Thatcher's 'golden scenario' backfires

by William Engdahl

On Oct. 5, just two days following German unification, Britain's Thatcher government made a surprise announcement that it had reversed its 11-year-long refusal to link the pound sterling to the discipline of the European Monetary System (EMS), the currency bloc of 10 European nations. Britain joined the continental currency stabilization regime, established in 1979 by France and West Germany to insulate European currencies from the wild fluctuations of the dollar.

"The move is at one and the same time being done for domestic and foreign reasons," said City of London economist Stephen Lewis. According to reports from London, Thatcher was persuaded to join the EMS by Conservative Party strategist Kenneth Baker and other close advisers, who convinced her it would create a "golden scenario" in the runup to the anticipated 1991 U.K. general elections, in which Thatcher intends to run for a fourth term. Under this scenario, international capital would flood into sterling, attracted by its relatively astronomical interest rates—15% bank base rates at time of joining—and the new prospect of German-style anti-inflation discipline within the EMS.

Within minutes of the announcement, sterling shot up above DM 3.04, from DM 2.93 the day before. The "golden scenario" said that with such a flood of new funds, Thatcher could begin to steadily lower U.K. interest rates into next summer, prior to new elections, ensuring another Tory victory.

But the strategy has already backfired. On Oct. 23, the House of Commons began an official inquiry into the rushed circumstances leading to Thatcher's decision to link sterling to the EMS. In the intervening three weeks of entry status, far from being a "strong" currency, sterling dropped steadily, down close to the maximum 6% divergence from the weighted EMS currency basket allowed under the rules of the game, until it stood at DM 2.94—just where it was before entry.

Industry is hurting

"If the fall of the pound continues, the Bank of England will be forced, under strict EMS membership rules, to take measures which would ultimately lead to raising British interest rates again," said Lewis. With U.K. inflation hovering at just under 11%, and interest rates at a staggering 14%, it is no wonder that the productive economy is in very bad shape indeed.

Even industrial giants such as Imperial Chemicals (ICI) are upset at the sudden decision by Thatcher to join. ICI chairman Sir Denys Henderson has made no secret of his anger at Thatcher's timing, which he argues locks British industrial exports to an artificially high exchange rate. "We should have joined . . . six months ago, when the pound was DM 2.75-2.80," he argues. "The pound is seriously overvalued at the moment."

This means that British industrial exports, already suffering against German and French competitors, are hampered even more. Already in August, the Confederation of British Industry warned that were present economic and interest rate trends to continue, "manufacturing output will decline significantly and job losses will increase . . . a clear warning of the possibility of a recession in the second half of this year."

As of September, the U.K. business failure rate jumped an eye-popping 83% compared with the same period a year earlier. Engineering, metals, building, and construction were the worst hit. Major British banks are in horrible shape, with blue-chip names such as Midland Bank or National Westminister running up staggering losses on domestic real estate lending, as well as earlier Ibero-American debt exposure. Cuts in defense budgets are forcing layoffs at Rolls Royce, a prime maker of military engines. Machine tool orders had fallen 18% by July over the previous year, and in the last three months, the rate of exports has been cut in half.

Strategic manipulations

Why, then, make such a risky gamble, even after German Bundesbank chief Karl-Otto Poehl urged Britain to wait until correcting its inflation problem, before entering the EMS? The answer, as with most major British policy decisions of the postwar period, lies not in the realm of the economic interest of British industry or the working population. It is political and strategic.

"The majority of the British Establishment is determined that it will tie Britain's future course to continental Europe," said one analyst. "They view their postwar 'Atlantic alliance' with America as of declining usefulness. The elites of the City have little concern for rising unemployment and such. Their concern is to enter Europe in order to dominate it to their benefit. They used whatever argument worked to convince Mrs. Thatcher to go along. They will make it more difficult now for the Bundesbank, just at a time when its burdens with East Germany weigh heavy. That's the real reason."

But the British financial elites may have hesitated too long, allowing Europe to consolidate its policy. One thing is certain to all: Thatcher's "free market revolution," which was sold on the argument that her policies would squeeze inflation out of the economy, is a colossal failure even on her terms. Britain's inflation rate today is back exactly where it was in 1979 when she took office: 11%!