THE FOLLIES OF BRITISH AND EUROPEAN MONETARY POLICY

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"You can't buck the market", said Prime Minister Margaret Thatcher in early 1988. Yet that is precisely what the British Government is now, in 1990, committed to doing with the value of sterling against European currencies in the Exchange Rate Mechanism. For the present there are wide bands, although it is clear that there will soon be narrow ones of two-and-a-quarter per cent. The decision is the second major economic mistake that the Conservatives have made since the middle of the 1980s. (I shall come to the first later and show how it arose from the same roots.) Mistakes of that order are rarely forgiven by electorates, not so much because the Government is seen as departing from its principles as because of the effects in the real world - that is, a resurgence of inflation.

ECHOING HAROLD WILSON

The latest rhetoric of the Chancellor of the Exchequer is beginning to sound depressingly like that employed by Harold Wilson in the disastrous years when the Labour Party attempted to control the value of sterling under the Bretton Woods agreement. Already there are echoes of Mr Wilson's famous bit of nonsense that a devaluation "will not affect the pound in your pocket". The second point of contact with those years is the strident demands we are now hearing for workers to limit their wage increases. In the days of floating exchange rates any increase in our unit labour costs compared with other countries could be met by a depreciation in sterling. That was as sensitive to economic conditions as the flap of a butterfly's wings. Now that is impossible. The only real alternative (since people cannot be expected voluntarily to accept falls in their real standards of living) is wage controls, precisely the remedy that failed so spectacularly in the 'Winter of Discontent' of 1979. Thus the decision to break with principle in one area leads inexorably towards breach of principle in another, and wage controls may be the outcome. It is possible that the Government will also have to introduce controls on capital movements ('temporary' ones are allowed by the EEC Commission), the abolition of which was one of the first moves made by the Government in the direction of freer markets in 1979. Thus the attempt to control sterling may push the Government into two possible further breaches of principle: controls on wages and controls on capital flows.

THE POWER OF PRINCIPLE

Continuing the theme of how one breach of principle has knock-on effects in other seemingly unrelated areas, I wish to broaden the perspective for a moment. The Government, having accepted the logic of EMS, will be drawn inexorably towards a single currency for the whole of Europe. There will be no escape from logic. The baleful effects of that can be seen by looking at the micro level. Britain itself is an economic area which has a single currency, and, although this is often overstressed, there are some regions that are far more depressed than others. If they had had their own currencies they would have been able to allow them to devalue, so that their competitive position could be evened up. They cannot do so, and the only alternative is Government grants to the regions, which inflict severe distortions upon normal economic life.

If Europe becomes an economic area with a single currency the same effects as occur in the regions of Britain will occur throughout Europe. That will cause demands for EEC grants to poorer economic areas on a huge scale. European taxation will be imposed and vast schemes dreamed up by bureaucrats to 'benefit' countries like Greece, Spain and Portugal. The cost to the richer areas will be tremendous.

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Indeed, Mr Delors realises that this will be the outcome of a single currency, so regional grants are precisely what he is proposing to put in place. It is into this nightmare that we are now being drawn. We have unblocked the dam and there will be nothing to prevent the torrent.

Such is the power of principle that once a single currency has been established by the Eurofanatics there will immediately be calls for its value to be held steady against the Yen, the Dollar and the other currencies of the world. To do that (particularly in the increasingly difficult circumstances that will ensue from a single currency) will require further massive tax raising capacity vested in a central European Bank or Government. As yet there is precious little democratic control over European institutions and therefore little control over the way our money will be used.

A further instructive example from very recent monetary experience concerns the unification of Germany. That has led to a single currency in that country (hailed rather naively at the time by Mr Heath as an example of how easy it would be to introduce a single currency for the whole of Europe). The effect is that West German taxpayers are now having to foot a massive bill for grants and subsidies simply to keep East Germany afloat and to prevent everybody leaving immediately. Herr Pohl of the Bundesbank has become considerably more lukewarm about the rush towards a single European currency after seeing the effect of a single currency in his own native land. Mr Heath has turned his attention to the Gulf.

OTHER FOOLISH EPISODES

To return to the merely British scene, all the attempts to control sterling have ultimately had to be abandoned. In 1925 Churchill (who was always a paternalist as far as economic policy was concerned, and whose crossings of the floor of the House of Commons occasioned no ideological change) took Britain back onto the Gold Standard, but that had to be abandoned by the National Government in 1931 and had a depressing effect on British Industry. The Bretton Woods system of Exchange control was ultimately abandoned in 1971 when sterling was allowed to float freely, but only after titanic struggles to hold the value of the pound steady against other currencies.

Other interventions in the market place by Government have eventually come to grief. The OPEC oil cartel, formed to keep prices high, eventually met its nemesis after the normal forces of the market had pushed down consumption and made more profitable the search for other sources of oil, for instance in the North Sea. The United States' attempt to hold the price of gold down to $35 an ounce by keeping a massive amount of it at Fort Knox was eventually destroyed because it depressed production but increased the demand for gold, and because the policy proved impossible to sustain against the financial demands of the Vietnam War and Lyndon Johnson's 'Great Society' programme. The only cartel which does not seem to have collapsed yet is in diamonds - but that appears to be maintained by somewhat un-ethical methods and may well be destroyed in the long term, especially if diamonds are discovered somewhere else besides South Africa and the Soviet Union.

THE PARTY THAT NIGEL LAWSON HELD

I turn now to the first economic mistake made by this administration, which was Chancellor Nigel Lawson's attempt to shadow the Deutschmark in early 1988. To do that, he decided to print money and buy Deutschmarks to keep the pound down. That new money fed through to inflation and its effect was amplified by the decision to cut interest rates to 7.5% and not to abolish double mortgage interest relief until August 1988. The latter created a house price boom the hangover from which is still being felt. (Unfortunately, he did not do what is really needed, which is the total abolition of mortgage interest relief.) The current inflation rate of nearly 11% is the consquence of the party that Nigel Lawson decided to hold and its aftermath may cost the Conservatives office for a very long time to come. It is governments that cause inflation: not workers, not companies, but governments.

The mistake Lawson made is about to be repeated but on a permanent basis, and with all the countries of Europe and not just Germany. Thus when sterling floats above or below the 6% band outlined by the Government, the Bank of England alone will have to spend money to keep the pound within its limits. It is only when the pound is 12% out of line that the resources of the other European Central Banks will be used. This country has thus agreed to take on a permanent and expensive commitment to a futile objective. This represents a breach of principle, which will lead to further breaches of principle. It will harm the international competitiveness of our industry, push up the rate of inflation, and bring nearer the day when controls on wages and capital will be reimposed. It will deliver us bound and gagged into the eager hands of European socialists, all ready to impose their twisted religion, so newly thrown off in Eastern Europe, on the last truly capitalist power to resist their wiles.

A HARD LESSON WILL HAVE TO BE RELEARNED

The answer to all this lies in a firm stand: the decision of Mr Heath's Government in 1971 to allow sterling to float freely must be restored. We must stop worrying about the international value of sterling: it is not a political virility symbol which must be protected at all costs. Despite the fact that sterling floated freely between 1971 and 1989 it remained a 'strong' currency reaching $2.40 when its petro currency value was at its height. Governments must not print money merely to save the value of sterling.

The proper path for the immediate future has been mapped most clearly by Professor Sir Alan Walters, whose very public disagreement with Nigel Lawson over entry into the EMS and the decision to shadow the Deutschmark was such a talking point in the media. He lost the argument. But because he did this so publicly he will be judged to have been right by future historians and future governments. A hard lesson will have to be relearned, but there can yet be value in that for us.

A FREE MARKET IN MONEY

The best way out of the dilemma would be to prevent governments from issuing money at all, by denationalising the currency. At first, maybe, different banks would be granted licenses to operate their own system, but in due course anybody would be able to issue currency. That would lead to a free market in money and end once and for all the disastrous temptation for governments to print money for the purposes of holding sterling's external value against the currencies of the other states of the world. Bucking the market would become an impossibility.