MONETARY COMMITTEE

OF THE EUROPEAN COMMUNITIES

- the Chairman -

Brussels, 9th August 1989

Dear Mr Lawson,

The Monetary Committee conducted a detailed examination of the economic and monetary situation in the United Kingdom at its July meeting, concentrating on developments since the previous examination in 1985. The discussion was interesting both for the insight given into your government's long-term strategy and for the light thrown on the origins of certain disequilibria.

The Monetary Committee was of the clear opinion that the long-term policies of the British Government, pursued with determination over a decade, have been a success and have transformed the supply side of the U.K. economy. The reduced role of the State expressed both in a lower absorption of the nation's savings and in its withdrawal from many sectors of activity has extended the area open to the private entrepreneur while his incentives have been greatly enhanced, notably by tax cuts and the reform of labour relations. The economy as a whole has felt the beneficial effects of greater exposure to market forces and this has been particularly true of the financial system, which has become more responsive both to the needs of the domestic economy and to the challenge of the emerging global markets.

There is widespread recognition that these policies have raised the long-term growth potential of the UK economy substantially, to a rate which a cautious estimate would put at 3%. The Committee were particularly pleased that one consequence has been a rapid fall of unemployment from its previously very high levels, and the creation of a huge number of new jobs.

However, one of the fundamental objectives of the British government, the elimination of inflation, has not been met. It seems likely that the GDP deflator will show a rise of some 7 1/2% this year and there is a danger that a similar rate, or one only a little below it, will become embedded in pay settlements. In this respect the United Kingdom is now diverging from best performance in the Community. At the same

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time a very large balance-of-payments current account deficit has emerged. This has been financed by private capital flows, but not without occasional bursts of downward pressure on the pound, even in the presence of high short-term interest rates. The Monetary Committee shares the British government's concern that the balance-of-payments deficit should not be allowed to give rise to any precipitate fall of the exchange rate, which would compound the problem of restraining inflation.

These disequilibria undoubtedly had their immediate origin in the sudden and very rapid growth of domestic demand in 1987, at a rate which could not conceivably have been met by domestic supply and which persisted into the early part of 1988. Since the middle of last year the British authorities have responded firmly to the dangers by imposing tight monetary measures and putting the public sector into a substantial financial surplus. In order in particular to squeeze out the inflation which has been allowed to enter the system, it seems likely that restrictive policies will have to be maintained for some time, even at the cost of bringing the economy below the new long-term growth path and of foregoing a further reduction of unemployment. Thus the short-term disequilibrium of the British economy threatens the achievement of the results which the long-term policies of your government make possible.

The Committee asked itself what might be the deeper causes of the instability of the British economy. While acknowledging the difficulty of policy formation in the context of the reform of the financial markets and in the aftermath of the 1987 Stock Exchange crash, many members felt that an important part of the explanation lay in the large amount of consumer credit extended by the banking system and, more generally, the very rapid growth of the money supply as generally defined. Warnings have been given in the Monetary Committee that the rates of money growth tolerated in the United Kingdom in recent years could undermine stability. There was a feeling at our recent meeting that there should be a more prompt response to major overruns in such indicators as M1, M3 and M4, in order to ensure that monetary policy follows a steady medium-term course. There is apparently a problem of monetary control in the U.K. and British experience appears to show the inadequacy of relying on one instrument alone, the money-market interest rate, in pursuing monetary objectives; there is something to be learned from the experience of other countries with a wider range of instruments.

All in all, there is clearly a need to strengthen the nominal framework set for the British economy. This will mean returning to a steady medium-term monetary course involving closer attention to the monetary aggregates and a readiness to use a wider range of instruments. Such a revised Medium Term Financial Strategy should be anchored in a stabilization of the exchange rate, which could be seen as leading to participation in the E.M.S. exchange rate mechanism.

Yours sincerely,

Mario Sarcinelli