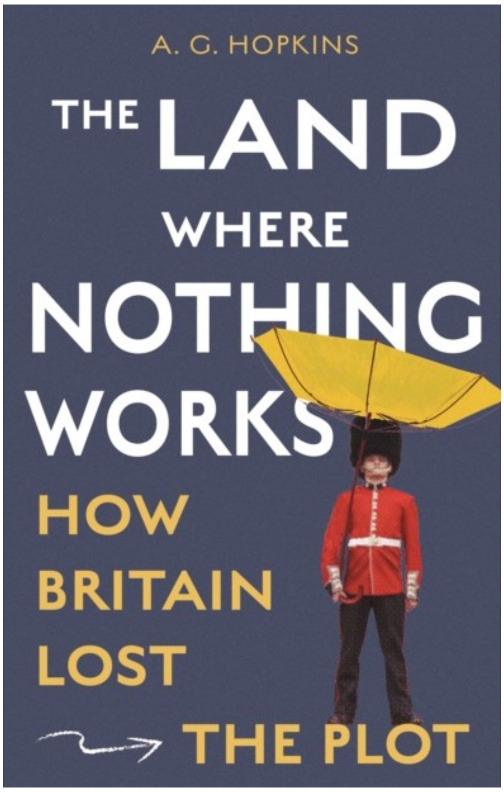
Thatcher, oil and the City of London

Robin Ramsay

I have been down this path before in these columns, notably in Lobster 60. However, this story seems important to me and there may be new readers who are unfamiliar with it.



Reading Professor A. G. Hopkins' new book[1] reminded me of the early days of Mrs Thatcher's first regime, when this country's economic problems began. The Thatcher government in 1979 took office promising to reduce inflation, which was then around 13% per annum. Inflation had been 25% in 1975, created in part by the rise in wholesale oil prices in 1973/4 and partly by the Heath government's 'dash for growth' in 1972/3 which allowed the bankers to create huge amounts of domestic credit.

In parallel with the inflation question, in the late 1970s the economic ramifications of North Sea oil began to be considered by the Conservative Party (then in opposition) and the economics media.

The central argument went thus:

1. As Britain produced oil, it would need to import less oil. Assuming the British economy continued exporting as much as it had before oil, the result would be a growing trade surplus.
2. Such a surplus would push up the value of the pound.
3. A rising pound would make British exports more expensive, imports

---

1 <https://www.lobster-magazine.co.uk/article/issue/93/the-land-where-nothing-works-how-britain-lost-the-plot-by-a-g-hopkins/>

cheaper and British manufacturing would thus decline.

The financial nexus offered a solution to this problem: if exchange controls – i.e. state-imposed restrictions on the movement of capital out of the UK, then in force – were abolished, some British capital would leave the country and this would counterbalance the new wealth coming in from the North Sea. There would be no trade surplus and thus no rising pound. Freedom to move money – what the City had sought since 1945 – would solve the problem.[2]

On 1 November *The Times* reported Shadow Chancellor Geoffrey Howe claiming that:

> Relaxation [of exchange controls] would also prevent the pound from rising artificially high and damaging the competitiveness of our exports . . . [and] would boost overseas investment and increase opportunities to improve Britain's invisible exports.[3]

The economist Gordon Pepper was then the monetary expert at the City firm of Greenwell's. Nigel Lawson tells us that he was also a man with Mrs Thatcher's ear.[4] Pepper edited a *Special Monetary Bulletin,* the 1 July 1977 edition of which was 'The Economic Implications of North Sea Oil'. Pepper argued that sterling should be allowed to float freely and exchange controls should be relaxed, allowing the oil revenues coming in to be balanced by capital going out. He concluded:

> If the authorities do not intervene heavily in the foreign markets and resist an appreciation of the pound then North Sea oil will have a beneficial effect on the economy. If . . . they continue their present policy of intervention to push the [sterling] rate down, monetary growth will tend to be excessive and will damage growth.

---

[2] On 26 November 1977, the *Economist* discussed the so-called 'Dutch disease' – the experience of the Dutch economy in the early 1970s when gas from the North Sea reduced their energy imports, caused a trade surplus, and a rise in the value of the guilder. Writing for *The Times* in the same month, Hugh Stephenson also concluded that the 'Dutch disease' could be avoided by lifting exchange controls. For the most influential financial journalist of the period, Samuel Brittan, scrapping exchange controls was the 'only serious way of preventing North Sea oil from imposing a contraction in manufacturing'. The *Financial Times*, July 3 1980. The same view was expressed by Roy Peters in 'Overseas Portfolio Investment – Developments Since the Abolition of Exchange Controls', in the *NatWest Quarterly Review*, May 1981: 'It may be that the only way to protect manufacturing industry in the short term is to ensure that there are sufficient outflows on the capital account to stop sterling rising further.'

[3] The general tenor of the oil debate can be seen in *The Times* Index for 1977, especially p. 375, under Economic Situation and Policy.

[4] Quoted in Peter Riddell, *The Thatcher Government* (London: Martin Robertson, 1983) p. 34.

In one neat little package, concern about monetary growth produces the abolition of exchange controls and an appreciating pound – the two things the City wanted. But Pepper said nothing about the effects an appreciating pound would have on the domestic manufacturing economy, which was about 20 times the size of the financial sector at this point.

It seems to have occurred to none of the commentators in this period that on top of the rise in the value of the pound expected from its status as a 'petro-currency', the government would raise interest rates. Which is what it did in 1979/80. The Conservatives had been persuaded that the way to reduce inflation was to reduce the money supply; and the best way to do this was by putting up interest rates. If credit – loan repayments – cost more, people have less money to spend which (eventually) causes the price of goods to fall. Supply and demand.

Looked at another way: the bankers helped create the inflation by lending too much and were now going to 'cure' the problem by charging more on their loans. Win–win.

But an interest rate increase raises the international value of the pound. I asked Google AI why.

> Raising interest rates increases a currency's international value by attracting foreign capital seeking higher yields, which drives up global demand for that currency.

This makes imports cheaper and exports more expensive. For reasons that have never been explained, to my knowledge, the government ignored this.

In October 1979 Chancellor Geoffrey Howe announced the end of the remaining exchange controls (some had been scrapped in June). The following month the Thatcher government raised interest rates to a minimum 17% – nearer 30% for many individual customers – where they stayed for eight months. The pound soared in value as 'hot money' poured into London attracted by real interest rates of over 5%.[5] Frank Blackaby noted that, during the great rise in the international value of the pound in 1980, while the government hoped that a substantially increased capital *outflow* would help to keep the exchange rate down, it did not happen:

> Far from *discouraging* capital inflows, the government – pursuing a high interest-rate policy in the interests of its money supply target – has

---

[5] The 'real' interest rate is the stated interest rate minus inflation. 17% interest rate with 12% inflation is a real interest rate of 5%. In the 1930s real interest rates were 3% or less.

encouraged them.'[6] (Emphases added.)

British exporters and manufacturers struggled but the champagne flowed in the boardrooms of the banks. No exchange controls, no limits on lending, and record interest rates? This was everything the City had been seeking since the end of World War 2. These were 'dream conditions for London's financial apparatus in 1980 and 1981'.[7]

For that 'financial apparatus' in London, the beauty of the simple-minded 'monetarism' which the Thatcher government espoused in 1979 and 1980 was that until sterling M3[8] – the measure of the money supply chosen by the Conservative government – behaved in the way predicted by the theories, interest rates (and thus the value of the pound) would rise. Throughout 1980, as sterling M3 failed to fall, the value of the pound rose – eventually up to $2.40, the level it had been in 1967 – and British manufacturing slumped.

Many years later Mrs Thatcher wrote this remarkable sentence:

> *Before the end of* Geoffrey Howe's Chancellorship the value of the pound against other currencies — the exchange rate — was *also* being taken into account.[9] (Emphases added.)

For some — perhaps most — of the Chancellor of the Exchequer's first term of office, the exchange rate was not only not being given economic priority, it *wasn't even being taken into account*.

Oil revenues provided a convenient explanation for that rise in sterling. A headline in the *Sunday Times* Business News of 20 July 1980 proclaimed, 'How North Sea oil is killing our industry'. Writing in the July 1980 edition of the journal *Fiscal Studies*, P. J. Forsyth and J. A. Kay further stated that:

> . . . [a] contraction of manufacturing output, and an increase in the

---

[6] Frank Blackaby, 'Exchange-rate Policy and Economic Strategy', *Three Banks Review,* June 1980.

[7] Tom Nairn, *The Break-up of Britain* (London: Verso, 1981) p. 392.

[8] Google AI: Sterling M3 combined physical cash with various types of bank accounts. Its main components were:

> **Notes and coin:** Physical cash held by the public and in circulation.
>
> **Private sector bank deposits:** Money held in UK banks by private individuals and businesses, including both easy-access (sight) accounts and longer-term (time) savings accounts.
>
> **Public sector sterling deposits:** Money deposited by the UK public sector in sterling.

[9] Margaret Thatcher, *The Downing Street Years*, (London: HarperCollins, 1993) pp. 688/9.

> domestic absorption of imported manufactures, are the *only means* by which the British economy can benefit from the North Sea. (Emphasis added.)

Former senior Treasury official, Leo Pliatzky:

> It was a strange period to look back on. There appeared to be a great gulf between attitudes in much of the City and in industry throughout the country. In some quarters there was a Khomenei-like fanaticism about, a reluctance to see the connection between high interest rates and a crippling exchange rate.[10]

As unemployment soared and British businesses went bust, Mrs Thatcher looked for a way out. Not by abandoning her belief that controlling the money supply would reduce inflation, but looking for another, less damaging way to control the money supply. Nigel Lawson sneers in his memoirs:

> there was no more assiduous seeker for *gimmicks* which would supposedly give us tight money without high interest rates than Margaret Thatcher. (Emphasis added.)[11]

The 'gimmick' Mrs Thatcher favoured was monetary base control (MBC), which instead of trying to influence the *demand* for money by raising interest rates, tries to control the *supply* of money by regulating the amount the banks could lend.[12] Regulating the amount the banks could lend? This the money-lenders were not going to wear. A series of meeting took place with the financial apparatus at which Mrs Thatcher and her advisers argued for MBC.[13]

MBC was rejected. Mrs Thatcher tells us 'the Treasury were not prepared to move to the system of monetary base control which Alan [Walters] favoured

---

[10] Leo Pliatzky, *The Treasury Under Mrs Thatche*r (Oxford: Basil Blackwell, 1989) p. 128.

[11] Nigel Lawson, *The View from No. 10* (London: Corgi, 1992) p. 77.

[12] On MBC see the discussion in David Llewelyn (ed), *The Framework of UK Monetary Policy* (London: Heinemann, 1982) pp. 56-60 and Lawson (see note 12) pp. 80 and 81 for his reasons for rejecting it. Milton Friedman, the guru of monetarism: '*Direct control* of the monetary base is an alternative to fiscal policy [i.e. taxes] and interest rates as a mean of controlling monetary growth.' (Emphasis added.) Cited in David Smith, *The Rise and Fall of Monetarism* (Harmondsworth: Penguin, 1987) p. 95. Direct control was precisely what the City did not want.

[13] Philip Stephens tells us that the Treasury was hostile to MBC because its officials regarded controlling public spending as more important than controlling the money supply and public spending was a key element of their adopted money supply indicator, sterling M3; they could use curbing M3 to reduce public spending. Philip Stephens, *Politics and the pound* (London: Macmillan, 1996) p. 20.

and to which I was attracted by his clear and persuasive analysis.'[14] She got the consolation prize:

> 'Bank of England and Treasury officials were instructed to put together proposals for changing the methods of monetary control, with a view to moving away from excessive reliance on high interest rates.'[15]

'Action this day' it was not

On 16 November 1980 the Bank of England finally reduced the Minimum Lending Rate to 14%. This was a consequence of the notorious speech (which cost him his job) by Sir Terence Beckett, the Director General of the CBI (Confederation of British Industry) calling for a 'bare knuckle fight' with the government over economic policy, and the Chair of ICI warning Mrs Thatcher that the recession was so serious ICI was going to announce a third quarter losses.[16] (She had already admitted to leaders of the CBI that she was concerned about interest rates and the exchange rate.) This interest rate reduction was the end of the 'monetarist' experiment; for the monetary figures (sterling M3) did not justify the cut.

In 1985 Mrs Thatcher tried again to get MBC off the ground, but, writes Nigel Lawson: 'The issue was satisfactorily put to bed with the promise of "further studies" of the US and German systems.'[17]

Mrs Thatcher took on the City-Treasury-Bank of England nexus – and was defeated. She might be willing to smash the striking miners but was unwilling to overrule the money-lenders' agents in the state. She never challenged them again. And neither did any of her successors.

---

14 Margaret Thatcher (see note 9) pp. 133 and 4.

15 *Ibid.*

16 Smith (see note 12).

17 Nigel Lawson (see note 11) p. 77.