive thing.' [111]

According to a Thatcher confidant, Thatcher privately reversed her position in mid-September during the time she was preparing for the party conference. He commented:

> It came as the result of a lot of things, the state of the economy, the fact that inflation was going up. She was very keen to start getting interest rates down and sensed it was a trade-off between her and John Major and interest rates. If he would announce virtually simultaneously, she would accept that it was sensible to join ERM providing we did so at a sensible parity.[112]

Thatcher's subsequent insistence on entry at such short notice rendered any strategic discussion within the core executive of the details or presentation of entry almost impossible. On the question of the central rate for sterling, Thatcher left the decision to the Treasury. One Thatcher confidant stated that 'I don't remember it being a subject of great difficulty for her.'[113]The Treasury believed that there was essentially no choice and that entry would have to be around the prevailing market rate of DM2.93 at the end of trading on 4 October.[114] Nevertheless, asked whether it would have been possible to go in 10 per cent below the prevailing rate one former Bank of England official commented:

> It would have been very difficult politically to do that, but it is possible to do so. You call a meeting. You call around on a Friday afternoon - say we want to come in. We spend the whole night in Brussels and everybody argues and you probably wouldn't be allowed the 10 per cent. But since every one thought the rate was high, I think they would have allowed it.[115]

For the Treasury, Thatcher's spontaneous decision for entry created the opportunity for membership at the DM2.95 rate which it preferred. A senior civil servant affirmed 'I was pretty confident it was a reasonable rate.'[116] According to a City economist with close links to Whitehall: 'The Treasury, Terry Burns, was very confident he had got the right rate.'[117] By contrast, those Bank of England officials who wanted a rate of DM.3.10 or above were disappointed by the decision.

Neither did the core executive generally discuss the appropriateness of simultaneously cutting interest rates and entering ERM. Leigh-Pemberton, who was absent on the 4 October meeting, and other senior Bank officials were mortified when they learnt of the decision. At one stroke the decision undermined the Bank's hope that wide margins could be used to maintain the interest rate differential with the ERM states. With rising wage settlements, the Bank of England was far less confident than the Treasury that inflation would soon fall as the lagged result of the previous two years' policies. At the same time, it believed that for membership to be successful, it was necessary to send a clear signal to the financial markets that the government understood membership to be a counter-inflationary discipline. Only when some credibility had been earned inside the ERM, could a cut in interest rates be justified. In television interviews over the weekend, Leigh-Pemberton criticised the decision as 'politically motivated'.[118] In the view of one former Bank official who had long supported membership:

> They snatched at the interest rate cut. They could have had the interest rate cut if they had waited a few weeks. But to do it at the time made the whole thing vulnerable. They got themselves off on a very bad start. It could not have been a worsely [sic] handled decision.[119]

The Bank's view was not shared by the Treasury who believed that an interest rate cut was necessary in view of falling output. One Treasury official dismissed Leigh-Pemberton's criticism: 'I never really understood that. ... We did have a reason for doing it and it worked.'[120]

Since Thatcher was forced to accept that actual ERM membership could not begin until Monday 7 October, it is reasonable to assume that she insisted on making the announcement on 5 October before the EC Monetary Committee could be convened. This action again precluded any discussion about consultation with the ERM states which it appears that Thatcher intrinsically wished to avoid. A Thatcher confidant commented on Thatcher's position: 'I am afraid the attitude would have been "stuff them." There was no need for it [consultation]. It was our decision.'[121] Consequently, Hurd and the Foreign Office's desire to present membership so as to strengthen the UK's credibility in the run up to the IGC was undermined. On hearing the decision, the ERM states were quick to welcome it and were genuinely relieved that the UK's isolation was over. The German government described it as 'extraordinarily positive' and the

French as 'good news for Europe'. However, in private, the member states were angry that the announcement pre-empted what should have been confidential negotiations in the monetary committee particularly about a central rate. Since the ERM represented a collective responsibility to defend currency parities, they believed that a central rate should be arrived at by a mutual agreement. The UK's unilateral announcement was particularly problematic in that some member states and central banks, led by the Bundesbank, believed that DM2.95 was too high a rate particularly in view of the UK external deficit. One Foreign Office official stated that the unilateral decision 'created some bad blood'.[122] In the view of a former Bank of England official:

> Typical. After waiting after all these years, they just told them. If they had actually had a meeting, had a whole weekend, and said in any kind of an open sense: 'Look, we are thinking of this kind of rate.' I'm sure they would have heard from the others, at least privately, if not in open committee: 'Are you sure about this rate?' ... It was an extraordinary thing to do.[123]

Both City institutions and the CBI publicly welcomed the decision. The Chairman of Barclays Bank, John Quinton responded: 'Thank goodness, I've been advocating this for five years or more.'[124] The CBI issued a statement saying that it was 'delighted':

> It gives a clear indication of the commitment of the UK government to greater monetary union. Both ERM membership and lower interest rates will help to sustain business confidence in a difficult economic climate.[125]

The IoD was more cautious stating that high inflation would make membership more difficult.[126]

Nevertheless, within both sectors, some believed that DM2.95 was too high a rate for sterling given the problem of UK competitiveness. Sceptics within the City did not publicly condemn the decision since they believed that it would jeopardise the government's ability to make a success of ERM membership.[127] Manufacturing companies were more open in their dissent. One spokesperson for a large exporting company commented:

We would have preferred a rate of DM2.65. The current rate is far too

> high. The internationally tradeable sector will have a very tough time, there could be two years of sub-optimal growth, investment will be cut and I expect a sharp rise in unemployment.[128]

A senior executive in another top manufacturing company described the rate decision as 'an unmitigated disaster.'[129]

Conclusions

After Thatcher defeated her Chancellor and Foreign Secretary on a timetable for ERM entry at the Madrid summit, the Lawson-Howe axis was quickly broken. Thatcher was able to sack Howe from his position essentially over the very issue on which the axis was based, without Lawson offering Howe any support. Then, Thatcher used Walters to undermine Lawson to the point when he concluded that he could no longer continue in office, without Howe backing Lawson. With Lawson departed and Howe marginalised, Thatcher seemed to hope that the ERM issue could be laid to rest.

This outcome proved impossible beyond the short term since Thatcher was neither willing nor able to influence the ultimate imperatives for entry in terms of either the government's economic or EC policy. Unless the government re-addressed the issue of ERM membership in 1990, it could not use the exchange rates as any kind of policy tool. Without such a policy tool, ministers would have left themselves with no means to pursue their macro-economic goals. Similarly, after the government announced that it would attend the IGC on monetary union and Germany indicated its continued support for the conference, there would have been little chance for the UK to make any kind of effective contribution on the issue either by itself or in alliance with other states outside ERM.

During the second and third quarters of 1990, Thatcher was prepared to accept that her new Chancellor and Foreign Secretary should create and then exploit the expectation that entry was imminent. In so doing, she increased the premium for actual membership within the government's own economic terms of reference since not fulfilling those expectations would impose new and immediate costs. The problem for the government was that this strategy meant that it entered ERM at a time and on terms likely to involve significant short-to-medium term costs. At the same time, those costs and the precise circumstances of entry both undermined the possibility that membership could be used to strengthen the Conservatives' EC policy.

AFTERWORD

Having opposed repeated attempts by her Chancellors and Foreign Secretaries to enter ERM for nine years, Thatcher presided over only seven weeks of the UK's participation in the system. In preparation for the monetary union IGC, Italy as EC President called an extra European Council meeting in Rome for 27-28 October. Italy's aim was to set a timetable for Stage Two, to begin in January 1993, before the content of that stage was agreed. Italy also aimed to secure a formal commitment to achieving a single currency and a central bank. The UK government opposed both developments, and believed that it was not necessary to consider the issues until the summit already scheduled for December.

At the Rome summit, the eleven member states minus the UK issued a communique stating that they would proceed to Stage Two by January 1994 and committing themselves to the irrevocable fixing of exchange rates but not a single currency. Thatcher dismissed the agreement as 'cloud cuckoo land'[130] and insisted that the UK government would block things which were not in the UK's interests.[131] On 30 October Thatcher reported on the summit to the House of Commons. In her prepared statement, she adopted a more conciliatory tone to the one which she used in Rome, suggesting that at the IGC her government would press for the Hard Ecu option. If people and governments so chose, Thatcher said, the Hard Ecu could one day evolve into a single currency. However, in answering Commons questions, Thatcher markedly changed her tone and her approach. She declared that in her view, people would not want to use the Hard Ecu, and that the opposition parties were prepared to betray British democracy and its currency to foreigners.

On listening to her performance, Geoffrey Howe concluded that Thatcher's behaviour was destroying the government's ability to achieve its interests in EC policy particularly on monetary union. On 1 November Howe resigned. Although Thatcher and other ministers sought to deny any difference of policy between Howe and herself, his action touched the anxieties of those Conservative MPs, including Michael Heseltine who believed that the government's EC policy was too isolationist. On 13 November Howe delivered a stunning resignation speech in the Commons, which he said that Thatcher's behaviour on monetary union was hopelessly compromising the credentials of the Chancellor and the Governor of the Bank of England on the Hard Ecu and risking the 'future of the nation.'[132] One day later, Heseltine announced that he was challenging Thatcher for the leadership of the Party. After failing to defeat Heseltine by sufficient votes to avoid a second ballot, Thatcher resigned the premiership on 22 November. Five days later, the Conservative Party elected John Major as her successor and Norman Lamont became Chancellor.

Trying to cut interest rates

By the time that Major assumed the premiership, ERM membership was posing difficulties for the government with sterling trading below its central parity. Sterling appeared to lack credibility as a currency in part because the interest rate cut which accompanied entry created uncertainty in the financial markets about the government's commitment to continued maintenance of the parity. At the same time, recession deepened. During the final quarter of 1990 GDP fell by 0.8 per cent and manufacturing output by 3.3. per cent. Yet with the government needing the interest rate cuts which it presumed membership would deliver more than ever, sterling's weakness did not allow for any loosening of monetary policy. Unable to respond with monetary policy and unwilling to use any other means, the government was left to deny the full extent of the recession, talking optimistically of a mild downturn. [133]

On 31 January the Bundesbank raised its interest rates by 0.5 per cent. In the aftermath, sterling fell to become the weakest currency within ERM.

Opposition to the government's policy began to mount. On 13 February, the *Times* published a letter from six monetarist economists including Alan Walters arguing that unless the UK either left ERM or devalued within it, 'real disaster' would strike the economy.[134] The government's position was finally eased by a cut in Spanish interest rates. Since the peseta was now the strongest currency within the ERM system this change reduced the pressure on sterling. On the same day as the *Times* letter Lamont cut rates from 14 to 13.5 per cent. Thereafter, the Deutschmark started to weaken against all ERM currencies as the dollar rose and the problems of German reunification increased. These shifts sufficiently strengthened sterling for the government to cut interest rates in half-per cent stages to 10.5 per cent at the start of September 1991.[135]

Monetary Union Compromise

On monetary union Major renewed the government's efforts to sell the Hard Ecu. On 8 January 1991, the Treasury published a draft treaty outlining details of how the Hard Ecu could be created and managed by the European Monetary Fund (EMF) as a new European monetary institution. The EMF would have minimal powers but would contribute to the progressive realisation of economic and monetary union. Within a few months, the government concluded that it could not build on the interest which the proposal gained in the previous autumn. The Treasury was forced to drop the scheme as a negotiating tactic.[136] By May the government appeared to face a choice between vetoing any treaty on monetary union which emerged, or committing itself to a single currency with the other states. By choosing the former course, the government would greatly compromise its whole membership of the Community given the level of support for monetary union among the other major member states. Meanwhile the latter option was contrary to the government's own preferences and risked fundamentally splitting the Conservative Party.[137]

In June 1991 Jacques Delors suggested the basis of a compromise. He proposed a special clause in a treaty which would allow the UK to postpone any final decision on membership of a monetary union until it was prepared to make such a commitment. Ahead of the Luxembourg Summit, the Major government took up the idea. The Prime Minister and Lamont indicated that they were not looking to use the UK's veto and stressed that they would not be sidelined in the talks. At the same time, the government would not under any circumstances sign any treaty which did not contain a clear provision that the UK government and parliament would only move to a single currency if they took a further, separate and explicit decision to do so.[138] At the Luxembourg summit EC member states agreed to leave any firm commitments on both the monetary and political union treaties to the Maastricht summit in December. In the interim period, the IGC worked on the details of an opt-out clause for the UK on the monetary union treaty. Bank of England officials believed that the compromise worked out in the IGC would not have been possible if the UK had remained outside ERM.[139]

One Year of ERM Membership

By October 1991 membership appeared to have delivered the specific economic ends for which the government was looking a year previously. During the year sterling never fell below 2.25 per cent of its central rate, producing a large measure of exchange rate stability. With UK interest rates at 10.5 per cent and German rates slightly below 10 per cent, the rate differential between the UK and ERM states was largely removed. Similarly inflation fell steadily to 3.7 per cent in October 1991, leaving it in line with the rates prevailing elsewhere. For its part, the government was keen to stress that membership was a key part of its anti inflation stance. In practice, it is difficult to assess how far the fall in inflation was produced by the discipline of membership and how much was due to the full effects of the 1988-1990 monetary and exchange rate squeeze working through the economy.

The problem for the government was that the abstract benefit of the interest rate cuts did not produce the tangible economic outcomes which it desired. Thatcher felt dissatisfied enough with the situation to disown her part in the decision to enter the system. In the US, in June she declared:

If you fix the exchange rate, then interest rates and domestic

> monetary conditions go where they will. And finance ministers are left like innocent bystanders at the scene of an accident.[140]

The four and half per cent cut in interest rates did not stop the UK's recession deepening as output fell through the first three quarters of the year and unemployment rose to 8.5 per cent. Although indicators of business confidence began to improve in September 1991, there was no evidence of any actual upturn in activity.[141]

In this respect the government faced two problems. First, although interest rates were now within a fraction of German rates, they were still high in absolute terms: and German rates were a floor below which UK rates could not fall. Whilst the Bundesbank set rates at this level to manage Germany's rising inflation, the recession left the UK at the opposite end of the economic cycle. With the Bundesbank likely to raise its rates further, the UK government would find it exceedingly difficult to give the economy any further monetary stimulus.

Second, the 4.5 per cent cut in rates did not appear particularly effective. The extraordinarily high levels of personal and corporate debt created by the credit boom left potential mortgage holders and companies unwilling to borrow further when the boom ended, even when given the incentive of lower interest rates. The American experience of low interest rates and continuing recession indicated that debt overhang was changing the dynamics of the macro-economy

The government did not want to use alternative policies to stimulate the economy, any more than it had previously had a diverse approach to controllingl inflation. In the 1991 budget, the government ruled out using an expansionary fiscal policy to assisting recovery. Indeed the government actually tightened policy by £295 million in the 1991-2 year and £1.89 billion for the full year. Similarly, rather than taking action to stimulate the housing market, the government abolished mortgage tax relief against the 40 per cent rate of tax. By increasing VAT from 15 to 17.5 per cent to pay for a general reduction in poll tax levels, the government further reduced consumer demand. Without a policy framework which extended beyond interest rates, the government was left looking to continued ERM membership to deliver something which it was extraordinarily unlikely that it could produce.

At the same time, the balance of payments deficit remained a potential problem both in terms of sustaining the sterling parity and increasing competitiveness. Although exports to Europe grew strongly during the year, this change was largely due to manufacturers taking advantage of the excessive growth in the post- reunification German economy. After this particular and finite boost to continental demand, most manufacturing exporters were again left with an institutionalised problem of competitiveness. Only the Japanese car manufacturers operating in UK offered the hope of a sustained rise in exports with a continuing central rate of DM2.95. For the whole of 1991 the current account was £6 billion in deficit. Whilst this figure was low in comparison with 1988-1990, it was a large deficit given that the economy was in recession. Even with home markets depressed and foreign markets expanding, UK manufacturing industry could not provide sufficiently for domestic demand. When the economy finally recovered, imports were likely to surge again without exports earning enough to finance them.[142]

Maastricht

At the Maastricht summit of 9-10 December 1991, the government agreed to a treaty on monetary union which did not commit the UK to a single currency and to a treaty on political union which excluded the UK from its protocol on the social chapter. The government heralded the agreement as a triumph for the negotiating skill of Major and Hurd and the best possible deal for the UK and the Community. The UK had preserved the option of entering a monetary union without giving any commitment that it would do so. The monetary union treaty outlined three steps to the achievement of a single currency. Stage Two would begin on 1 January 1994. During this stage, member states would seek to avoid excessive budget deficits, to be monitored by Ecofin and the Commission, and they would use narrow bands and avoid devaluation within ERM. Each member state would start steps to make its central bank independent if it was not so already. At the start of Stage Two, a European Monetary Institute (EMI) composed of central bank governors would be established to strengthen the coordination of monetary policies, with a view to ensuring price stability and to monitoring the EMS. By 31 December 1995, the Institute would specify the framework for the establishment of the ESCB composed of a European Central Bank and the national central banks.

At the end of 1996 the heads of governments would decide by majority voting whether at least seven states had achieved a set of conditions for economic convergence:

- an average rate of inflation in the previous year of not more than 1.5 per cent higher than that of the three best performing member states;
- an annual budget deficit of no more than 3 per cent of GDP and a national debt below 60 per cent of GDP;
- no devaluation within ERM for at least two years;
- an average nominal long-term interest rates no more than 2 per cent higher than those of the three best performing member states in terms of inflation.

If seven states had achieved such convergence, a date would be set for the start of Stage Three. If by the end of 1997, the date for the beginning of Stage Three had not been set, it would start automatically on 1 January 1999 even if only 5 member states qualified. Other member states would be able to enter on achieving the convergence conditions.[143]

At the start of Stage Three, the currencies of the member states participating would be irrevocably fixed at a chosen set of rates. The Ecu would then be substituted for those currencies at these rates and finally would become a single currency for those member states under the auspices of the ESCB. The primary objective of the ESCB would be to maintain price stability, with the European Central Bank and national central banks independent from EC institutions and member state governments. In a protocol attached to the treaty, the twelve signatories agreed that whether they fulfilled the necessary conditions for the adoption of a single currency or not, they would respect the will of the Community to enter swiftly into Stage Three.[144]

The treaty recognised that the UK would not be obliged or committed to move to Stage Three without a separate decision to do so by its government and parliament. If the UK notified the Council that it would not move to Stage Three then it would not have voting rights on deciding whether sufficient member states had achieved economic convergence. At any time, it would have the right to change its mind and move to Stage Three if it satisfied the conditions of economic convergence. The UK would participate in Stage Two as if it were preparing for Stage Three like the other member states: the precise relationship was not clearly specified. The protocol is explicit only that the UK would seek to avoid excessive budget deficits, submit to a formal review of its monetary policy and be subject to rules on balance of payments problems. At no stage and under no circumstances could the UK use a veto or any other instrument which might slow down the process.

The 1992 General Election

After the Maastricht summit, the government's economic problems mounted. On 19 December the Bundesbank raised interest rates by 0.5 per cent and the Deutschmark soared. With all the other ERM states raising their rates in response, the UK government faced a dilemma. There was no evidence of a recovery and on the same day as the German action, unemployment rose above 2.5 million for the first time in almost four years. To raise interest rates would have risked plunging the economy further into recession. Yet in deciding as it did to leave rates unchanged, the government disregarded the informal rules of ERM and put sterling under new pressure. By the end of the year, sterling was trading at DM2.83, only six pfennigs off its ERM floor. Although the Bank of England was eventually able to stabilise sterling, the government lost some further credibility in the financial markets.[145]

Given sterling's weakness, Major and Lamont were unable to cut interest rates in the run up to the general election in April 1992. At the same time, the prospects for sustaining the sterling parity weakened. During the first quarter of 1992 the current account deficit widened with imports rising by 2.9 per cent as exports fell by 0.4 per cent. The government was left to fight the election with the economy still in recession and using high interest rates to defend a sterling parity which was becoming increasingly uncredible. Only on inflation could the government claim an economic policy success. The government's ultimate election victory was largely dependent on creating fear about the prospect of a Labour government, in particular that it would add £1,000 to all tax bills and that the PSBR would increase by £37B a year.[146]

The Major Cabinet appeared to believe that their election victory would produce the necessary boost to confidence to stimulate a recovery and strengthen sterling without any change of policy. Although a recovery did not materialise, sterling rose sufficiently for the government to cut interest rates to 10 per cent on 5 May. This left UK rates only 0.25 per cent higher than the German Lombard rate. Within the established framework of ERM, there was little room for manoeuvre left.[147]

On 2 June the Danish electorate rejected the Maastricht Treaty in a referendum. The next day, the French government announced that it too would hold a referendum on Maastricht, believing that the likely 'yes' vote would add legitimacy to the now embattled treaty. The financial markets started to doubt whether the treaty would be ratified. They believed that if the monetary union project were forestalled, then the ERM states would have less incentive to hold their currency parities against the Deutschmark and avoid realignments. As a result, the Deutschmark rose pushing most of the other currencies, including sterling, towards the bottom floor of their bands.[148]

Major and Lamont accepted that the sterling parity was now in serious jeopardy. It did not order the Bank of England to intervene but embarked on a dual public and private strategy. In public over the next two months, Major and Lamont stressed the government's absolute commitment to ERM membership at a central rate of DM2.95. On 10 July, Lamont declared that if the UK left ERM:

> The credibility of our anti-inflationary strategy would be in tatters....We would have surrendered. The ERM is not an optional extra, an add-on to be jettisoned at the first hint of trouble. It is, and will remain, at the centre of our macro economic strategy.[149]

Under no circumstances would the government devalue. Indeed, the government's aim was to deliver zero inflation and to turn sterling into the hardest currency within ERM. It also floated the idea of cutting interest rates below German rates on the basis that since Germany was no longer the best performing counter-inflationary state, its rates need no longer be the floor for other ERM states.[150]

In private, the week after the Danish referendum, the Bank of England began an internal assessment about the desirability of a general ERM realignment. On 16 July the Bundesbank raised its discount rate by 0.75 per cent to 8.75 per cent. Alone among the ERM states Italy raised its rate in response. The ERM now faced its most serious crisis for years. German interest rates were set to squeeze inflation out of their post-unification economy. Meanwhile the ERM states, some of which (including the UK) possessed lower inflation rates than Germany, were required to keep their interest rates around German levels to maintain their currencies. Stuck in a long recession, the UK now had real rates of around 7 per cent. With no sign of the recession ending, it was becoming increasingly difficult for the financial markets to believe that the government would increase interest rates to defend sterling.[151]

After the German action, the UK government discreetly started to signal its willingness to consider a general realignment of all currencies against the Deutschmark. If the Deutschmark were to be revalued, Germany could switch the balance of its counter-inflationary policy to the exchange rate and pave the way for a reduction in German interest rates. Germany itself was particularly keen on a realignment, but the French government was determined to maintain the *franc fort*. As Bank of England officials engaged in bilateral negotiations on the issue, it became apparent that only a broad realignment would be possible in which sterling, the lira, the peseta, escudo, and perhaps the punt and krone, would all be devalued against the Deutschmark, the guilder and the French and Belgian francs. The UK government could not accept such an outcome because it would put the UK firmly into the second tier of the EC's monetary development. Ministers let it be known that they would not participate in any realignment which did not involve the Franc.[152]

The situation soon deteriorated further. The UK current account registered a deficit of £1.25 billion for July and £1.85 billion for August, twice the level at which it was running a year previously and adding to the perception of sterling as a weak currency. A study for Phillips and Drew calculated that for every 1 per cent rise in domestic demand, imports were likely to expand by 1.5 per cent. If domestic demand grew at 3 per cent a year during the 1990s economic growth would only be 2 per cent and lead to a trade deficit of 15 per cent of GDP by the end of the century. On 25 August a poll was published showing a majority of French voters opposed to the Maastricht treaty. This news placed the weak ERM currencies including sterling under further pressure.[153]

Three days later, at the UK's behest, the ERM states issued a joint declaration that there would be no devaluation of currencies. As sterling fell through its divergent indicator and then DM.2.80, the government maintained its policy of non- reserve intervention. Then on 3 September the government changed course and took out a £10 billion ecu loan to add to the exchange reserves. Sterling strengthened strongly in response leaving the lira as the weakest currency in the system. The next day Italy raised its interest rates and the Bundesbank supplied the Bank of Italy with billions of marks to support the lira.[154]

With the French referendum looming on 20 September, finance ministers and central bank governors were due to meet in Bath on 5 September. Before the meeting, Italy told Germany that while it would refuse to devalue alone, it would consider participating in a more widespread realignment of currencies. The German finance minister, Theo Waigel, and the Bundesbank chief Helmut Schlesinger went to Bath hoping to persuade as many states as possible to join with Italy in such a realignment, in exchange for a cut in German interest rates. Lamont went to the meeting unprepared to countenance any realignment since it was obvious that France would not be prepared to devalue before its referendum. As chairman of the meeting, Lamont effectively ruled out any open discussion of the subject and pointedly refused to admit to sterling's weakness. Instead he pleaded with Germany to make a unilateral cut in interest rates but was brushed aside by Schlesinger. The meeting ended with the EC ministers issuing a statement that there would be no realignment although with some states implying that Germany had guaranteed that it would not raise its interest rates further.[155]

Schlesinger was angry at the outcome of the meeting since the Bundesbank would continue to be obliged to defend currency parities which it believed were unsustainable. On 8 September Schlesinger told the press that the Bundesbank could not indefinitely support the lira. The same day, the Finnish marka which was informally shadowing the Deutschmark, was allowed to float. By 11 September the lira's position was no longer tenable. Italy requested a full meeting of the EC monetary committee to deal with the situation. The UK, French and Spanish governments refused. The Major government did not want to discuss the possibility of a broad realignment including sterling. Eventually, Germany and Italy were forced to accept a unilateral devaluation of the lira which they negotiated between themselves. On 13 September they agreed to devalue the lira by 7.5 per cent and that Germany would lower its Lombard rate by 0.25 per cent and its discount rate by 0.5 per cent.[156]

The UK government hoped that the cut would be sufficient to stabilise sterling. Yet by the end of Tuesday 15 September sterling was on its floor of DM2.78 and the weakest currency within the system. In the evening Lamont held a meeting with Treasury and Bank officials to discuss a plan of action for the next day. The first line of defence would be overt intervention by the Bank followed by an increase in interest rates if necessary. However, within hours their task was made more difficult by the release of comments from the Bundesbank chief which suggested that sterling needed to be devalued.

When the financial markets re-opened on 16 September, sterling came under immediate pressure. At 10.30am Leigh-Pemberton told Lamont that a two per cent rise in interest rates was necessary. Lamont sanctioned the move and informed Major. By lunchtime, Leigh-Pemberton told Major and the group of ministers he assembled as a crisis committee in the strongest terms that it was impossible to hold the line. In his experience, the scale of the selling was totally unprecedented and further action was futile. According to one Bank of England official:

> I can't stress enough the sheer scale of the selling. We had never seen anything like it. Every new weapon we brought out seemed to have less and less effect. It was as if an avalanche was coming at us.[157]

However, Major and Lamont insisted that the Bank continue to intervene.

Within an hour, Leigh-Pemberton asked Lamont to sanction a further three per cent increase in interest rates and Lamont gave him the go ahead. With intervention totalling £11 billion and amounting to half the UK's exchange reserves and 15 per cent interest rates unable to stop the flood out of sterling, the government decided to suspend the UK's membership of ERM.

After announcing the decision the UK government convened a meeting of the EC monetary committee where Treasury and Bank officials unsuccessfully requested that the whole ERM be suspended until after the French referendum. Instead, Italy decided to suspend its membership and Spain to devalue. After less than two years inside the system, 'Black Wednesday' represented the end of the UK's membership of ERM. On 17 September the government reduced interest rates back down to 10 per cent. By the end of the week sterling was trading at DM2.61, six per cent below its previous ERM floor. Faced with the complete failure of the government's entire economic policy, Lamont simply announced: 'We will now have a

British economic policy for the needs of the British economy.' Major completed the U-turn when he declared: 'A growth strategy is what the country wants and a growth strategy is what we are going to get.'[158] Over the next six months, the government reduced interest rates on a discretionary basis to six per cent with sterling floating between DM2.40 and DM2.60. Given the combined stimulus of a loose monetary policy and a devaluation, the economy slowly and patchily started to recover in 1993 at the same time as inflation continued to fall.

The ERM Suspended

During the nine months following sterling and the lira's ejection from the system, the remaining ERM currencies came under intense pressure at different times. As a result, the peseta and escudo were devalued twice and the Irish pound once. Significantly, the *franc fort* which lay at the heart of the post-1987 ERM survived the turbulence. Nevertheless, by June 1993, the operation of the system was posing huge problems for the ERM states and for the French government in particular. The markets believed so firmly that the Deutschmark would never be devalued that the other ERM states could not have lower nominal interest rates than Germany and many were significantly higher. Yet with the German economy now having one of the highest inflation rates in the EC, the other states were left with very high real rates at a time when their economies were in recession.[159]

After unemployment rose to a record 11.5 per cent and criticism of the *franc fort* mounted within the RPR and among industrialists, the French government became increasingly desperate. On 21 June France cut its short term interest rates below German levels for the first time. Ministers talked optimistically that given its consistent low inflation it could replace the Deutschmark as the ERM anchor currency. The French finance minister publicly called for coordinated interest rates cuts in Germany and France. The German government responded by cancelling a top-level Franco-German economic meeting. By the end of the month, the franc came under renewed pressure.[160]

The weakness of the French position was revealed on 1 July when the

Bundesbank finally cut its discount rate by 0.5 per cent but France could only shave 0.25 per cent off its relevant rates. In the aftermath, the franc slipped again and the Bundesbank became notably less firm in its willingness to defend the currency. The financial markets concluded that France would not raise its rates to defend the franc and that the French economy's future was now dependent on the Bundesbank cutting its rates. All eyes now turned to the Bundesbank.[161]

After the Bundesbank cut its repo rate twice in a week, the markets and commentators expected a discount rates cut to follow at the Bundesbank council on 29 July 1992. At the meeting, the Bundesbank cut its Lombard rates by 0.5 per cent but left the discount rate unchanged. During the next day and a half most of the ERM currencies, including the franc, crashed to the bottom of their ranges. By the end of trading on Friday 3 August, it was obvious that most of the parities could not survive the onslaught they would inevitably face during the next week. Over the weekend, EC finance ministers agreed that all currencies except the Deutschmark and the guilder would use 15 per cent bands and the ERM as it had existed for fourteen years was de facto suspended. With the freedom offered by such wide bands, the ERM countries slowly started to lower interest rates to deal with recession whilst seeking to maintain their currencies as close to their previous parities as possible. Although the UK government cried 'We told you so,' the search for exchange rate stability in the EC continues.[162]

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CHAPTER 7
THE FAILURE OF ECONOMIC POLICY-MAKING

In many ways the Conservative government's handling of the ERM membership issue was a story of failure: a failure to find a policy on which the Prime Minister and Chancellor could agree; a failure to judge the likely consequences of particular decisions; and a failure of many core executive actors to understand what ERM membership was all about both when the UK was oustside and inside the system. On occasion decisions were made on erroneous assumptions and claims to knowledge. Eventually decisions were made in conditions in which strategic discussion about policy between all the relevant core executive actors was impossible. As a result, the government often failed to act in its own best interests and significantly damaged the UK's economic performance and influence within the European Community. This final chapter looks at how this situation arose and its implications for our theoretical understanding of core executive economic policy making. The first section reviews the behaviour of the Treasury, the Bank of England and the Foreign Office as institutional actors and the behaviour of the Prime Minister, Chancellor and Foreign Secretary as the rational electoral actors analysed in Chapters Two to Six. The second section reconsiders the overall performance of these core executive actors using a more substantive concept of rationality standing back from the detail so that the failures of the government's policy-making become apparent despite our understanding of how wrong decisions could be 'rationally' made. The final part of the chapter briefly considers the uniqueness of the economic policy making environment and considers whether institutional chanes could help make decision-making less difficult in future.

7.1 EXPLAINING THE POLICY PROCESS: NEW INSTITUTIONALIST AND RATIONAL ACTOR VIEWS

At the outset of this analysis, I argued that core executive actors at the

Treasury, Bank of England and the Foreign Office should be understood as institutional actors in the new institutionalist sense. The logic of institutionalist action is one of appropriateness, so that actors will endorse those policies which are most congruent with prevailing institutional rules and have the best consequences in maintaining institutional stability. This does not mean that the institutional actors determined ERM policy, or that institutional and bureaucratic constraints and rules can be used to explain the shifts and developments in ERM policy. Indeed it would be impossible to explain, for example, the sudden decision to enter ERM in October 1990, in these terms. The Foreign Office might prefer stability in the UK's relations with the other EC states but the government's unilateral announcement of ERM membership was disruptive in this respect. The Bank of England will generally endorse policies which are likely to produce stable monetary conditions and stability in the foreign exchange markets. However, monetary and exchange rate instability were inevitable when the UK entered ERM at a central rate of DM2.95 with inflation rising, output falling and with a large balance of payments deficit, Similarly, the Treasury will generally prefer policies which function as an automatic pilot. But in the economic conditions prevailing in October 1990, ERM membership was highly unlikely to operate as a routine procedure in the medium term.

Nevertheless, in understanding the policy preferences which the Treasury, Bank of England and Foreign Office developed even when they were overridden by ministers' political imperatives, a new institutionalist approach yields considerable understanding. From 1979 onwards the Foreign Office supported ERM membership in part because it would have made the UK's relations with the other EC states less awkward. At the same time, Foreign Office officials pressed their case most strongly when the rewards in terms of EC relations were greatest, namely after 1988 when the development of the agendas for monetary and political union threatened to leave the UK even more isolated than hitherto.

From 1980 onwards opinion at the Bank of England on ERM membership was divided. Most senior officials tended to be in favour of membership at least until 1989, when doubts about timing arose. Meanwhile a mix of views prevailed among other Bank officials throughout the period. At least in part this complexity and division of views reflected the ambiguous relationship between UK membership of ERM and the Bank's preference for maintaining monetary and exchange market stability. Both the pursuit of strict monetary targets and non-membership of ERM produced continuing monetary and exchange market instability. Yet the underlying weakness of the UK's inflationary and trading performance meant that for the UK ERM membership might not produce monetary and exchange market stability as effectively as it did for most of the ERM states throughout the 1980s. The Bank's dilemma was that without an improvement in UK economic performance, it was never consistently clear and uncontestable that ERM membership would best preserve the Bank's institutional stability.

What is most striking about the institutional preferences of the Treasury, both on ERM membership and overall economic policy, was the manner in which they came to resemble those of the Conservative ministers whom they served. Despite Wass's personal opposition during the early 1980s, the MTFS was in many ways an 'appropriate' policy for the Treasury because it was a potential automatic pilot and source of autonomy. The policy required them to do effectively no more in macro terms than manage interest rates and public borrowing. At the same time, the MTFS minimised the Treasury's relations with other departments, notably Trade, Industry and Employment. It further meant that the Treasury did not have to manoeuvre in the exchange markets, operate a formal demand management policy, or administer an incomes policy with all its potential pitfalls.

In taking up ERM membership as an alternative counter-inflationary monetary framework, the Treasury, like Lawson, remained wedded to the theoretical justifications of the MTFS. ERM membership eventually presented itself as a more stable and effective means of retaining the Treasury's departmental autonomy and avoiding interventionist or implementative economic policies. Once the first Thatcher government divested the Treasury of the responsibility for operating difficult policies, Treasury officials saw no incentive to return to them. Similarly, although the Bank was concerned about the inflationary consequences of the credit boom and saw a problem between rising inflation and ERM membership, it did not advocate a return to the credit controls which it no longer had to operate. Overall, the Treasury disparaged policies which were simply 'inappropriate' to its continuing institutional stability with the assertion that 'these things do not work.'

Certainly, the congruence between ministers' and officials' preferences was increased by the manner in which advancement in the Treasury took place. Middleton's appointment as Permanent Secretary in 1983 was not an isolated incident. Rather it was a clear signal that accepting the government's broad policy approach was a key determinant of career success. Some of those closest to the Treasury argue that the people who rose in the department during this period were those who most easily accommodated ministers. For example, any official who advocated formal wage restraint would quickly have found his or her career sidelined.[1]

'Thick' Rational Actor View

The analysis in Chapters Two to Six used a 'thick' rational actor model to understand the decisional behaviour of the Prime Minister, Chancellor and the Foreign Secretary. The aim was to reconstruct the choices which faced these actors in terms of their perception of the macro-economic benefits and costs, capital accumulation benefits and costs and European policy benefits and costs given the constraints on any particular course of action or in-action. Using this analytical framework, it has been possible to explain how ERM membership surfaced and resurfaced as an issue for top political actors at different times.

- May-October 1979: An issue of European policy
- March 1980: An issue of European policy
- October 1981-January 1982: An issue of economic policy

- February-November 1985: An issue of economic and European policy
- September- October 1986: An issue of economic policy
- July 1987: An issue of economic policy
- April-June 1989: An issue of economic, capital accumulation and European policy
- March- October 1990: An issue of economic, capital accumulation and European policy

At the same time, the 'thick' rational actor framework has produced plausible explanations of particular decisions made by the Prime Minister, Chancellor and Foreign Secretary. Despite ascribing to these actors a unitary goal of re-election, it is still possible to account for the different positions taken by Margaret Thatcher, Nigel Lawson, Geoffrey Howe, John Major and Douglas Hurd on ERM membership. The analysis has shown that it was 'rational' for Howe (as Chancellor), Lawson and subsequently Major to push for ERM membership both as a counter-inflationary monetary framework given the repudiation of the monetary targets; and to provide lower interest rates for a given rate of inflation. Similarly, it was 'rational' for Howe, (as Foreign Secretary), Major (as Chancellor) and Hurd to support ERM membership, given their belief that the UK needed to increase its influence within the EC and that entry to ERM would improve the government's relations with other member states.

Yet despite the 'rationality' underlying the position of successive Chancellors and Foreign Secretaries, Thatcher's opposition to ERM membership until October 1990 cannot be described as non-rational within the 'thick' rational actor framework deployed. Despite the monetary costs of non-membership, there was a 'rationality' to Thatcher's position since participation within ERM would have restricted the benefits otherwise available to ministers in terms of fiscal expansion and short term growth. At the same time, Thatcher's rejection of the argument that ERM membership would increase the UK's influence in the EC in other policy areas simply reflected her view that the costs in terms of membership itself outweighed the dubious gain elsewhere.

By factoring into the explanation the broadest possible range of considerations both in the objective sense and in terms of actors' perceptions of those considerations, it has been possible to make comprehensible both internal divisions and the development of policy towards ERM membership. In this sense, the rational actor framework developed in Chapter One proved an effective tool of explanation. Nevertheless, in reconstructing decision-making in these 'thick' rational term, there is a danger of implying that whatever is is rational.

The restrictiveness and unpredictability of the macro-economic policy-making environment means that there is a risk of 'whitewashing' policy-makers by reading back from their apparent mistakes, particularly in timing, to the strength of the constraints or the complexity of the benefit-cost trade offs which they faced. This is particulary true when we consider the processes by which and manner in which decisions were actually taken.

The 'thick' rational actor explanation makes it possible to comprehend why Thatcher finally accepted ERM membership in October 1990 since there was no other short term macro-economic option within her own terms of reference. Yet even within this loosely rational framework it is difficult to understand the suddenness of the decision or the absence of consultation about a central rate for sterling. At the same time, by comprehensively accounting for the basic decisional outcomes in economic policy, smaller actions, (especially in relation to the foreign exchange markets), which fit very badly with any form of rational actor explanation are analytically ignored. For example, why did Thatcher impose such costs on the government and the economy by treating questions asking for her views on sterling almost as an act of existentialist definition? Whilst it is understandable that Thatcher's and Lawson's private conflicts affected their economic policy judgement, it is more difficult to comprehend why they allowed public feuding to damage their joint interests. Given the huge significance of economic policy these considerations make it important to step back from the detailed explanation of policy and take a broader and objective look at the Conservative government's policy choices through a more critical 'thin' rational actor view.

7.2 A 'THIN' RATIONAL ACTOR PERSPECTIVE

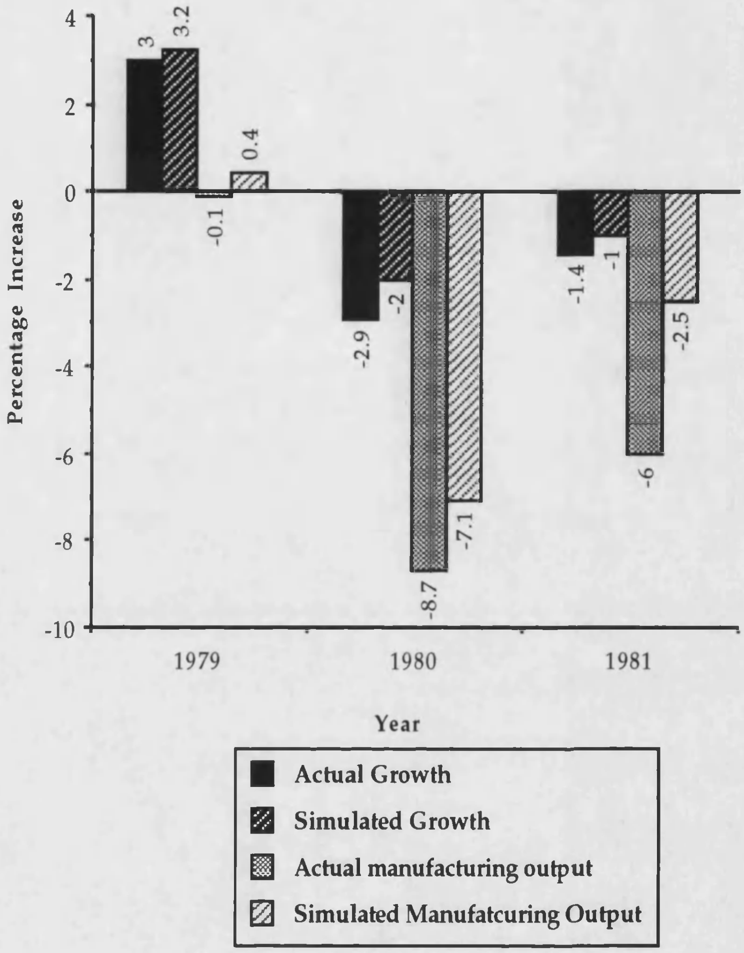
This approach moves the analysis away from an open-ended and formalistic model of rational action as maximising benefits, net of costs given constraints towards a more substantive concept of rationality. In principle there is nothing a 'thick' rational account cannot explain because anything can be labelled as a constraint. By contrast, the utility of a 'thin' approach is to critically evaluate actors' conception of policy problems, the factors that they are prepared to accept as constraints, and the costs of decisions in terms of actors' own goals and interests. For example, when the Conservative government accepted the MTFS that inflation is only a monetary phenomenon was a constraint on policy, this was in itself a costly decision from a 'thin' rational actor perspective. When the costs of this stance mounted and its benefits receded during the government's third term of office, a substantive conception of rationality would expect ministers to revise their initial view in line with experience. In general terms if actors do not adjust their perceptions of costs, benefits and constraints in line with their experiences, then it is possible to regard their behaviour as 'non-rational' in a 'thin' rational actor framework.

The aim of this section is to consider certain aspects of the government's economic-policy-making within this light. The first part evaluates the 'rationality' of the government's non-membership of ERM in terms of the overall performance of the UK economy. The second part assesses ministers' performance as actors seeking to secure re-election. The third part examines how the breakdown of the core executive decision-making process on economic and EC issues after 1985 encouraged non-rational decision-making. The fourth part considers the manner in which ministers held positions on policies and issues without adjusting them to changing economic conditions or contrary empirical evidence. The final part seeks to explain some of the non-rationality in decision-making described above in terms of the particular set of actors involved and the specific conditions under which they operated.

The Lost Past and Future

In trying to assess how UK economic policy would have developed inside ERM following a much earlier decision to join there are obvious problems of making counterfactual judgements. A simulation produced by the National Institute of Economic and Social Research of what would have happened between 1979 and 1988 if the UK had been a member of ERM from 1979 provides a useful starting point for discussion. The analysis assumes that membership did not affect the underlying behaviour of the economy, that there was no credibility problem for sterling and that the UK's membership did not change the policies of other member states. Between 1979 and 1981 sterling's effective exchange rate would have been significantly lower inside ERM and at its peak in the first quarter of 1981 20 per cent lower. Similarly, interest rates would have been around 4 percent lower in 1979 and 1980. As a result, the 1980 to 1981 recession would have been less severe at the expense of higher inflation in these years. Thereafter the recovery would have been slightly slower in 1982-83, with inflation significantly higher in 1982 and marginally higher in 1983. [2]

Figure 7.1: The Consequences of ERM Membership on GDP Growth and Manufacturing Output 1979-1981

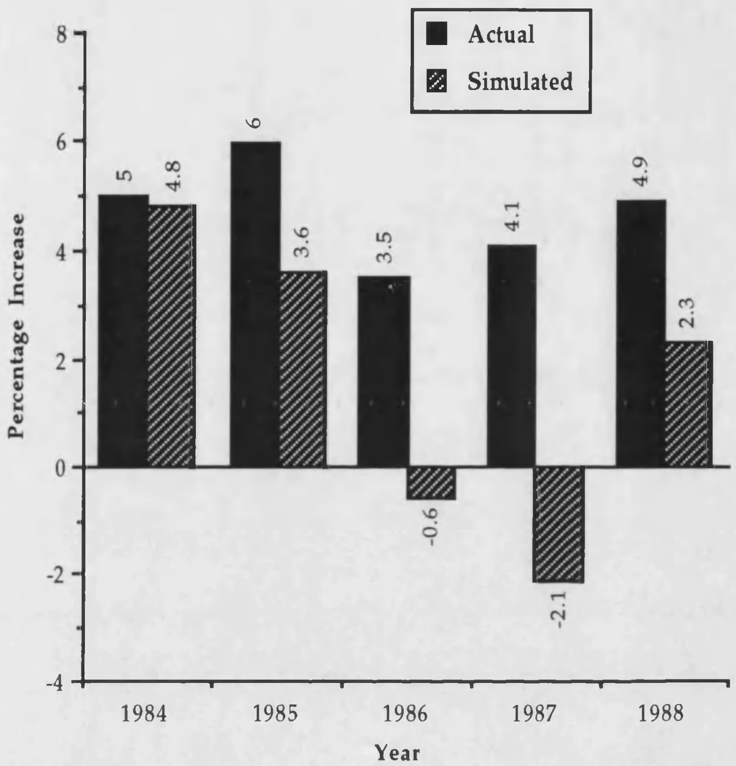


As figure 7.1 indicates, manufacturing industry would have benefitted the most from ERM membership in comparison to other sectors of the economy with manufacturing output higher than the GNP figure would perhaps suggest, especially in 1981. The National Institute's findings support the now widely accepted view that sterling's appreciation was largely responsible for the destruction of significant parts of the UK's manufacturing capacity in 1980 and 1981 as export dependent firms lost the markets which they needed to survive. Whilst some upward movement in sterling would have been likely inside ERM given sterling's petro-currency status, if interest rates had been targeted at the exchange rate rather than £M3 then manufacturing industry would have retained its competitiveness. Outside ERM it is not surprising that the UK's export performance between 1979 and 1982 was the worst among the G7 states. [3]

With more of the manufacturing sector surviving the 1980-1981 recession, the simulated analysis indicates that the sectors' capacity would have been greater throughout the 1980s, rising to 2.5 per cent above actual levels in 1988. Such a difference would have been important because a large part of the UK's balance of payments deficit is due to the lack of a manufacturing base broad enough to satisfy domestic demand. At the same time the depletion of the manufacturing sector in 1980 and 1981 weakened the capacity of the economy to produce export-led growth and intensified the likelihood of prolonged economic slowdown and recession.

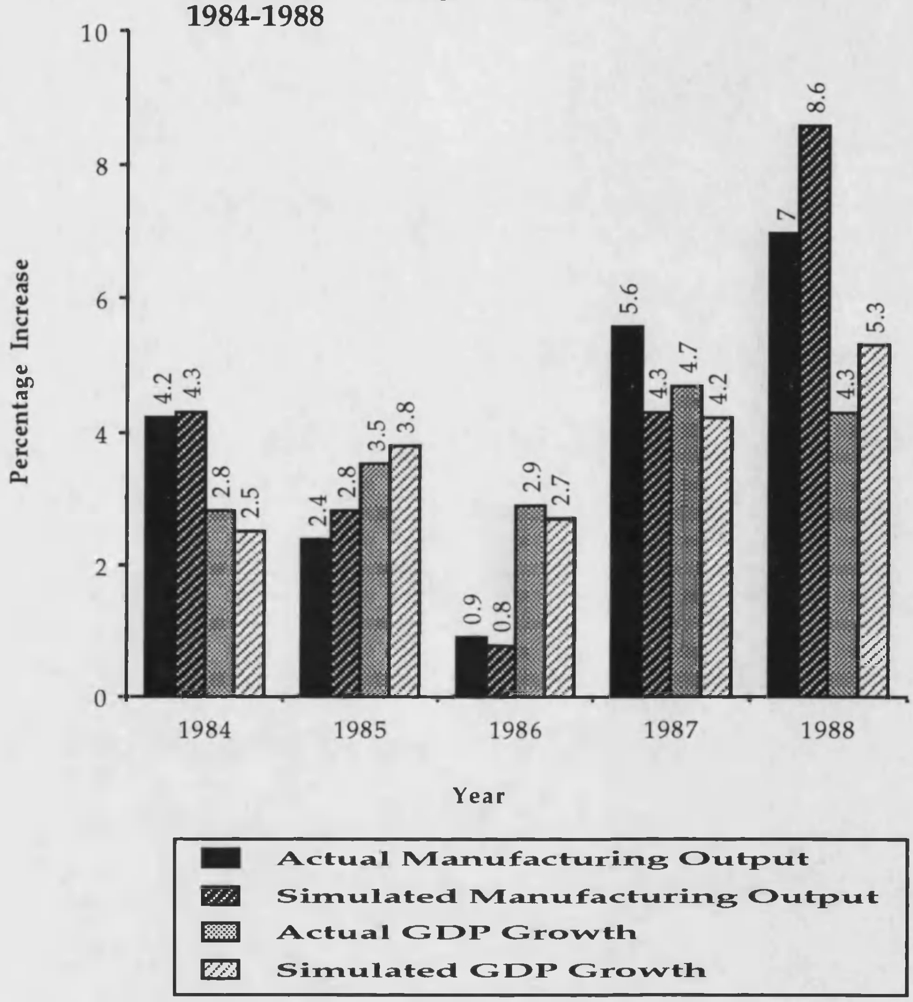
Inside ERM a healthier manufacturing capacity would not have been paid for at the expense of long term inflation control. Inflation in 1983 was actually 4.6 per cent compared to a projected 5.3 per cent given ERM membership.[4] As a Treasury paper finally acknowledged in 1987, much of the fall in inflation in the early 1980s was due to a decline in world commodity prices. Non-membership of ERM and high interest rates simply allowed UK inflation to fall more rapidly than would otherwise have been the case. From the mid-1980s ERM membership would have resulted in lower inflation and wage increases. Indeed, as figures 7.2 and 7.3 (page 340-341) indicate, in 1987 and 1988 inflation would have been negative without an overall trade-off in terms of GDP growth and manufacturing output.

Figure 7.2: The Consequences of ERM Membership on Annual Inflation 1984-1988



Whilst the *National Institute's* simulation ends in 1988 it seems logical to suppose that with lower inflation and ERM membership the UK would not have required a tight monetary policy from the second half of 1988 to 1990. Consequently the UK would not have entered a unilateral recession in the second half of 1990. Nevertheless it is hard to see how the UK economy could have performed as well as the most successful ERM states between 1988 and 1990. Assuming ERM membership in 1979, the *National Institute* calculated that the current account deficit would have been even higher in 1988 at 4.2 percent of GNP than its actual level of 3.2 percent. [5]

Figure 7.3 :The Consequences of ERM Membership on Manufacturing Output and GDP Growth 1984-1988



Since the deficit was high in comparison with other ERM states such as France (0.4 percent) and Italy (0.7 percent), the UK would probably have needed to keep interest rates higher than other member states and pursued a more deflationary fiscal policy to maintain the sterling parity.[6] Since the deficit represented a weakness of the manufacturing sector, UK firms would have been in a relatively poor position to take advantage of the opportunities created for export-led growth by German reunification. The likely overall result would have been an economic downturn in the UK before recession hit the other ERM states in 1992 and 1993.

Entry in 1985 and 1986

Compared to entry in 1979, ERM membership in November 1985 would probably have caused serious problems for the UK economy. Sterling would have been condemned to a central rate of DM 3.75, nearly 30 percent higher than its eventual rate, without the scope for realignments which existed earlier in the decade. If the UK had devalued in 1986, then as a new ERM member it would probably have forfeited a significant amount of credibility, and the government would have been forced to tighten policy in response. Certainly, the government could not have achieved the nearly 30 percent devaluation that it secured outside the system. The boost to growth and manufacturing production in 1986 and 1987 would have been lost. At the same time, membership in 1985 would probably have produced a balance of payments deficit earlier, since the higher rate for sterling in 1986 would have decreased exporters' competitiveness and intensified the demand for cheaper imports. If a deficit had then destabilised sterling, the UK would have had to increase interest rates or tighten fiscal policy, both of which would have been detrimental to growth.

ERM entry in 1986 would have been far more beneficial to the economy since it would have stabilised sterling after rather than before the 1986 devaluation. Once the current account swung into deficit in 1988, a devaluation within ERM might have been possible if the UK had been prepared to take other actions to restore competitiveness and restrain domestic demand. Even if the Conservative government had initially believed that it could maintain an expansionary fiscal policy and control neither the credit boom nor wage increases, a reconsideration of policy would probably soon have been necessary. Once sterling was an ERM member, the foreign exchange markets were likely to view sterling in the same light as other ERM currencies. Sterling would have been subject to the prevailing informal rules and expectations about buying and selling currencies, and would have been a bad bet as an inflationary currency in a counter-inflationary exchange rate system. If the foreign exchange markets had extracted a price for the inflationary boom earlier, then the disastrous expnasionary 1988 budget would not have been possible.

In sum, if ERM membership had been used imaginatively then it could have provided an anchor for growth which was less driven by domestic consumer demand and more export oriented. Whilst growth might not have reached the peaks of the 1987 to 1988 boom, it would have been less inflationary and more sustainable. Consequently, the tight monetary squeeze of 1989 to 1990 and unilateral recession would have been avoided.

What future in the global economy?

The Conservative government's chosen course of action and inaction will have profound long term consequences for the UK economy. Its attitude towards exchange rate management represented an unwillingness to grapple seriously with the central economic question of the 1980s and 1990s - how to create sustainable employment given the destabilising effects of vast capital movements around the globe. Through the foreign exchange markets, technological advance and the deregulation of capital and financial markets put a new onus on governments using macro-economic policy for anti-inflationary purposes. Whilst unemployment has inexorably risen the option of countries making a unilateral dash for growth and job creation no longer exists without risking a huge capital exodus. By the mid-1980s the ERM represented a collective if temporary defence against the foreign exchange markets, a defence which created at least some room for monetary manoeuvre for a group of highly open and otherwise vulnerable economies. Whatever disastrous misjudgments were made after November 1989, in the 1980s at least the ERM represented a means of minimising the costs of destabilising capital inflows and outflows through collective credibility.

By operating unilaterally outside the ERM for so long the UK was forced to face the full brunt of capital movements. In the process one-fifth of manufacturing industry was destroyed and significant parts of the service sector which was supposed to replace lost manufacturing capacity were decimated in a second recession. From 1986 to 1988 non-membership of ERM and good luck allowed the government some short term fiscal autonomy. Yet even then ministers threw money at consumption rather than finely targeting expansion on generating employment.

Rather than search for an alternative solution to the problem which the ERM sought to address, the Thatcher government publicly celebrated the new 'market forces' and pursued policies and non-policies which increased the damaging consequences of those forces for the UK economy. Whilst export-led growth is generally not destabilising in the foreign exchange markets, ministers preferred growth driven by domestic consumer demand which usually will be unstable. Then, when the current account unsurprisingly went into deficit, the government did nothing to reverse the situation. As Japan has demonstrated, a good trade performance can be a crucial means of sustaining employment by minimising the negative impact of capital movements on a particular economy. Yet the UK government's economic policies simply ensured that for the foreseeable future sterling will be a strong candidate for speculative outflows whenever the mood takes the foreign exchange markets.

Since the end of the UK's short-lived membership of ERM, UK producers are unlikely to find any long-term respite from the costs imposed by the government's unilateral and ill-considered approach to the problem of capital movements. As an ERM member, the government overvalued sterling, failed to abide by the informal ERM rules and dodged all responsibility for sterling's exit from the system. If (one day) a UK government wishes to join another fixed exchange rate system, questions are bound to arise about sterling's credibility as a participant. In the long term, the price of a reputation as a non-credible currency is likely to be an interest rate premium over other European states.

Although the Major government's post-1992 policies helped stimulate at least a partial economic recovery and a fall in unemployment, in the long term they are likely to further weaken the UK's performance within the global economy. Since autumn 1992 policy-makers have been determined to reduce the PSBR through large public expenditure cuts and tax increases. Ministers are using a tight fiscal policy both for its own sake and as a counter-inflationary anchor to maintain sterling as a credible currency. However, using fiscal policy in this way is misconceived As Reich argues, it is now illogical to presume that government spending and borrowing might crowd out private investment or that it is necessary for any country to maximise national savings.[7] Since capital sloshes freely across national borders in search of the highest returns, the UK like any other economy has access to a vast pool of capital. Reductions in public expenditure will hence have a negligible effect on the level of private investment. At the same time, the foreign exchange markets have tended to view high budget deficits as an inflationary disincentive to buying a given currency only where governments increase deficits to finance domestic consumption.

Yet if the benefits of the Major government's fiscal policy are illusory, the costs most certainly are not. The severe public expenditure cuts which were implemented in 1992 and 1993 and planned for future years will further erode the transport networks and educational provision which the UK economy needs to compete in the global economy. In Reich's words:

> There is ... a growing connection between the amount and kind of investments that the *public* sector undertakes and the capacity of the nation to attract worldwide capital. ... The skills of a nation's work force and the quality of its infrastructure are what makes it unique, and uniquely attractive in the world economy. Investments in these relatively immobile factors of worldwide production are what chiefly distinguish one nation from another: money, by contrast, moves easily around the world.
>
> Well-trained workers and modern infrastructure attract global webs of enterprise, which invest and give workers relatively good jobs; these jobs, in turn, generate additional on-the-job training and experience, thus creating a powerful lure to other global webs. ...
>
> Without adequate skills and infrastructure, however, the relationship is likely to be the reverse - a vicious circle in which global investment can be lured only by relatively low wages and low taxes. These enticements in turn make it more difficult for the nation to finance adequate education and infrastructure in the future.[8]

Decision-making and Ministerial Fortune

The opening chapter of this thesis argued that politicians' behaviour on economic policy should be analysed within the context of a range of considerations driven by the desire for re-election and defined by the nature of the electoral cycle. In part this means that ministers will want to provide material benefits to sufficient voters particularly in the run-up to a general election. Yet however much the evolution of ERM policy can be explained in these terms, both a broad overview of the development of policy and particular decisions made in the third term of office do not fit easily into this perspective. Indeed, on occasion, ministers pursued options and took decisions which offered only extremely short term benefits and put their longer-term re-election in serious jeopardy. It is further difficult to understand how any Conservative policy-maker could have convinced themselves otherwise. In operating both ERM membership and non-membership, the government missed out on possible benefits and incurred unnecessary costs, and used inappropriate and inefficient means to achieve its ends. In this sense, decision-making became non-rational.

In terms of interest rates and exchange rate stability, the government missed out on the possible benefits that ERM membership offered during the 1980s, whilst incurring the costs which the system imposed in the 1990s. For most of the period from 1981 to 1989, ERM membership offered the government a relatively effective means of achieving exchange rate stability and lower interest rates for a given rate of inflation. By October 1990 membership was the only means by which the government could immediately achieve either end. Yet within a year the situation was reversed, as any sound assessment of the UK's economic performance and the likely behaviour of the Bundesbank could have predicted. In a recession as deep as that facing the UK, exchange rate stability was an unnecessary counter-inflationary discipline and interest rates were far higher than would have been possible outside the system, given the diametrically opposite positions of the German and UK economies. In purely monetary terms the government imposed on itself high interest rates and exchange rate instability outside ERM, and high interest rates and an uncredible stability for sterling inside ERM. In neither case did it maximise its electoral interests.

Beyond monetary policy, ministers wasted the opportunity that non-membership of ERM gave them to pursue an independent fiscal policy. Having used an increase in public expenditure in 1986 and income tax cuts in 1987 to secure re-election at the general election, Thatcher and Lawson proceeded with another expansionary budget the year after. By acting hastily in 1988 the Prime Minister and Chancellor wasted the opportunity to make further tax cuts towards the end of the electoral cycle. At the same time, they escalated the economic boom so that it could not possibly be corrected in time for an election by 1992 and forfeited at least part of their claim to be the party of low inflation.

The government's economic failure on ERM membership was compounded by a European Community policy in which the government paid the costs of both isolationism and activism without securing the benefits of either. The policy was not isolationist because despite the government's professed opposition to monetary union it agreed to the creation of the Delors Committee, and to start work on the Delors Report and the creation of an IGC. One former Cabinet minister commented on Thatcher's performance on EC policy:

> She was very powerful in her rhetoric, but then at the end of the day, she would say, "Well, I have said my piece and therefore I have salved my conscience. I have said that the Germans suffer from halitosis and the rest. And if that is what you want I did my best, and I will go along with what you want." It is very difficult to interpret her actions because she wasn't all that effective at blocking things.[9]

At the same time, the policy was not active because UK core executive actors were unable to bargain effectively within the range of EC forums deliberating on monetary union. Ultimately, ministers left themselves open to the charge both from Labour and from within their own party that they were too isolationist but were too weak to effectively present the government as a defender of UK national interests against the 'hostile' EC. In October 1990 Thatcher could not save herself from one final self-destructive act in allowing membership whilst simultaneously breaching the protocol of the system and creating further ill-will towards the UK.

Even within the terms and limitations of membership from 1990 to 1992, Major and Lamont failed to achieve the ends they sought. From the start sterling was not a credible ERM participant and the government's actions in both interest rate policy and reserve intervention only undermined that credibility further. In the words of one City economist: 'How and why the Treasury and the Bank saw fit to confront the might of the international currency markets from a position of abject weakness beggars belief.'[10] Whilst the Danish referendum in June 1992 heralded a period of instability for the whole system, the lira and sterling were prematurely ejected from the ERM that autumn because the financial markets quite rationally believed that the parities were unsustainable. The government later claimed that the suspension of the ERM's working arrangements vindicated its view that sterling's departure resulted from the system's 'fault-lines'. In truth, Black Wednesday cannot be separated from the failure of the Prime Minister and Chancellor to understand the relation between ERM membership and their own objectives.

The Breakdown of Core Executive Debate

After the series of broad-based discussions on ERM membership in 1985, Thatcher found herself isolated from almost all other senior core executive actors. Her response was to effectively veto any discussion of ERM membership for the next four years whilst retaining in office those who opposed her on the issue. With this background split in the Prime Minister-Chancellor axis, debate within the core executive on economic policy became unstructured and officials were marginalised, particularly at the Bank of England.

After the 1986 devaluation there was little open discussion of how to operate monetary and exchange rate policy outside ERM. From February

1987 to March 1988 Thatcher essentially left Lawson to choose and run an alternative policy for himself. Since Lawson's policy of shadowing the Deutschmark bore a clear relationship to ERM membership, and therefore Thatcher could not publicly endorse it, no broad discussion of its merits or likely effectiveness took place. The Bank of England was responsible for its implementation but was neither consulted nor properly informed about the decision. Without participating in any formal debate about monetary and exchange rate policy, the Bank was in a weak position to contribute to discussions on overall macro-economic strategy and the appropriateness of the fiscal-monetary policy mix.

In March to April 1990 Major persuaded Thatcher on a purely bilateral basis to use a public commitment to membership to talk sterling up as the main instrument of exchange rate policy, even though the Prime Minister was still privately opposed to membership. Since the deal did not recreate a firm Prime Minister-Chancellor axis on the issue, Thatcher's position continued to preclude any broad discussion of the policy and its consequences in terms of actually achieving entry or remaining outside the system. The Bank of England was again left in the dark about the rationale for the chosen monetary and exchange rate policy.

At the same time as the economic policy debate was deteriorating, the government's decision-making on European Council level EC issues became unco-ordinated and fragmented because the Prime Minister's position precluded any effective policy debate. Policy on monetary union was often determined by *ad hoc* Prime Ministerial decision-making very shortly before or at summits, notably at Madrid, when Thatcher suddenly decided that the government would develop an alternative to the Delors report. After Thatcher returned from summits, other Cabinet ministers were left to deal with the consequences of policies which were formulated without their input.

The unco-ordinated nature of the decision-making process was particularly well demonstrated by the government's handling of the Delors Committee and its aftermath. At Hanover Thatcher agreed to the creation of a committee on monetary union and then left Leigh-Pemberton to operate on his own within the committee. When she and Lawson subsequently became worried about the likely contents of the report, they initiated a series of broad core executive discussions to develop a strategy to manage the Committee. However, their intervention was too late and when the Delors Report was published over their objections, broad discussions within the core executive on European monetary matters ceased again. To try and reactivate any discussion on the issue, Howe was forced to convene an Anglo-Dutch summit on military policy.

In sum, the manner in which the core executive took decisions became erratic and susceptible to unilateral and unpredictable initiatives from within the Prime Minister-Chancellor-Foreign Secretary triangle. There came to be very little scope for structured debate of these initiatives between all the relevant core executive actors, even including those who would be responsible for dealing with the new policies on a day to day basis. As a result, decision-making by the whims of feuding ministers suppressed rational discussion based on knowledge and experience.

At the same time, after 1985 the substance of debate on ERM membership was reduced to a struggle by those who advocated membership to secure the Prime Minister's support for entry. Between 1985 and 1990 four visible shifts in policy occurred: the Madrid conditions; Thatcher's implicit repudiation of the conditions in October-November 1989; the public commitment to membership from May 1990; and entry to the system. All four were essentially *ad hoc* decisions unaccompanied by any formal Prime Ministerial meetings in which the strategic base of policy could be examined. The first two simply resulted from a shift in the power relations between the Prime Minister and her Chancellors. Before the Madrid summit, Lawson forged an alliance with Howe and the pair threatened a joint resignation. As a result, Thatcher was forced to make at least a public concession to them. When Lawson resigned office four months later, Thatcher was able to reassert her previous position as government policy and implicitly repudiate the Madrid conditions.

In March-April 1990 Major was able to shift Thatcher's position on a bilateral basis in part because of the Prime Minister's need to avoid conflict with her new Chancellor backed by a new Foreign Secretary. The decision to enter ERM was then conceded by Thatcher in October 1990 at the moment when she decided that further resistance was futile. During 1985 the Prime Minister held three broadly attended meetings to discuss membership. In 1990 the government entered ERM without any such meeting. And ERM supporters ignored the question of the appropriateness of membership at this time given the divergent monetary imperatives confronting the UK and the Bundesbank.

Policy on a Prayer

Whilst sustaining low inflation and some kind of balance of payments equilibrium were necessary to make ERM membership successful, ministers and officials ruled out the means to achieve these two ends. Those who supported ERM membership never addressed the incompatibility of their support for entry with their views that inflation was only a monetary phenomenon or that the balance of payments deficit was irrelevant. Their position would have been less ill-considered if the government's overall policy framework could have been easily adjusted once inside ERM. Yet at least on inflation the opposite was true. By presiding over the creation of a decentralised pay bargaining structure in the private sector, the government made it very difficult for itself to pursue any policy which linked wage increases to the demands of the national economy. Within the housing market asset price inflation was not an unfortunate outcome which could be simply avoided in the future. As Hutton notes, by the mid-1980s a whole edifice ranging from DIY superstores to estate agents chains was created on the basis that the two million houses bought and sold each year would continue forever. Similarly banks lent to small businesses not according to their business prospects but more on the degree of collateral through housing equity they could provide. The government allowed activity in the economy to be structurally dependent on rising housing prices.[11] To compound the problem, ministers made a rhetorical political investment in the policy framework by proclaiming that in a free-market economy there neither was nor should be an alternative.

It is particularly striking that core executive actors retained their ill-considered view of macro-economic policy relationships even when practical experience was demonstrating the fallacy of their intellectual framework. When Lawson made his first bid for ERM entry as Chancellor, the inflation problem lay dormant because the government was careful to trumpet its counter-inflationary credentials. However, outside the ERM from 1986 to 1990, the government pursued policies which were directly inflationary: and it failed to pursue policies which would tackle inflationary pressures in the wage market. By the second half of 1988 rising inflation made it difficult to sustain sterling without high interest rates, and by the second half of 1989 and 1990 to sustain sterling at all. Yet only at the Bank of England did any supporters of ERM membership adjust their position to the changing economic conditions produced by the government's own policies.

On the balance of payments, ERM supporters turned a blind eye to its relation to membership even in 1985. Although the overall current account remained in surplus, underlying problems of competitiveness in the manufacturing sector were emerging. Lawson and the other actors within the core executive did not accept that the prospective external deficit constituted a potential problem, since they believed that it could easily be financed given the level of international capital flows. Between 1986 and the second quarter of 1989 their view was to some extent vindicated because the deficit only produced short episodes of sterling weakness in September 1986, May to June 1988 and November 1988.

However, from May 1989 the deficit became a manifest constraint on the government's ability to pursue exchange rate stability as a policy. The financial markets increasingly took the view that since the deficit would constrain growth (with consequent costs in terms of output and employment) the government would ultimately allow sterling to depreciate to deal with the problem. By 1990 international capital flows were stabilising after the expansion driven by financial deregulation. International investors were increasingly careful about where they directed their money and were less willing to hold a range of different currencies and international assets, particularly when their money was being used to finance excessive consumption. Despite this evidence, supporters of ERM membership continued to press their case in 1990 without changing course. They did not seek either a devaluation or action to tackle the structural aspect of the deficit, by shifting resources from the consumer service sector (which could not export) to recreate a broad manufacturing base (which could). They simply secured Thatcher's acceptance of membership without anyone examining just how membership was supposed to work.

In the same way, Thatcher's opposition to ERM membership flew in the face of the manifest failure of the monetary targets and her own acceptance of the costs of practicing benign neglect towards the exchange rate. The pursuit of exchange rate stability offered Thatcher a counter-inflationary framework centred around interest rates, and consistent with her rejection of policies which assumed relationships between costs and demand and inflation. Whatever disadvantages Thatcher saw in membership, it was the most attractive means to pursue exchange rate stability since for a given rate of inflation, it offered lower interest rates.

By trying to pursue exchange rate stability outside ERM, Thatcher left a perennially open question: if the UK was serious about exchange stability and was not prepared to allow sterling to depreciate, why was it not a member of ERM, (given that the system had a successful record of delivering exchange rate stability)? Thatcher acted as if the costs of the public airings of divisions over ERM membership did not exist. For in the specific sense that the government wished to control inflation once the money supply targets were discredited by a *monetary* counter-inflationary policy, ERM membership was always an inevitable outcome. If Thatcher ever wanted to do more than delay membership then she would have had to construct a counter-inflationary framework outside the vestiges of the MTFS. Like the ERM supporters, Thatcher ended up willing an end whilst she renounced the means to achieve it in large part because they both refused to accept that inflation was more than a monetary phenomenon.

The government's general tendency to make decisions which lacked any kind of empirical rationale can only be termed government by faith and hope. One influential account of UK economic policy-making argues that the government concentrates on massaging back to normality those variables which show signs of going badly wrong, a pattern of policy stability punctuated by crisis management. However, Conservative ministers took decisions which were always likely to create crises for themselves. At the macro-level ministers were aiming after 1983 to deliver as low as possible inflation for the lowest interest rates and the lowest taxes, without using any counter-inflationary policies which could be labelled as a return to the 1970s. Yet these priorities were always likely to conflict with each other. The government appeared to react by seeking the maximum potential reward on each priority, assuming that particular policies were successful and without costs in terms of another priority. As a result, ministers made their calculations of the costs and benefits of particular policies not in terms of the most likely outcomes given past experience but in terms of the most beneficial possible outcomes. By discounting the potential cost in terms for one priority of maximising on another, the government risked having to pay a higher cost in terms of one or another or both than by initially trading off between priorities. Ministers maintained this stance even when the basis for the most beneficial scenario occurring was nothing more than hope for the best. Even for economic benefits crucial to the government's electoral benefits, adverse policy consequences were only dealt with after they occurred and not assessed *ex ante* in the decision-making process.

The Thatcher-Lawson Conflict

The Prime Minister and her fraught relations with successive Chancellors were central to the government's problems. Conflicts over sterling and personal struggles of ambition between Prime Ministers and Chancellors have been regular occurrences - Attlee and Dalton, Wilson and Callaghan, Wilson and Jenkins, and Callaghan and Healey. However, the Thatcher-Lawson schism was uniquely resonant in terms of the core executive's whole approach to decision-making.

By the Conservatives' second term of office the Prime Minister and Chancellor were firmly established as the core political actors due to the early predominance of economic objectives and Lawson's unwillingness to accept the subordinate role adopted by most of Thatcher's ministers. As a result the Prime Minister-Chancellor axis often dominated the core executive beyond economic policy. Their alliance or their divisions were influential on a range of issues from the poll tax to health policy to education. To some extent, and apparently in the view of the protagonists, the conflict over ERM membership eventually became a personal struggle for power over economic policy between the two most influential actors in the core executive.

Such a conflict was always likely to cloud the objective economic issues at stake. However, given the two ministers' general approach to office, the rise of a direct European component to the issue in 1988 left the government with little opportunity to pursue a coherent policy. Europe could not be ignored as an issue either on political or economic grounds. Politically, there was no alternative to the Community and the UK's effectiveness in the Community would be diminished outside ERM. Economically, the government's reliance on monetary policy and the exchange rate as its central policy tools left it particularly dependent on maintaining international confidence, which could not be divorced from ongoing openness to Europe. Given the pursuit of strict financial and fiscal discipline, the UK could perhaps have avoided joining ERM. However, the government's belief that it needed to offer more than low inflation to voters ensured that this was not the case. In an open economy, exacerbated by the government's own choices, the go-it-alone solution (which defined the original Conservative project and for which Thatcher kept striving) evaporated.

Yet for the Prime Minister and Chancellor to fully embrace a

European solution to their problems after 1988 would have seriously jeopardised their established governing framework. Whether Lawson realised it or not, ERM membership was ultimately likely to produce pressures to adopt policies from which he and the Prime Minister recoiled. Similarly, Thatcher and Lawson were not well equipped to be effective players in EC decision-making either in terms of providing the necessary rhetoric or in the kind of international realpolitik required. At the same time, their dominance of the core executive marginalised those with a potentially greater understanding of the terms of the EC's operation, both within the Cabinet and inside the Foreign Office and the Bank of England.

Thatcher and Lawson were left trapped between their inability to maintain a set of policies which did not include ERM membership, or to embrace it as part of a full-blooded alternative. In the vacuum, their conflict moved into a feud over tactics. Consequently, even when Thatcher and Major apparently succeeded in resolving the conflict, the resolution did not amount to a strategy. In effect, Thatcher agreed to membership as a final effort to secure the benefits which the Conservative's original economic policy framework could no longer deliver, yet without renouncing that earlier effort. Consequently she did not leave either herself or the rest of the core executive in any position to use membership within a European policy framework. By entering ERM Thatcher formally accepted the constraints imposed by the open economy. However, she left in place a policy framework, both as a process and a set of assumptions, which excluded full attachment to the EC and any new means of controlling economic benefits beyond the short term. Unsurprisingly it proved impossible to reconcile the implications of ERM membership with the approach to core executive decision-making which emerged under Thatcher's premiership.

7.3 CONCLUSIONS

Yet if the ultimate aim of the Conservative's economic policy was to retain office, then they were successful. Ministers were fortunate to operate in economic and political conditions in which it was possible to win elections whatever the magnitude of the mistakes which they made. Indeed, achieving re-election for the Conservative government actually put little premium on securing even the semi-optimal performance of UK producers.

Ministers were able to use their regulatory powers to give a general stimulus to certain sectors of the economy without orientating their macro-economic policy to maximise the interests of any sector. Given a divided opposition, the operation of the electoral system meant that the government only needed to provide economic benefits for a relatively narrow constituency, which could exclude those who worked in manufacturing industry or more to the point formerly worked there. The government's privatisation policy gave it the means to provide big income tax cuts without having to increase government revenues elsewhere through sustained economic growth. By deregulating bank and building society lending, the government created benefits among a new class of mortgage holders, a prosperity which did not require the productive side of the economy to perform effectively. When the consumer-driven boom eventually turned to recession in time for the 1992 election, the Conservatives could still successfully portray themselves as a less worrying alternative on economic policy to the opposition parties. Given this unique set of circumstances in which the Conservatives' inability to pursue effective policies for the UK's producers did not matter, neither ministers nor officials faced sufficient incentive to critically evaluate their approach to decision-making.

Macro-economic policy-making is a unique policy-making area. It is a closed policy arena and decisions must be made in an unpredictable and fast-moving international environment. On the issue of ERM membership, this posed clear difficulties for policy-makers in terms of managing a volatile currency in the rapidly fluctuating foreign exchange markets, making trade-offs between economic and European policy and taking a (supposedly) big strategic long term decision against a background of UK economic under-performance. Whilst the discussion above has been heavily critical of certain aspects of Conservative economic policy-making, the difficulties that any Prime Minister and Chancellor will face in pursuing an effective policy given the policy-making environment should not be ignored.

The Prime Minister and Chancellor are closeted in a closed and secret policy-making environment against the enormous backdrop of the foreign exchange markets where their every public word might have huge consequences. Perhaps it should not be surprising if these two actors develop an intense self-consciousness about their capacity or responsibility for action. In this situation, the personal psychological impact of any action may become more important than the objective policy rationale of that action. For example, could Thatcher simply have treated questions on sterling and ERM membership as an act of self-definition because that is how she had come to see the issues?

In a more accountable system of government the need to properly explain policy might break that self consciousness. Yet in the UK the Prime Minister and Chancellor have nothing to fear from scrutiny by the legislature and there are no effective tripartite structures which could serve as forums for open discussion with external business and labour interests. Without any kind of freedom of information, the media generally feeds off insider official information on economic policy and so reinforces a culture of secret knowledge and self-importance. With a few exceptions the financial press in the second half of the 1980s reinforced the Thatcher-Lawson struggle by defining their economic commentary in the same terms and unreservedly supporting the Chancellor. Those journalists who stood out against the trend were simply dismissed as unreconstructed Keynesians.

At the same time, the public language which the Prime Minister and the Chancellor must use in economic policy may have a generally distorting effect on decision-making in two ways. First, the foreign exchange markets tend to respond as if there is an optimal policy which policy-makers could be pursuing, so ministers' public discourse tends to contain a strong element of optimal or even idealistic purpose. As a result, it becomes costly for ministers to admit that errors have been made and once some mistakes are made they may not be reversed, even when further seemingly irrational decisions are then required. For example, unless Major and Lamont were prepared to devalue sterling and take a risk on the inflationary consequences, they could never admit that either entry to ERM in a recession or the DM2.95 parity were a mistake. Consequently policy could not be adjusted to stimulate growth and the cost of the original error was increased.

Second, it is possible that the incongruence between policy-makers' public language and their private knowledge of policy problems affects their approach to decision-making. Can a point arise when the incongruence between the presentation of policy and its real rationale becomes psychologically too hard to bear without adjusting one to the other? If policy-makers find it difficult to sustain two diverse realities, then will the public language which is less flexible in the short term and contains a more preferable 'optimal solution' start to influence decision-making itself? Although ministers operate in many policy-areas with a public rhetoric at odds with their private motives, only in economic policy is policy-makers' language so intensely scrutinised. And only here does any tiny casualness have such huge consequences. Moreover, only in economic policy are the two actors who deliver the public rhetoric so uniquely responsible for decision-making itself.

Using Goffman's terminology in *The Presentation of Self in Everyday Life*, the Prime Minister and Chancellor have to give an unremitting performance to the foreign exchange markets which ultimately may affect their private judgment.[12] Goffman defines performance as all the activity of an individual which occurs during a period marked by their continuous presence before a set of observers and which has some influence on the observers.[13] The performer will seek to control the impression which the observers receive of the situation and so will stage a reality removed from the more complex and messy reality. Yet the performer asked to compress two different roles into the same individual can easily suffer from self-deception:

> A performer may be taken in by his own act, convinced at the moment that the impression of reality which he fosters is the one and only reality. ... In such cases the performer comes to be his own audience; he comes to be performer and observer of the same show. Presumably he intracepts or incorporates the standards he attempts to maintain in the presence of others so that his conscience requires him to act in a socially proper way. It will have been necessary for the individual in his performing capacity to conceal from himself in his audience capacity the discreditable facts that he has had to learn about the performance; in everyday terms, there will be things that he knows or has known, that he will not be able to tell himself.[14]

In this sense policy-makers may at least partially substitute the 'reality' of their public discourse for their private knowledge and make choices without an empirical rationale. For example, it is quite plausible to suggest that Major and Lamont could not completely separate their 'performance' to the foreign exchange markets that the commitment to the DM2.95 was absolute and credible from the view which they took on sterling as the prime if not sole actors in decision-making.

In sum, it is quite possible that the general economic policy-making environment in the UK reduces policy-makers' capacity to make effective and rational choices. Certainly, comparative core executive analysis could shed some further light on whether the structures of UK decision-making create unique difficulties for ministers in dealing with the foreign exchange markets. At the same time, the Major government itself has implicitly admitted the need for greater openness in economic policy-making. The government now consults on a regular and formal basis with seven prominent economists and has at least marginally strengthened the position of the Bank of England within the core executive.

Nevertheless, the problems of UK economic management continue. Whilst the economy is no longer suffering from a feuding Prime Minister and Chancellor, the Conservative government still remains in a weak position to pursue any kind of effective policy on sterling. If Major and Clarke are personally better equipped on the European stage than were Thatcher and Lawson, they have to contend with a small parliamentary majority and a party with a distorted perspective on international economic issues. When the go-it-alone solution comes to an end yet again, the Prime Minister's and Chancellor's room for manoeuvre will be restricted by a party fetish which has scapegoated managed exchange rates (rather than the circumstances of the UK's membership of ERM) for recent problems. To all intents and purposes the ERM is now back in action. However, the Major government is too preoccupied with problems of party management over the general question of Europe to consider the long term strategic questions about the UK's relation with the reborn system, or the economic realities of the impending single European currency. Without any fundamental reassessment of economic policy-making, the UK's economic problems in an environment defined by global capital flows seem likely to continue.

ENDNOTES TO CHAPTER 7

1. Non-attributable interview.

2. National Institute of Economic and Social Research (1989), 'The Consequences of Full EMS Membership,' *National Institute Economic Review,* August 1989, 8.

3. D. McKie, (1992) *The Election: A Voters Guide,* London: Fourth Estates, 103.

4. National Institute of Economic and Social Research, 'Full EMS Membership,' 8.

5. National Institute of Economic and Social Research, 'Full EMS Membership,' 8.

6. McKie (ed), *Election,* 103.

7. R. Reich, (1993) *The Work of Nations: Preparing Ourselves for 21st Century Capitalism,* London: Simon and Schuster.

8. Reich,*The Work of Nations:,* 264-265.

9. Non-attributable interview with Cabinet Minister.

10. *The Guardian,* September 18, 1992.

11. *Guardian,* June 8, 1992.

12. See E. Goffman, (1959)*The Presentation of Self in Everyday Life*

Harmondsworth: Penguin.

13. Goffman, *Presentation of Self*, 32.

14. Goffman, *Presentation of Self*, 86.

APPENDIX I: RESEARCH METHODS

Printed Media

Since a systematic search of all quality newspapers using 'Profile' was impossible to finance, I used the *Financial Times*, the *Times* and the *Economist* as my main media sources for the thesis. The *Financial Times* and the *Economist* provide the most comprehensive and detailed coverage of UK politics and international economic developments on a daily and weekly basis respectively. The *Times* was used in preference to other daily publications simply because it and the *Financial Times* are the only two British national newspapers taken by the library of the London School of Economics. Using the annual indexes, I found and examined every article which related to the UK and the ERM in the *Financial Times* and the *Times* and the ERM in general in the *Economist* between 1979 and 1990.

After having read the secondary literature and assessed all the relevant media material, I wrote draft versions of Chapters Two to Six. My aim was to have a clear idea of the broad development of policy and the central issues involved to maximise the utility of the elite interviews.

Interview Methods

Initially I requested interviews with 49 people involved to a lesser or greater extent with the issue of ERM membership either from within the core executive itself or as an interested external party. I was particularly interested in contacting people who faced the issue in more than one capacity, for example, officials who worked in different areas of Whitehall and those with significant experience both inside and outside the core executive. Twenty three people were unwilling or unable to see me. A particular problem was that many of them received letters shortly before the UK's abrupt exit from ERM in September 1992 which made the whole topic of earlier ERM policy-making highly sensitive

Eventually, I conducted 26 interviews over a sixteen month period in 1992 and 1993. The interviewees were all involved in at least one and sometimes several of the following capacities:

- as a former Cabinet or junior minister;
- as official at the Treasury, Foreign Office, MAFF, the Cabinet Office, the Number 10 Private Office or the Bank of England;
- an adviser to a minister;
- a European Commission official;
- or as a member of a business organisation.

Overall, officials significantly outnumbered ministers and most officials were from either the Treasury, Foreign Office or the Bank of England.

The interviews were conducted in person with one exception which involved written correspondence over written questions. Those conducted in person ranged in length from half an hour to two hours and all but three were tape recorded. I asked the interviewees to recall their memories of particular periods of decision-making and to comment on my interpretation of general themes. The particular questions for each interview depended on the interviewee's position and period of involvement, and the point in time when they were interviewed. People interviewed towards the end of the period were often asked about claims made in previous interviews

All the interviews were conducted on a non-attributable basis. Given the ongoing sensitivity of the issue, this was insisted upon by all interviewees. Where possible the approximate institutional position of the interviewee quoted or referred to is cited but the requirements of anonymication sometimes make even this guidance difficult.

Obviously citing non-attributable interviews as evidence is an imperfect approach. The reader is in no position to judge for him/herself about the status or credibility of the source. In addition, using interview evidence necessarily involve the researcher in making judgments about competing subjective memories and claims. However, although the approach is not perfect is not sufficient reason to withdraw it. First, without assuring interviewees of non-attributability, no interviews would have taken place. If political scientists are serious about understanding more about core executive decision-making on the most politically sensitive and significant issues, then they have to accept the terms on which core executive actors will allow themselves to be interviewed.

Second, it is possible to make reasonable judgments about the validity of particular information offered through cross-referencing or 'triangulating' evidence, comparing claims with other interviewees responses, documentary sources and mass media coverage. For example, the suggestion in Chapter 2 that Geoffrey Howe came to support membership in 1981-1982 was based on evidence to this effect by three interviewees, one of whom was a personal friend of Howe but opposed to ERM membership, one of whom was a personal friend of Howe and a supporter of membership, and the third who opposed membership and had generally clashed with Howe. Within the course of any particular interview, it is also possible to judge the extent to which the interviewee is generally trustworthy as a source so long as the interviewer has a good overall grasp of the subject under discussion. Those interviewees who seek to sell a suspect line in one part of the interview were treated more sceptically when offering new information than might otherwise be the case. As a broad rule, no information from any particular interviewee has been used unless there is some other reason for believing it to be true.

Future historians with access to official papers will inevitably be able to provide a fuller and more accurate account of the development of the UK's policy towards ERM from 1979 to 1990. The reader can certainly not take this work as the final word on the subject - for example, the record of the discussions which took place about ERM membership in late 1981 and the start of 1982 is most clearly incomplete. Nevertheless, the evidence which is currently available and utilised in this thesis has certain merits., The printed media now produces a more rigourous coverage of the activities of the UK core executive than was traditionally the case. Whilst the press did apparently sometimes get it wrong, broad positions ascribed by the press to ministers and officials between 1979 and 1990 were often borne out by insider accounts. At the same time, the interviewees, sometimes unwittingly, offer a unique insight into the atmosphere in which and the assumptions on which the core executive took decisions on ERM membership during the Thatcher governments.

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