

The sad history of the Exchange Rate Mechanism

In interviews about Nigel Lawson I have discovered a lot of journalist uncertainties about shadowing the DM and seeking to join the Exchange Rate Mechanism. Let me tell you more of what I know, based on the advice I gave Margaret as her Economic Adviser /Head of Policy Unit in the middle period, and as an informal adviser in the later years.

I argued that ERM membership would be destabilising. When the pound was rising money would be created to sell pounds, swelling sterling money and credit. This would prove inflationary. When the pound wanted to go down the Bank would buy up pounds. This would be contractionary. I wanted the government to stick with the Medium Term Financial strategy Nigel Lawson had helped to create. Margaret agreed and thought her new Chancellor accepted the position. She made her view clear.

It later became apparent to me that despite the MTFs in place, despite the PM's wishes, and despite the absence of any formal statement to Parliament of a change of economic policy control the Treasury and Bank were shadowing the DM. Interest rate moves seemed to be related to maintaining the exchange rate. I appreciated this was an inconvenient view for the PM but she came to believe it. One day when I was with her in the study she turned on the news only to hear the BBC claim a policy shift based on DM fluctuations. In later years Treasury pressure to join the ERM worsened the relationship with Number 10 more.

It was a sadness that a good reforming Chancellor who worked well with a reforming PM and her advisers on tax cuts and privatisation got into a fight over using the DM exchange rate as the economic control. In the later Thatcher years following the DM led to excessive money and credit creation and to inflation. The Treasury who never much liked tax cuts tried to blame them for the inflation. In the 1980s the Treasury and Bank worked closely together and Ministers were involved in interest rate and money policy.

The ERM led to the economic problems of the early 1990s, undermined the Conservative reputation for economic competence and was the reason for the defeat in 1997. The irony was this bad economic policy was supported by the other main parties, the CBI and TUC.