The economy and ERM membership

*The **Governor** discusses[1] the difficult economic environment in the United Kingdom and the calls these difficulties have prompted for lower interest rates or a lower exchange rate. He argues strongly that current conditions and policy are the necessary response to the resurgence of inflationary pressures, since only be subduing inflation can a durable strengthening of the domestic economy be achieved. Premature relaxation of monetary restraint would undermine the credibility of policy. He stresses, too, that the decision to enter the ERM should be seen as re-inforcing anti-inflationary policy through public acceptance of the disciplines that membership involves, and depends for its success on establishing a clear commitment to price stability: any readiness to lower the exchange rate would undermine belief in that commitment and so be more likely to require higher, rather than permit lower, interest rates.*

As we all know, for well over two years now, interest rates have deliberately been kept high. This followed a period in which domestic demand grew excessively, leading to a resurgence in inflation, and that can only be described as a major setback after the successes during the early 1980s in getting inflation down.

There has inevitably been a price. And this can make it difficult to appreciate that current conditions and policy are not themselves the problem, but rather the necessary response to the problems created by the earlier excessive growth. The important thing is to recognise that current policies will work; and, indeed, inflationary pressures *are* beginning to ease.

The key has been the deceleration of domestic demand. This has made it possible for more domestic output to be devoted to exports and import substitution, and so we have seen some improvement in the current account, which is welcome. But it is also true that slowing domestic demand has been reflected in falling output and productive activity. There can be quibbles about whether or not the statisticians have conclusive evidence that we are in a recession. But it is obvious enough that it looks like a recession and feels like a recession. Sadly, 1991 is likely to be a hard year for everyone, and a painful one for many. As in all recessions, financial difficulties in the corporate sector have increased. There have already been company failures. And it would be foolish to pretend that there will not be more.

The picture here in Scotland has been slightly different, and favourably so. The Scottish economy seems to have come through the last several years much more smoothly than other parts of the United Kingdom, notably the South East of England. The boom here was never as feverish as in the South East; and the recession and its consequences are so far less severe. But it will nevertheless affect us all.

This is the domestic economic background. It is uncomfortable. But we need to be realistic about it.

In particular, it has a bearing on the calls for lower interest rates, or a lower exchange rate, or both. I am very well aware that for many this seems the obvious course to take.

But it has been tried in the past, and failed. Indeed, there is in these calls, if I may say so, an element of short-termism—a vice about which we hear so much. Attempts to employ monetary policy to anaesthetise us against the pain of an economic slowdown would in the longer run only lead to greater problems—and hence even more pain when we eventually applied the remedy. The only way to achieve a *durable* strengthening in the domestic economy is by subduing inflation first; and in this respect it needs to be remembered that we did not get inflation down in the early 1980s without pursuing robust policies.

The running sore of inflation has been the single greatest obstacle to sustained economic success in this country. It has left us behind our major competitors. In a very obvious and direct way, inflation has hurt savers and those on fixed incomes; the retired have often been badly affected. But it goes deeper than that. Inflation infects all economic and business decisions; it makes us think of the short term rather than the long term; and so it discourages fixed investment. It creates a false impression of rising values; a successful economy cannot be built on false impressions.

I am glad to say that, in fact, there *are* signs that underlying inflation is now flattening out. But there has not yet been a decisive downturn. To relax prematurely would seriously dent the credibility of policy and expose us to the risk that inflationary pressures would again revive, jeopardising the long-term prospects of our businesses and so our prosperity.

(1) In a speech to the Institute of Bankers in Scotland, in Glasgow, on 14 January.

This time round, we must both get inflation down and *keep* it down.

The decision last October to join the exchange rate mechanism of the European monetary system can be seen in this light. It reinforces our anti-inflationary policy through the public acceptance of the discipline embodied in the obligation to keep sterling within fixed bands against other ERM currencies. In this way, the ERM provides a clear framework for monetary policy; and it provides an external discipline on policy-makers. The flexibility we have as policy-makers depends on the performance of sterling in the band; and this, in turn, depends on the credibility and consistency of our policies. For businesses, the ERM offers a more certain environment within which they can plan investment decisions and identify more clearly than in the past the constraints about product pricing and pay settlements. Once again, this requires consistency and resolve from policy-makers. No-one should have any doubt about that resolve.

It is important to make that clear, as it has been suggested that the economy is suffering unnecessarily because our central parity of DM 2.95 is too high, requiring interest rates to be kept too high to defend it. I categorically reject this view. Our central rate against the other Community currencies was not abnormally high; indeed in real terms, our rate of entry was below the average over the previous decade. So we are not trying to defend sterling at an unrealistic level.

In addition, we should not imagine that life would have been any easier outside the ERM. We would still have wanted a strong exchange rate and high interest rates in order to bear down on inflation. In fact membership—and in particular the reassurance provided by the lower limits for sterling—appears to have had a powerful calming effect on the behaviour of the foreign exchange market, and may have allowed somewhat easier interest rates than would otherwise have been feasible. No-one can know for certain, but I think it likely that if we had *not* been in the ERM, the political uncertainties towards the end of last year would have led to a substantial weakening of sterling, forcing us to put interest rates up—and I mean up from 15%—to offset the inflationary consequences.

High interest rates are not, then, some externally-imposed burden on the economy, unrelated to our domestic needs. They are a necessary part of establishing our commitment to price stability, and achieving that price stability through the impact on demand. And the ERM mechanism will require high interest rates of us until it is clear to the markets that we are determined to succeed and that rates can safely be lowered.

Changing the policy on ERM would, in effect, mean abandoning the objective. But as markets come to appreciate this commitment—but not before—rates will be able to come down within the ERM to levels that, frankly, we could not achieve simply by an unearned and premature policy relaxation outside it. Conversely, if we were seen to abandon the objective and to be prepared to lower the exchange rate, interest rates would be more likely to be forced up, not down as some commentators seem to think.

A good deal is said in this context of course about our competitiveness. But we all recognise that our long-term and fundamental competitiveness depends on the ability of our businesses to control costs and offer attractive, high quality products. The short-term competitiveness brought by exchange rate depreciations is all too illusory, and actually damaging, through the way inflationary pressures are fuelled. We have seen this in the past. The ERM makes us face this challenge squarely.

Together with wider world developments, ERM membership also provides a fresh impetus for looking carefully at economic developments in other countries, and the market reaction to them. Perhaps I could therefore conclude with just a few words on this.

For example, it *is* true that the sterling/dollar rate has risen very sharply recently—it went up by nearly 20% last year—causing difficulties for companies trading with the United States, or directly or indirectly competing with American producers in other markets. This change is, of course, part of a more general weakening of the dollar, which affects different countries in different ways. The steps which the United States has taken to rein back its budget deficit are extremely welcome, and perhaps more substantial than some people have supposed. It is questionable, however, whether they could be expected to strengthen the dollar; indeed a significant influence on the dollar recently has been the steady easing of interest rates in the United States, provoked by evidence of slowing-down in the economy.

The situation in Germany is rather different. Germany is currently facing strong and unavoidable domestic demand pressures arising from unification, and the need to re-equip East German industry so that its productivity can be brought up to the levels of the West. The current policy issue facing Germany is to what extent unification should be financed through higher taxes or restraining growth in public spending and how far it will be necessary to resort to high interest rates to stimulate private saving and attract capital from abroad. Given the concerns of many other countries to avoid recession, my judgement is that the international interest would best be served by fiscal restraint in Germany, so that domestic demand and the upward pressure on German interest rates could be contained. But whatever happens on the fiscal front, it will be essential for German monetary policy to be kept tight enough to resist domestic inflationary pressures.

Other Community countries are differently placed. For example the situation of France, where demand is slack and unemployment is rising, is in some ways similar to ours. I think it very significant that it has not been suggested by the French authorities that the ERM parity of the franc against the German mark should be changed: *France has learned the drawbacks of soft options.* And so must we.

Conclusion

I am afraid I have described a gloomy picture for the period immediately ahead. Industrial businesses and policy-makers face a very difficult environment, with both the UK economy and the international economy slowing down.

The best way through is to recognise conditions for what they are, and adjust behaviour. The people of Scotland, like those in the rest of the country, can best protect themselves from economic hard times by taking seriously the authorities' determination to subdue inflation, and by looking upon ERM membership, and the associated exchange rate parities, as facts of life to be taken into account when taking decisions about prices and wages. If this message and its implications are fully understood, then we can have what we all really want—namely both lower interest rates and a permanently stronger economy—more quickly and at less cost.