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PREM 19/743

European Monetary System (EMS)

EUROPEAN POLICY

June 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
15.6.79.		28-11-80					
26.6.79		24.2.81.					
3.7.79		27.6.81					
4.7.79		23.9.81					
5.7.79		14.10.82					
10.7.79		22.10.81					
12.7.79.		18.11.81					
13.7.79		16.11.81					
6.9.79		5.1.82					
13.9.79		9.1.82					
26.9.79		26.1.82					
5.10.79		25.2.82					
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PREM 19/743

SECRET

PART 1 ends:-

cc (82) 7th Item 3 - 25.2.82

PART 2 begins:-

LPS to ch/Er 3.3.82



Prime Minister

(2)

Mus 26/2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

24 February 1982

The Rt. Hon. Lord Carrington, KCMG MC
Secretary of State for Foreign
and Commonwealth Affairs

Don Pule

EMS DEVALUATIONS: 21 FEBRUARY

The story of the devaluations of the Belgian and Luxembourg franc by 8½%, and of the Danish krone by 3%, in the EMS on Sunday has been pretty fully told in the press, for example in Monday's Financial Times. However, some account of the background may be helpful to you and to others.

I was asked by Community Finance Ministers on Saturday evening (20 February) to repeat what happened on 4 October during our Presidency and to chair a realignment meeting in Brussels on 21 February. The Belgian Finance Minister could not, as the main applicant, take the chair; neither could the Dane, who is next in the Presidency. So the EMS had recourse to the previous Presidency and to the "neutral" British. I accepted, without enormous enthusiasm.

The Belgians sought a 12% devaluation as a "reflationary" element in the package of measures which the new Martens Government is undertaking to tackle the deep structural problems of the Belgian economy. The other elements are a determined attack on their enormous public deficit (said to be 16% of GNP); and an attempt to modify wage indexation in 1982 so as to reduce real wages. The Danes asked for a 7% devaluation, saying that their wage costs necessitated a change quite soon, and that the Belgian move provided a convenient opportunity. In fact this seems to have been a piece of opportunism: they appear to be operating a "crawling peg" system within the EMS.

The initial reaction of all other members was that it would be best to limit the Belgian devaluation to 6 or 7% and the Danish to nil. However there was a wide disposition to settle in the area of 8/9% for Belgium and 2/3% for Denmark.

The obstacle to such a deal was that for many hours the French would not come up to these figures and the Belgians would not come down to them. It emerged that a condition for agreement at about 8% for most members (especially the French) was that the



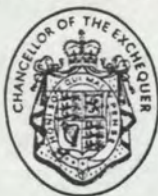
Belgians and Danes should not get "green rate" devaluations for their farmers in the middle of the current agricultural price negotiation. With much travail, and some tiresome semantics about how long the "freeze" on green rate devaluations arising from these devaluations should last, agreement was reached on a freeze which is likely effectively to last until the end of the negotiations. Agricultural experts in capitals (including in MAFF) were consulted frequently during this argument. The eventual deal, and the agreed parity changes, finally emerged at 2 a.m. on 22 February, after 12 hours of continuous, and sometimes acrimonious, debate.

Highlights of the day were provided by the Belgians, who on several occasions threatened to leave the EMS if their wishes were not adequately met. A large part of this should no doubt be regarded as theatricals, but it was in striking contrast with their normal enthusiasm for the system. Curiously, my French colleague took a leaf from the Belgian book, and also uttered dire threats about walking out. Urging on him, and the Belgians, the merits of the system, and the undesirability of breaking it up, was a task which I found a little ironic.

The real sob story was Luxembourg's. They found themselves because of their monetary union with Belgium, forced to accept a devaluation quite unjustified by their economic circumstances, with the attendant inflationary risk; and with neither need for, nor possibility of, taking offsetting measures. I was told that their Prime Minister, who had bilateral talks with M. Martens on 20 February, was upset: he had every right to be, and his representatives needed careful handling.

For the Belgians a devaluation represented a sharp change of policy. Although they have had an effective devaluation with the rest of the EMS as EMS currencies have fallen as a unit against the dollar, they have for very many years resisted any significant formal devaluation, whether in the EMS, the Snake or the old Bretton Woods system. They have had a good record on inflation. But they must now have learned the lesson that the fight against inflation cannot in the end be sustained simply by hanging on to the exchange rate if wage costs remain immune both to policy and to market forces, and if the defence of the exchange rate is not firmly supported by fiscal policy. The Martens' Government seems to be making a bold effort to tackle both fiscal policy and real wages. It remains to be seen whether through success on these fronts they can channel the effects of the devaluation into lower real wages, higher output and higher employment and prevent it simply turning into higher inflation. Doubts about their ability to achieve this were one of the reasons for the general resistance to a devaluation of as much as 12%.

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I am still not sure why the French resistance was much the strongest. I suspect that Jacques Delors may have felt that he might be vulnerable to criticism in Paris for having been too soft in October if he conceded the Belgians a devaluation significantly and obviously greater than he then secured. The eventual 8½% change was of course equal to the change in the French franc against the Deutschmark which was agreed in October.

No major UK interests were at stake in all this rumpus. However, Belgium is quite an important export market for us. It is therefore in our interests that the Belgian economy should recover; but we also had an interest in keeping their devaluation, like that of the Danes, as moderate as possible for competitive reasons. We have the same interest as the Germans and others in preventing resort to competitive devaluations. The outcome suits us quite nicely.

On the agricultural points, I imagine that there are tactical arguments to be made in both directions. The agreement to a short freeze on green rate devaluations, even though expressed as a piece of "voluntary restraint", departs from a tradition to which we, like others, have attached importance: that a country with negative MCA's should be accorded a green rate devaluation whenever it wished. On the other hand, holding up the agricultural price settlement is our one real weapon in the present Budget negotiations, and both restricting the devaluations and denying the devaluers the effect of green rate devaluations maintains, and indeed increases, the bite of that weapon on them. No doubt we also want the possibility of these green rate devaluations to be taken into account in the final agricultural settlement. Moreover, the proposition that there should not be green rate changes arising from new devaluations during a price negotiation was widely accepted. Even the devaluers were ready to accept it, at least in part, from the outset, and it was universally supported by the other members.

As a tailpiece to the argument on MCA's the French pressed hard a further highly technical point about the application to them of the "franchise" rules. These involve a form of disregard or margin before an MCA is introduced and they can therefore produce modest competitive advantages or disadvantages. The French, prior to the devaluations, enjoyed a competitive advantage because the gap between their central rate and green rate was 1.44%, or just short of the point (1.5%) at which the normal rules reduce it by creating a 1% MCA. If the normal "franchise" rules had operated the French 1.44% would have become 1.79%; a 1% MCA would have been created which, under the main agreement, they could not immediately use to benefit their farmers; and they would have lost 0.65% of competitive advantage. Nobody else was in that particular situation. The French were totally determined that, within the general principle of a temporary "freeze", this should not happen to them and there was a general acceptance of their case. Implementation has however required a Commission regulation and they have chosen a method which adds 0.35% to the French advantage

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for the period up to 31 March rather than a method preferred by MAFF here which adds nothing to that advantage, but requires small corresponding adjustments to border changes in other Community countries to offset it. We have unfortunately been unable to obtain any support from other Community countries for our preferred method. So the French will get their 0.35% for the next 5 weeks. Hopefully the world will not come to an end.

Another important UK interest was to avoid too much turmoil in the currency markets which might lead to a general reassessment of currencies. That pointed strongly to limiting the devaluations. As it is, the movements agreed for Belgium and Denmark could lead to more pressure on the Irish currency. But I have to report that exchange market considerations did not appear paramount in most minds. Even the fact that the Tokyo market had already opened - thus providing an opportunity for speculation - was brushed aside by some as I tried to close the deal.

The procedure itself was quite absurd. Thanks to the Belgians, who had announced the meeting, let in the press, and had insisted in public that they must have at least a 10% devaluation, the negotiation was conducted in a glare of publicity, which made it difficult to secure support for compromises. I have asked the Chairman of the Monetary Committee to review the arrangements, including location, size of meetings, confidentiality and supporting services. But even so I hope that I shall not have to chair another such meeting for some considerable time!

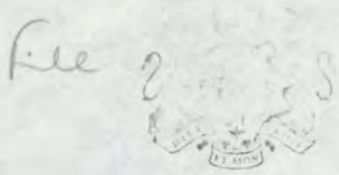
I am copying this letter to the Prime Minister, the Minister of Agriculture, the Governor of the Bank of England and Sir Robert Armstrong.

GEOFFREY HOWE

A handwritten signature in dark ink, appearing to read 'Geoffrey Howe', with a horizontal line above it.

Emo Pol

SUBJECT.



cc: FCO

Gov./Bank of Eng.
Co

Emo Pol DSG

10 DOWNING STREET

From the Private Secretary

26 January 1982

AD
DC Peretz
(Treasury)

see transfer act.

THE EUROPEAN MONETARY SYSTEM

The Prime Minister held a discussion about British membership of the European Monetary System (EMS) on Friday 22 January with the Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, the Governor of the Bank of England, Sir Robert Armstrong, Sir Douglas Wass, Sir Kenneth Couzens, Mr. Burns, Mr. Middleton, Mr. George and Mr. Walters.

The Chancellor said that our stance had been that we were prepared to join the EMS when the conditions were right. Our reasons for not joining, however, were often such as not to be affected by changing events. The petro-currency status of sterling, which militated against full UK membership, would be with us for a long time; on the other hand, the pressures on the exchange rate vis-a-vis the other European currencies which arose from this source were variable and this did not seem in itself to be a decisive consideration. It was always possible to argue that the re-alignment mechanism in the EMS could deal with this factor. The most powerful argument, in his view, against joining was the potential conflict with monetary policy. This too was a permanent feature of the scene, and it might be argued that it had not seemed a decisive consideration to the Germans against membership of the EMS. He saw attraction in the possibility of anchoring counter-inflation policy to an exchange rate target within the EMS. Public opinion might respond more easily to an external exchange rate target than to a set of complex and often conflicting signals from the monetary variables. He saw dangers, however, in putting too much faith in a disciplinary mechanism which bore a European label: it would probably have precisely the wrong impact on anti-EEC opinion, whose opposition to necessary corrective measures would gain public support from the accusation that the measures were imposed upon us by our EEC partners. Industrialists were not attracted to our joining at the sterling/DM parity now prevailing. He himself was clear that, for this reason alone, we were not in a position to join now, even if, on general grounds, we thought it right in principle to do so.

The Governor said that he was in principle in favour of our joining. He believed that it would be necessary to give much attention to the exchange rate in the coming years. Although

/ forecasts

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forecasts of the exchange rate were particularly hazardous, he believed, on balance, that sterling might be rather vulnerable over the next few years. A world recovery and further upward pressure on the oil price would strengthen sterling, but, against this, our own economic recovery might well put pressure on the current account balance of payments, and there might be sizeable outflows as the election drew nearer. Although the present sterling/DM parity was too high, he would not otherwise like to see in present circumstances either a significant depreciation or appreciation from the present broad position of sterling. The evolution of monetary policy pointed towards a clearer policy on the exchange rate. Membership of the EMS would provide a framework within which to pursue such a policy. The EMS provided a web of rights and obligations in which we would have the help of others to hold our exchange rate where we wanted it. It would be very difficult to operate an explicit exchange-rate policy, with a published band, outside the EMS and, so to speak, in mid-Atlantic, in view of our position in the EEC and all that we had said about our possible EMS membership.

The Foreign and Commonwealth Secretary said that there was a good case for our joining the EMS at some stage, and he hoped that we would not rule it out now; we should keep the matter under review. He did not, however, believe that a decision now to join the EMS would have a particularly favourable impact on the attitude of our European partners in regard, for example, to our objectives in respect of the Budget.

In discussion it was argued that there were powerful reasons against joining. A sudden change in the fortunes of sterling or of one of the other currencies in the system would lead to heavy outflows from, or inflows into, the reserves over which the Government would have little control; on some occasions these flows would take place purely to assist other currencies which were in difficulty. There would be a loss of freedom of manoeuvre. Membership of the EMS had not helped Belgium or Italy to manage their economies successfully: it had not prevented the Belgians from running a huge deficit, with very high interest rates, nor the Italians from a continuing and high level of inflation. Sound economic management depended upon sound domestic fiscal and monetary policies; EMS membership offered no escape from these imperatives. It had been hoped that the EMS would lead to a convergence between the economies of its members. In fact, as the Bundesbank October Bulletin said, there had been a divergence. The discussions of realignments were highly politicised and could import into discussion of exchange rates wholly irrelevant and distracting bargaining factors which were at issue in other fora between the member countries.

Against this, it was argued that membership of EMS would provide a more predictable and stable world in the short run for our traders. A large and constantly increasing proportion of our trade was with other EMS members and it would undoubtedly be helpful for business if there were a more stable relationship between all the currencies concerned. The record of the EMS in this respect had been one of reasonable success. Membership of the system would not involve us in an unlimited obligation to use our

/ reserves.

reserves. It was arguable that the less successful economies within the EMS would have been in even greater difficulty outside the system.

The Prime Minister said that she was not convinced that there would be solid advantage in joining the EMS. She did not believe that in practice it would provide an effective discipline on our economic management. She was worried by the extent to which it removed our freedom of manoeuvre. She accepted, however, that when our inflation and interest rates were much closer to those of the Germans the case for joining what was essentially a DM-dominated system would be more powerful. We should, therefore, for the time being maintain our existing position on the issue.

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office), Tim Allen (Governor of the Bank of England's Office) and David Wright (Cabinet Office).

M. C. SCHOLAR

John Kerr, Esq.,
H.M. Treasury.



(1)

10 DOWNING STREET

Prime Minister

Given the technicalities of
the EMS issue, Lord Carrington
has asked if one official (Tom
Bridges) may accompany him
to Wednesday's meeting.

Content?

Yes
no

Ms 8/1

TOW ASC/PCO



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10 DOWNING STREET

Prime Minister

Monetary policy / EMS meeting

This has now been arranged
for Wednesday 13th Jan at 3.30.

I have suggested that the
Foreign Secretary should join the
meeting - to discuss EMS
and for a drink at 6.30.

Robert Armstrong has now put
in the attached paper - which you
could postpone reading until the
weekend. Shall I invite him to
the EMS part of the meeting?

Yes ~~no~~

P.T.O

I have asked Alan to start thinking about a brief for you.

Invitees are: Chancellor
Economic Secretary

Sir D Wass
Sir K Couzens
P Middleton

T Burns

>
Governor + Mr George

Alan Walters

Foreign Secretary after 6.30
Lord Bridges

Nothing in writing about this meeting.

MUS 6/1



10 DOWNING STREET

Clive

This is difficult: the
exclusion of Gordon Richardson
and Lord Carrington and inclusion
of John Nolt or Nigel Lawson is
likely to give offence to the
former pair.

Should you raise orally
with the PM?

M

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PRIME MINISTER

European Monetary System

In the run up to the Budget Ministers will need to review the case for and against the United Kingdom joining the exchange rate mechanism of the European Monetary System (EMS). This rests at present on a minute which the Chancellor of the Exchequer sent you on 18 September 1981, in which he argued against joining at that time, but thought that the balance of the argument might change in favour of joining later on.

2. When the EMS was first negotiated in 1979, the previous Government elected not to join the exchange rate mechanism, giving as its public reasons the special characteristics of sterling and of the United Kingdom economy. The position of this Government, as stated by you and the Chancellor on a number of occasions, has been that we intended to join when the Government judged that the conditions were right. The issues for discussion are therefore whether the time has now come to go in; if so, under what conditions; and if not, whether and how we can plausibly continue to argue that there will be some time in the future when conditions will be right for full United Kingdom membership of the EMS. In considering these issues, the Government will be primarily concerned to assess where the United Kingdom's economic interests lie, but there are also wider implications for our membership of the Community.

3. A short note summarising the EMS and the objectives is at Annex A. Basically its purpose is to encourage economic convergence and to bring about a zone of monetary stability in Europe. EMS cannot of itself change the underlying economic forces which make for convergence or divergence or impose greater exchange rate stability than those forces will support. Nor can it alone direct the policies of individual member Governments into a convergent path. When exchange rates threaten to diverge beyond the limits provided in the EMS, countries have to be prepared first to try and steady their exchange rates by intervention in the markets, then to take policy measures affecting their own economies, and finally to seek a realignment. The four realignments which have taken place since March 1979,

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together with the 6 per cent band adopted for the Italian lira, reflect the fact that little progress has so far been made towards greater economic convergence: among EMS members inflation rates are both higher and further apart than in 1979. At the same time it could equally be argued that the system has so far withstood the strains of conflicting national policies and pressures reasonably well, and that the four realignments are a measure of the system's ability to respond flexibly to changing circumstances within a disciplined and relatively stable framework. That at least seems to be the view of its existing members. And over a period of time the discipline of having to keep within the EMS could tend to steer Governments in the direction of convergence.

The Economic Case

4. Two main arguments have been advanced for the view that full membership of the EMS would benefit the United Kingdom economy:

- (a) At any time when sterling would otherwise be tending to move down against other European currencies, it would reinforce counter-inflationary policies; sterling would be linked to the Deutschmark (DM), which might be expected to appreciate, and United Kingdom policy would be forced to converge with that of West Germany, a low inflation country with a strong economy.
- (b) The CBI and others believe that full membership might, by giving more stability to sterling in relation to European currencies, assist the 40 per cent of our exports which now go to other EC members: this argument would be valid only so long as sterling was at a competitive rate in relation to other European currencies and above all to the DM.

5. Whether joining the EMS would over time contribute or run counter to the medium term financial strategy (or indeed more generally to a counter-inflation policy) would depend on the way that sterling moved. If sterling was tending to move downwards against European currencies, intervention to hold it in the EMS would make it easier to meet the requirements of the strategy (in terms of £M3); if sterling moved up again strongly against the ECU intervention would make it more difficult to meet these requirements. Intervention to keep the sterling/ECU rate up would require some use of our foreign currency reserves, but (so long as we were dealing with containable movements) less than if we were not in the EMS,

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because other member states would also have to intervene in support. The Government is, of course, already free to take (as it did last year) action to prevent the exchange rate from falling too far. Outside the EMS its judgment whether, when and how to act in that way and what degree of priority to give to the exchange rate objective (however defined) in relation to other policy objectives is unfettered. Inside the EMS it would be constrained by the obligation to keep the rate within the band, but the very fact of being in the EMS would be likely to make it easier, and over time less costly to our own reserves, to defend the rate against anything short of a major speculative attack.

6. It would therefore be important to the judgment of the economic case to take a view on whether the sterling/ECU rate (and more especially the sterling/Deutschemark rate) had currently reached a band below which we should not wish it to fall, and above which we would not expect it to rise; and to take a view on whether the rate was more likely to fall or to rise in future. If we judged that it had reached a level below which we should not wish it to fall, and which we should therefore wish to defend; and if we judged that it was more likely to fall than to rise in the future, there would be an economic case for going in. Indeed, if we were in any case intending to defend a rate - if, in other words, we had an exchange rate objective at least to the extent of being prepared to take action rather than see the rate fall below a certain level, and we had reason to expect such a fall - the defence of the rate could (in conditions that fell short of a major speculative attack) cost us less (in terms of expenditure of our own reserves and in terms of accompanying measures like increasing interest rates) if we were in the EMS than if we were not.

7. If we faced a major speculative attack on sterling but not on other European currencies, we should be less free in the EMS than outside it to respond by allowing the sterling/ECU rate to fall. We should no doubt start by intervening, and we should have the benefit of the EMS support facilities - others would also be intervening in our support. But, if intervention was clearly failing to stem the attack, we should have to seek a realignment. We might need to move fast. In the circumstances our partners could probably be expected to cooperate in moving fast; but it would be for consideration whether we should before joining seek to obtain assurances from our partners of readiness to move fast if the need

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arose.

8. If we were expecting the sterling/ECU rate to rise back to the levels of a year ago, it could be argued that we should do better to stay outside: if our expectations were fulfilled and we were in the EMS, we should have to sell sterling to keep the rate down, to the disadvantage of our monetary and counter-inflation objectives - unless and until we could persuade our partners to agree to a realignment. This might not in practice be too difficult, since the realignment would ex hypothesi improve their competitive position. But there would probably have had to be a period of trying to keep the rate within the band first: an EMS realignment would obviously be "stickier" than a float outside the EMS.

9. It is dangerous to hazard predictions about the movement of exchange rates. But I would incline to the view that for the next year or two the chances of the sterling/ECU rate falling are greater than those of it rising. The main factor which might cause it to rise is the oil market. But OPEC have pegged their prices to the end of 1982, and presumably Saudi Arabia will use its muscle to keep that peg in. Thanks to the reduction in demand for oil, as a result of recession, energy conservation and diversification away from oil, the oil market has been slack, and is expected to remain so. Unless therefore there is some political disaster in the Middle East affecting oil supplies, this factor is not likely to be pushing sterling up during the next year. The main factor tending to push it down is likely to be our relative inflation rate as compared with the Federal Republic of Germany; this is of course much less bad than it has been, but the assumption must be that it is likely to continue to be unfavourable for the next two years.

10. So much for the factors one can foresee. If that analysis is accepted, it could be argued that the conjuncture is at present more favourable than it has seemed in the past to the case for our joining the EMS. I would only add that, if during the next two years we were to run into a major crisis of confidence in sterling - and that possibility cannot be entirely excluded in the run-up to a General Election - we might well find it easier to see it through from inside the EMS than from outside.

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11. So far as the "stability" argument at paragraph 4(b) is concerned, any assessment needs to take account of the following:

- (i) Four realignments have already occurred, and more must be expected - especially if sterling is inside the EMS. The EMS might therefore provide only relatively short-term stability for the sterling exchange rate against other EMS currencies. But the trading sector of the United Kingdom economy would still prefer that to total floating, and it should become increasingly welcome as the proportion of our exports to other Community countries rises.
- (ii) The exporter can secure short-term stability by obtaining cover against exchange risks from the forward exchange markets, at a cost, for periods of less than a year. But this safeguard is in practice open only to the largest companies: many small firms and businesses have neither the expertise nor the resources to venture into this field on their own account.
- (iii) Although the United Kingdom economy has become much more orientated towards Europe over the past decade, and although the United Kingdom inflation rate is not now so far out of line with that of other EC members as it was in 1979, sterling still has some different characteristics from those of EMS currencies. For example, Community currencies together account for only 38 per cent of our effective rate compared with 47 per cent of the DM effective rate, 51 per cent of the French franc effective rate and 64 per cent of the Belgian franc effective rate. Sterling is still much more an international currency than any other EC currency apart from the DM. Moreover it is likely to be affected in a contrary direction to the DM by movements in the oil market.
- (iv) Any greater stability of the exchange rate could be - but would not necessarily be - at the price of less stable interest rates.

The Political Case

12. I agree with the Chancellor's analysis, in paragraph 13 of his minute of 18 September 1981, that joining the EMS would improve the climate for the current negotiations on the budget and the CAP, but that we could not use it as a bargaining counter. If it were linked with other issues, the danger of EMS adding to the unpopularity of the Community would only be reinforced.

13. The political case is, it seems to me, a much broader one, and concerned with our relations with other members of the Community. We are members of the European

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Community, and we intend to remain so. The EMS is a significant element in the Community: as one of the big members, we should be fully inside it rather than outside one element of it. We have said that we will join the exchange rate mechanism when conditions are right. Unless that is a hollow commitment and our real intention is not to join at all, we have to ask ourselves - as others may ask us - if not now, when else? A further postponement would probably not be politically damaging to our position in the Community, if we could credibly demonstrate that our intention to join was serious and that we foresaw conditions for joining more propitious than those of today. But if it were to become apparent that the United Kingdom had no serious intention of joining, this could have profound consequences for our relations with at least some of our partners in the Community, especially (but not only) when the Community comes to consider further developments in the EMS.

14. The political case against joining is largely a domestic one, that joining the exchange rate mechanism of the EMS might add to the risk of our economic difficulties being attributed by British public opinion to membership of the Community. In these terms perhaps the best time for joining the exchange rate mechanism would not (other things being equal) be now, when we still have the mandate negotiations to complete, but when those negotiations are successfully completed and a satisfactory longer-term solution to the problem of our financial contribution has been agreed. But perhaps British public opinion is unlikely to see joining the exchange rate mechanism as having much bearing on our economic problems one way or the other; and in that case the political benefits to our relations with Community partners (cf. paras. 12 and 13) would weigh more heavily.

15. Paragraph 8 of the Chancellor's minute of 18 September 1981 gives the reasons which could be advanced, consistently with the position the Government has taken up, for joining now. Our inflation rate is now closer to the Community average. Oil prices are not having an abnormal effect on sterling. Our present rate against the ECU is not an unreasonable one in terms of our competitiveness.

Technical Considerations

16. If on balance Ministers considered that we should now join, there would be the option of taking the wider 6 per cent band like the Italians. It would be preferable not to have to suggest that we shared the Italian reason for having a wider band.

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Nonetheless it would give us greater freedom within the EMS, and could be justified on the grounds of the differences in characteristics between sterling and the other European currencies (see paragraph 10(iii) above).

Handling

17. If this question is to be reviewed again before the Budget, you may like to invite the Chancellor of the Exchequer to produce a new paper, or a supplement to his minute of 18 September 1981, taking account of developments since his minute was written. Other Ministers who will have views include the Foreign and Commonwealth Secretary, the Secretaries of State for Defence, Industry, Trade and Energy, and the Minister of Agriculture. The subject could be discussed either at a meeting of the Cabinet - perhaps the pre-budget economic discussions which the Chancellor has proposed for the end of January - or at a meeting of the Ministerial Committee on Economic Strategy, or at an ad hoc meeting under your chairmanship.

18. At the meeting you might direct discussion towards these questions:

- (i) Given the best assessment one can make about future trends of sterling, are the possible consequences of joining the exchange rate mechanism of the EMS for the Government's economic and financial strategy acceptable?
- (ii) Are the economic and political conditions as favourable as they are likely to be for joining?
- (iii) If so, how should the domestic political reaction be handled?
- (iv) What benefits, if any, could we expect to secure within the Community from joining? Would there be any assurances or technical changes we would need to seek?
- (v) If the judgment is that it would be unwise to decide in favour of full membership now, how should our position be presented in public to avoid casting doubt on the Government's commitment to assume full EMS membership in due course?

RTA

ROBERT ARMSTRONG

5 January 1982

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THE (S) AND ITS OBJECTIVES

The EMS has the following elements:-

(1) 9 member states deposit 20% of their gold and dollar reserves with the European Monetary Cooperation Fund and receive ecus in exchange. (Greece has not yet done so). This is largely an elaborate charade, although it might develop into something more substantial if a European Monetary Fund was established. It does however provide a means of mobilising deposited gold reserves. The ecu is a basket currency consisting of fixed amounts of member state currencies (apart from the Greek drachma).

(2) 8 member states (all except the UK and Greece) participate in the exchange rate mechanism. Their exchange rates are fixed relative to the others within a narrow margin of tolerance. For Italy the margin of 6 per cent and for all others 2½ per cent. There is provision for parity changes by mutual consent, but it is intended that these should be rare and that participants should intervene or make policy adjustments when necessary to defend their currencies.

(3) For the same eight member states there is a "presumption" that intervention or policy adjustments will be made should the market rate for their currencies against the ecu diverge from ecu central rates by more than predetermined amount, calculated so as to give the least margin of divergence to the weightiest currencies in the basket.

It is also worth noting that

(4) The ecu is used for accounting purposes in the Community budget, although all transactions are carried out in national currencies.

Objectives of the EMS

3. It was intended that by March 1981 the "provisions and procedures of the EMS would be consolidated into a European Monetary Fund (EMF) with full utilisation of the ecu as a reserve asset and a means of settlement".
4. Second, there was to be increasing economic convergence between the participants. Governments would take into account the need for currency stability in formulating their economic and monetary policies.
5. Third, the EMS was to lead to a "zone of monetary stability in Europe", and for this purpose the exchange rate mechanism (described in paragraph 1(2) above) was set up.
6. From a wider perspective the EMS was also seen as a first step towards "Economic and Monetary Union" (EMU) in the Community. The essence of EMU would be a common currency (or alternatively an irreversible locking of parities between the existing national currencies) supervised by a supra-national central bank. It was envisaged that in due course the EMS would metamorphose into this central bank and the ecu into the common currency.
7. More immediately the EMS was to be an important political symbol of progress in developing the Community.

MR. SCHOLAR

cc: Mr. Whitmore

MEETING TO DISCUSS EMS

This is arranged for Wednesday
13 January at 1530, with the Foreign
Secretary coming in at 1830. The following
will be attending:

Chancellor
Sir D. Wass
Mr. P. Middleton
Mr. T. Burns
Economic Secretary
Governor of the Bank of England + 1
Foreign Secretary

A Walters ✓ confirmed

This meeting does not appear on the
diary and never will.

es.

5 January 1982

CONFIDENTIAL

European R H
Policy

MR WALTERS

u

CC:- Mr Wolfson
Mr Hoskyns
Mr Duguid
Mr Vereker

Monetary Reform and the EMS

The Prime Minister has read without comment your minute of 11 November.

M. C. SCHOLAR

16 November, 1981

CONFIDENTIAL

Prime Minister

(2)

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cc Mr. Wolfson ^{MS 11/4} copied to
Mr. Hoskyns Econ P31
Mr. Duguid Domestic Policy
Mr. Vereker
Mr. Scholar

PRIME MINISTER

MONETARY REFORM AND THE EMS

1. At a meeting between Terry Burns, Peter Middleton and myself today, there emerged a very wide measure of agreement, amounting almost to unanimity, on what should be done in the next stages of monetary reform and for the development of the general financial strategy. The main elements were those which I mentioned in my memorandum of 30 October 1981.

2. We could see no good reason at all for entering the EMS. You may be interested in the views expressed in the Bundesbank Monthly Report. The Bundesbank suggests that the EMS has been a failure in promoting monetary stability. I entirely agree with this assessment by the Bundesbank.

11 November 1981

ALAN WALTERS

CONFIDENTIAL

Advance copy of the article

New measures of monetary policy

which will appear in the
Monthly Report
of the Deutsche Bundesbank
Vol. 33, No. 10, October 1981

new measures of monetary policy

Exchange rates in the European Monetary System (EMS) were realigned with effect from October 5; against the Danish krone, the Belgian and Luxembourg franc and the Irish pound (as measured by the bilateral central rates)

- the Deutsche Mark and the Netherlands guilder were revalued by 5.5%, and
- the French franc and the Italian lira were devalued by 3.0%.

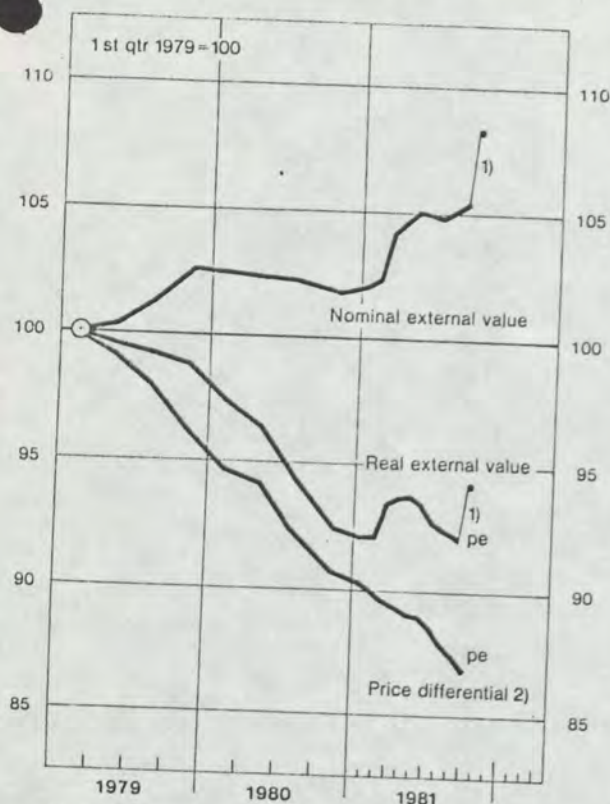
For the Deutsche Mark this resulted in a revaluation of 8³/₄ % against the French franc and the Italian lira.

The realignment of exchange rates in the EMS had become necessary because the price discrepancies and external disequilibria among the various partner countries had grown steadily over time.

Stability of exchange rates is an important goal within the EMS, but in view of the varying price and cost trends, the differing economic structures and the partly diverging economic policy approaches of the partner countries, the possibility of adjusting the central rates between the partner currencies, as and when required, had been envisaged from the outset. Central rate adjustments, such as the latest realignment, are therefore not at variance with the aim of exchange rate stability; indeed, they are necessary in order to preserve the system.

From the very beginning, however, the objectives of the EMS went beyond the establishment of stable (but adjustable) exchange rate relationships; the ultimate goal was the creation within the European Communities of a "zone of stability" which included monetary stability. In fact, no major successes have been achieved in this respect since the EMS was formed. Price rises in the Netherlands and Belgium have come more into line with those in Germany, but at the same time the differential in relation to countries with higher inflation rates like Ireland, Italy and France has increased. In August 1981, for instance, consumer prices in Italy were 19.5% higher than a year before, and those in France were up by 13.6%, while in Germany the inflation rate came to 6.0% and in the Netherlands to 6.4%. Since the EMS was established (in March 1979) such price rises have amounted to 54% in Italy and 36% in France, but to only 16% in the Netherlands and 14% in Germany. Given such divergent trends in general price and cost levels under a system of basically fixed exchange rates (the rates can move only within relatively narrow margins), the competitive position of the countries with higher inflation rates deteriorated in trade with member countries, while the countries with relatively stable prices registered competitive advantages, but also an increase in imported inflation. The latest exchange rate realignment was designed to rectify the accumulated price discrepancies. However, the exchange rate adjustments also owed something to other factors, such as the state of a country's balance of payments, the interest rate dif-

External value of the Deutsche Mark in the EMS*



*Weighted external value against the currencies of the countries participating in the exchange rate mechanism (Belgium, Denmark, France, Ireland, Italy, the Netherlands); geometric mean - 1) Realignment of exchange rates within the EMS with effect from October 5, 1981. - 2) Price movements in Germany - as measured by consumer prices - relative to those in the other EMS countries (in national currencies). A descending line indicates that prices in Germany have risen more slowly than those in the other EMS countries. - Latest position: ● = October 12, 1981. pe Partly estimated.

BBK

ferential and its impact on capital movements, and specific national objectives (e.g. due consideration of the index-linking of wages).

The exchange rates were realigned by first fixing the bilateral central rates anew, as already mentioned. In the aggregate, these central rate adjustments resulted in an average revaluation of the Deutsche Mark against the other EMS currencies of 5 1/2 %.¹ After taking account of the depreciation of the pound sterling in the market since the last realignment, the new parity grid also gave rise to new central rates vis-à-vis the European Currency Unit (ECU).

However, the actual exchange rates of the EMS currencies do not correspond to the bilateral central rates, because the market rates may fluctuate within fixed margins of normally 2.25 % on either side of the bilateral central rate.² Experience shows that, when the central rates are adjusted significantly, the exchange rate formed in the market does not change to the same extent. Immediately after the latest realignment the Deutsche Mark stood at a higher level than before, but it remained

within the lower half of the new margins of fluctuation and at times reached the lower intervention point vis-à-vis the French franc. Thus the result of the realignment was the same as usual in the initial phase: within the EMS the previously strong Deutsche Mark became a "weak" currency, and the devalued currencies appeared to be "strong". When this Report went to press (October 13), the actual appreciation of the Deutsche Mark against the other EMS currencies, relative to the market rates immediately prior to the realignment, consequently amounted to only 2 1/2 %, compared with - as noted - a revaluation of 5 1/2 % on the basis of the central rates. Only if the Deutsche Mark were to take up, within the present margins of fluctuation, a position similar to the one it had occupied before the realignment (i.e. close to the upper intervention point) and if other currencies were to approach the lower intervention point, would the market rates appreciate to the same extent as the central rates, viz. by 5 1/2 %. Hence the exchange rate adjustments are currently imposing a smaller burden on German exports to the EMS countries than had widely been feared when the central rate changes were announced, especially since the pressure on import prices due to the revaluation is at the same time bringing relief to enterprises.

No less significant than the exchange rate shifts among the EMS currencies in the wake of the realignment is the resultant increase in the room for manoeuvre of the Deutsche Mark vis-à-vis the U.S. dollar. In connection with the realignment the Deutsche Mark has become somewhat stronger against the dollar, too, partly perhaps because it has now been freed from certain adverse influences relative to the dollar which affect it when exchange rates in the EMS are unrealistic. But the fact that the Deutsche Mark has appreciated against the dollar since October 2 must also be attributed to another factor which may have been even more important, namely a general improvement in the international standing of the Deutsche Mark. After the realignment the Deutsche Mark strengthened perceptibly, not only against the dollar but also vis-à-vis other major third currencies; between October 2 and the time this Report went to press it appreciated by 2.3 % against the weighted average of the currencies of 23 of Germany's principal trading partners. More than half of this overall appreciation was accounted for by exchange rate movements in the EMS. The weighted external value of the Deutsche Mark is now 3.7 % higher than at the end of 1980, and thus back at the level of end-1979. At least for the time being this development is curbing the importation of inflation into Germany, which up to recently was accentuated by the tendency of the Deutsche Mark to depreciate.

However, a reservation must be made in this connection inasmuch as the restraining effect of the slight appreciation of the Deutsche Mark does not apply to some of the prices of agricultural imports, or to the prices of agricultural exports. In the case of market organisation prod-

¹ Weighted average in accordance with the shares in Germany's foreign trade between 1975 and 1977.

² In the case of Italy the margins amount to $\pm 6\%$; the United Kingdom is not participating in the exchange rate mechanism.

Changes in the central rates and market rates of the Deutsche Mark against the EMS currencies after the realignment of October 4, 1981

Currency	Bilateral central rates		
	DM per currency unit		Revaluation of the DM in %
	previously	as from Oct. 5, 1981	
French franc (100)	42.4505	39.0302	+ 8.76
Netherlands guilder (100)	90.4673	90.4673	0
Belgian/Luxembourg franc (100)	6.23800	5.91280	+ 5.50
Italian lira (1,000)	2.01518	1.85281	+ 8.76
Danish krone (100)	32.1373	30.4619	+ 5.50
Irish pound	3.71457	3.52090	+ 5.50
Average of the EMS currencies 1	—	—	+ 5.54
	Market rates		
	DM per currency unit		Appreciation/Depreciation of the DM in %
	Oct. 2, 1981	Oct. 13, 1981	
French franc (100)	41.630	39.880	+ 4.4
Netherlands guilder (100)	89.925	90.660	- 0.8
Belgian/Luxembourg franc (100)	6.103	5.948	+ 2.6
Italian lira (1,000)	1.950	1.874	+ 4.1
Danish krone (100)	31.680	31.110	+ 1.8
Irish pound	3.643	3.549	+ 2.6
Average of the EMS currencies 1	—	—	+ 2.4

1 Weighted with German shares in foreign trade between 1975 and 1977.

Changes in central rates and in monetary compensation for agricultural imports and exports after the realignment of October 4, 1981

Country	Revaluation (+) or devaluation (-) against the ECU in % 1	Change in monetary compensation in percentage points	Memorandum item Monetary compensation 2	
			before	after
			the realignment	
Germany	+ 5.6	+ 5.1	+ 3.2	+ 8.3
Netherlands	+ 5.6	+ 4.3	0	+ 4.3
Belgium/Luxembourg	+ 0.1	0	0	0
Ireland	+ 0.1	0	0	0
Denmark	+ 0.1	0	0	0
France	- 2.9	0	0	3 0
Italy 4	- 2.9	- 2.2	- 1.7	- 3.9
Memorandum item United Kingdom 4	5 (- 9.8)	+ 1.6	+ 1.9	+ 3.5

1 On the basis of central rates. — 2 Deviation of "green parity" from central rates in % (after deduction of franchise). +: monetary compensatory amounts are charged on imports (import levies) and refunded on exports (export refunds). —: monetary compensatory amounts are refunded on imports (import subsidies) and charged on exports (export levies). — 3 Monetary compensation is unnecessary as the "green parity" was also devalued (by 1.5%). — 4 Monetary compensation is adjusted weekly to exchange rate movements. — 5 Computed devaluation of the pound sterling against the ECU.

on the level of intervention prices. Other countries did not proceed in precisely the same manner; for them the positive or negative MCAs went up — in line with the current regulations — slightly less than would have been consistent with the change in central rates (see the adjacent table). France adjusted the agricultural conversion rate to the change in central rates (albeit likewise only in part). An additional factor in Germany's case is that, while the MCAs were raised in accordance with the central rates, the Deutsche Mark has so far not appreciated nearly so strongly in terms of the actual exchange rates, as noted.

In connection with the firmer position of the Deutsche Mark in the international exchange markets, long-term interest rates in Germany have fallen sharply since mid-September. In the money market, too, the time money rates have decreased slightly, while the day-to-day money rate has remained unchanged. At first this process took place independently of the movement of U.S. security yields, which continued to rise until the end of September. More recently, however, the fall in interest rates in Germany has been fostered by declining bond yields in the United States. The reduction in long-term interest rates in Germany due to market factors, which has now spread to bank lending rates as well, no doubt reflects the fact that fears of a further depreciation of the Deutsche Mark have disappeared — and if anything given way to expectations of an appreciation — as a result of the improvement in the current account and the strengthening of the Deutsche Mark against the U.S. dollar and other major currencies.

The Bundesbank took due account of the changed situation in the financial and foreign exchange markets and lowered the special lombard rate from 12% to 11% with effect from October 9. This correspondingly reduced the cost to the banks of raising funds by pledging securities at the central bank, which has averaged about DM 3 billion during the past few months. Money market rates have also fallen to about the same extent. The Bundesbank was able to exploit the resultant scope for interest rate policy because the importation of inflation has been slowed down by the appreciation of the Deutsche Mark against major partner currencies. Nevertheless, price rises in Germany, which are largely "home-made", continue to be strong. Even though the situation in the external field is somewhat easier, the monetary room for manoeuvre can be utilised only with caution, especially since international interest rate developments remain complex and subject to sharp fluctuations. The adjustment of the German economy to external conditions, which have been radically different for more than two years now, has made some progress but, as the monthly current account deficits show, it has not yet gone far enough. Moreover, it must be further supported by government fiscal policy and the incomes policy of management and labour, not least in order to avert adverse consequences for employment.

ucts, the revaluation of the ECU central rate of the Deutsche Mark in the EMS is offset by increasing the "monetary compensatory amounts" (MCAs) for imports of agricultural goods into and exports of agricultural goods out of Germany. In accordance with the Federal Government's wishes, the EEC Commission raised the MCAs for Germany to the same extent as the Deutsche Mark was revalued, in order to preclude repercussions

PRIME MINISTER

EMS

Because of the pressure on your time we have had to cancel several times the planned meeting on EMS.

When you last looked at this you wanted a preliminary meeting, with the Chancellor of the Exchequer, the Chief Secretary, Mr. Nott, Mr. Lawson, Alan Walters, Terry Burns, Ken Couzens and Peter Middleton.

May I suggest that we make this preliminary meeting a purely Treasury affair? My reasoning is that once we include people outside the Treasury others (especially Lord Carrington and Gordon Richardson) will think they ought to be invited. As I understand it, the point of the preliminary meeting is to get the arguments clear in your mind. There then would be a subsequent meeting with all the interests who will need to be brought in before a decision can be reached.

MS

It consists of
people all of whom
have been Treasury
Ministers or who are
with Treasury now
not

4 November 1981

CONFIDENTIAL

22 October 1981

2

ALAN WALTERS

PRIME MINISTER

EMS

Prime Minister

Alan Walters

Earlier date for a meeting on this is Nov 11.

MS 23/10

1. Pseudo-fixed versus fixed

The ~~real~~ underlying exchange rates are determined by fiscal and monetary policy, relative to those policies of our trading partners. Conversely, if we really fix exchange rates by some intervention system, we lose some sovereignty over monetary and fiscal policy. That policy will be determined by the behaviour of (much larger) aggregate of trading partners. The essential question therefore is whether this regime of fixed exchange rates with a monetary fiscal policy determined by the exigencies of the exchange markets, is a better regime for conducting economic policy than the one which operates at present, under which we determine our fiscal monetary policy and the exchange rate is left to market forces. (An additional complicating factor in the case of the UK is that the exchange rate is influenced to an unknown extent by the oil joker. But the objections on these grounds are well known and I will not deal with them further in this note.)

The EMS, however, is not a system of fixed exchange rates. First parities move within a band. And after bumping along against the ceiling or the floor they go through a process of periodic re-alignment. Then rates move in discreet jumps. The "exchange rate discipline", which many people think is desirable, is not one of a fixed rate but of a rate that is pseudo-fixed but periodically jumps. Ultimately, in a relatively free market, the extent of the movement in exchange rates must, of course, reflect the relative fiscal and monetary policy. The only difference is that the path may be determined by a free market or the administered EMS jumping bands.

2. The issue of stability

The argument that EMS would produce greater stability of exchange rates therefore can only apply in the short run. And such stability will be subject to the political uncertainties of the periodic jumps. It is also anticipated that the UK would enter initially with something like a 6% band which would imply the possibility of very short term instability in that band. With a free system any trader can

/buy stability

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buy stability by entering the forward market. (He can do this with EMS or non EMS currencies.) In short, if anyone wants a stable rate he can buy it.

3. Fiscal and Monetary Discipline

The only substantial argument for joining the EMS is that it will supply an exchange rate discipline which can be used to strengthen, politically, domestic fiscal and monetary policies. The EMS constraint could be prayed in aid in discussions of public expenditure, taxation, etc. It would be a European version of the IMF bogeyman.

The exchange rate discipline may point in the same direction as the domestic requirements. Assume for the present that that is the case. The next question is will it be effective, (say roughly to the same extent as the IMF under Bretton Woods)? There are good reasons for doubting this.

4. Evidence from History of EMS

Since 1979 the European countries have conducted their domestic policies with very much domestic objectives in mind. There is no convincing evidence that the movements in domestic policy have been motivated by external requirements of the EMS. The usual mechanism for domestic monetary control has been movements of interest rates. I think it is clear that movements in German interest rates since 1979 have been motivated by their domestic problems and in particular the need to contain inflation after the rise in oil prices. Similarly, the French have carried on a long tradition of pursuing a policy that they consider both politically and economically correct for their circumstances. (The French used the old Bretton Woods system far more skilfully than we did.) In the two-and-a-half years of its life there have been a large number of adjustments of the bands, far larger than under the Bretton Woods system. The general conclusion is then that the domestic economic policies have been not much influenced by the exigencies of the EMS bands. In case of difficulty the bands have been moved. Thus they cannot have acted as a crucial or important stimulus to the appropriate domestic policies.

5. The UK as a "Difficult Case" of
Conflicts

5. The UK as a "Difficult Case" of Conflicts

Obviously in some circumstances domestic and international interests may pull in opposite directions. This would probably have happened with sterling had we have joined with the Irish punt. In order to contain the upward pressure on sterling during 1980, we would have required a very considerable expansion in the money supply and much lower interest rates in order to keep sterling down in the EMS band. Following form in the EMS, we would have given primacy to our domestic requirements to control the rate of inflation and let sterling appreciate in one or two re-alignments. But this policy would have been accompanied by great difficulties in stemming the inflow of funds in anticipation of further increases in sterling. There would undoubtedly have been a much greater expansion of the money supply in 1980 running through the first months of 1981 which would have spelled trouble for our anti-inflation policy in 1981/82/83. Because of our special position with oil and the fact that sterling is still a widely held, freely available international trading currency, it is likely that we shall have conflicting domestic and EMS objectives more frequently and more severely than the other countries of Europe.

6. Credit Controls, Exchange Controls and Import Surcharges

If the EMS discipline is effective, then it is very likely to lead to demands for exchange controls and probably also credit controls. Temporary import surcharges, such as have been employed by Italy in the EMS, would also be considered as possible means of defending the rate. It would be argued that we could only defend our parity if there were additional weapons, certainly credit controls. Realistically it would be argued that sterling is inherently at least as weak as the French franc, if not the Italian lira. And draconian measures would frequently be needed.

(Rumours in the City are strong that exchange rates are likely to be re-imposed. There is also an increasing belief that we shall enter the EMS now our currency has fallen to what are thought to be more realistic levels. These rumours, and particularly those about exchange controls, are causing very grave difficulties both in general funding and in financial markets.)

7. The Likely Stability

7. The Likely Stability of the Deutchemark and Franc

Going into the EMS would imply tying ourselves primarily to the Deutchemark. This would mean that domestic monetary policy would be settled largely by the behaviour of the German economy and German monetary policy. Although Germany has been a model of stability since 1950, there is no guarantee that this will persist. It is not only external events, such as Poland, but also considerable internal divisions are appearing in what was once thought to be a wide consensus on the conduct of German economic policy.

Although the influence of France is considerably less than that of Germany, there are very grave doubts about whether the French will pursue policies anything like consistent with stable parities. The network of controls grows apace. And the performance of French governments before 1958 does not bode well. I suspect that the French will use the EMS system for what its worth but will break it up if it interferes with their domestic political aspirations.

8. Exchange Rate Regime Outside the EMS

In principle we could adopt an exchange rate regime with respect to the EMS, yet not join the EMS itself. Successful defence of the parities would require the same policies whether we were in the EMS or out of it. The only argument for joining the EMS would be it would conceivably make the defence of the parities more credible and perhaps involve less intervention.

9. Politicisation of EMS

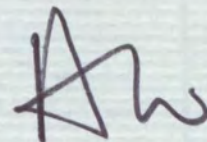
Lastly, there is the undesirability of being involved in the political process of fixing new parities or intervention bands. Movements in exchange rates bands, or re-alignments, are a matter for political horse trading. On some occasions such as the Italian devaluation, these have been done unilaterally. But the procedures of the EMS clearly require multilateral negotiation of re-alignments. This inevitably involves a great deal of political horse trading. Although the fundamental underlying economic reality has an influence on these arguments, there is no doubt that such a political process is not the best way of determining exchange rates. The market does a better job.

10. Conclusion

10. Conclusion

If the EMS were a step on the road to a true central bank for a Europe which would have one currency and a unified fiscal monetary system, then one would have a very different view of the desirability of joining the EMS. In my discussion I have assumed that this is not the case. I do not believe we shall ever achieve monetary and fiscal union in Europe. I do not think there is any chance of the emergence of a proper central bank, depoliticised and independent of governments, running European monetary policy.

I remain convinced that the disadvantages of joining the EMS far outweigh the small advantages of joining. With its present constitution, heavily politicised, I doubt whether it will ever be a propitious time for us to join. At present, however, in view of the likely disparate policies to be followed by the Germans on the one hand and the French and Italians on the other, it seems to be a particularly bad time to envisage joining a club that seems likely to pull itself apart.



ALAN WALTERS

22 October 1981

cc Mr. Alexander
Mr. Scholar
Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Vereker

PRIME MINISTER

EMS Seminar

We have tentatively pencilled in Friday, 30 October, at 1000 as the time for the seminar on whether or not we should join the EMS.

I see that in your discussion with the Chancellor in September you envisaged that the participants at the seminar would be the Chancellor, Lord Carrington, Mr. Nott and perhaps also Mr. Lawson. Later you felt that it would be helpful not to have the Bank present initially. I understand that Sir Robert Armstrong is planning to put in a note on this matter; so I imagine that it would be useful for him also to be present. Alan Walters would also, presumably, come.

If it is your intention to have a full discussion and to thrash out all the issues involved, it would probably be best to have a number of other people from the Treasury - I suggest Terry Burns, Douglas Wass, Ken Couzens and Peter Middleton. Unless the numbers are getting too big you may also feel that the Chief Secretary should be invited. The same argument also, perhaps, applies to John Biffen.

I see one problem about the Bank's exclusion. It is a certainty that the Governor will wish to express a view about this issue, and it would be wasteful of your time if that happens after a seminar at which he is not present. There may be a case, therefore, if it is your intention to have a wide-ranging discussion on the scale envisaged above, for including the Governor and Deputy Governor so as to deal with their views at the same time as you address the issue generally.

Content for me to set up the meeting on these lines? *No*

MCS

16 October, 1981.

I want a preliminary meeting first.
Ch. Ent. Ken Biffen, Mr. Nott - Mr. Lawson + Alan Walters + Terry Burns

Peter Middleton - Ken Couzens



cc Mr Walten *Ewo*
PJ7
NBFM

Foreign and Commonwealth Office
London SW1

14 October 1981

Dear Geoffrey,

EMS REALIGNMENT : 4 OCTOBER

Thank you for your letter of 5 October about the EMS realignment. I am grateful for this full (and lively) account of a successful operation, and I am sure that Peter Carrington will read it with interest. We have heard warm tributes for your skilful handling of the discussions from our partners.

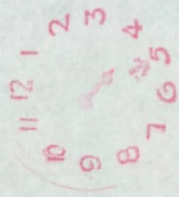
I am copying this to the copy recipients of your letter.

Yours

P. Humphrey

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1

114 OCT 1981



10.10.81
Fri 30^m 10.00

MR. SCHOLAR

Here is a note which I sent to John Hoskyns relating to the EMS. It summarises my view which I have held for many years. However, I propose to take another look at the recent performance and prospects, and I will write another memorandum for the Prime Minister.

AW

13 October 1981

pp ALAN WALTERS

MR. HOSKYNS

THE EMS - CHRISTOPHER JOHNSON'S LETTER, THE TIMES 1 OCTOBER

1. As you probably know, I have always taken the view that the best system of exchange rates is where they are absolutely fixed and do not change at all. This was broadly the system we had during the 19th century. If you can't have absolutely fixed exchange rates then the best system is one of free floating.
2. Even with absolutely fixed exchange rates, however, there are great problems if the dominant economy, Britain in the 19th century or the United States in the 20th, misbehaves itself and either pursues a great monetary expansion or contraction as the United States did in 1931 and 1965. Thus there is a real presumption in practice very much in favour of free exchange rates.
3. If the UK wanted to fix its exchange rates relative to some other country, such as Germany, it could always do so provided it was willing to follow the consequences. These would involve having enormous reserves to do sufficient exchange rate intervention, or arranging suitable swap agreements etc, and taking the appropriate domestic medicine. A country which has done this successfully for some time now is Chile. There the foreign exchange reserves exceed the total money stock so the running down of the reserves causes an automatic running down of the stock of domestic money and the system is self-regulating. But if they wished, the Chileans could devalue or revalue according to their domestic circumstances and in accordance with their judgement about what's good for them.
4. The EMS is entirely different. Rates and adjustments of parities are determined by the most enormous political argy-bargy. They are not subject to any of the normal rules which applied, albeit in a political environment and in a haphazard way, to the Bretton Woods system. It is, for example, not difficult to imagine a bargain being struck for turkeys against sterling.

5. And what do we gain by being in the EMS? So far as I can see the only feature would be the use of some additional reserves in the system. But if we run our system properly we can negotiate swap agreements with the United States in any case, and the dollar continues to be the main intervention currency in world markets. So any advantage we get on that score from joining the EMS is small beer.

 6. Christopher Johnson's argument merely says that the pound is somewhere near about right relative to the deutschemark and oil prices are not going to rise, (he doesn't talk about what's going to happen if they fall!) and that it would be helpful to the other EMS currencies if Britain joined. None of these arguments tackle the substantive issue. They are all concerned with the timing and transitory process of getting in, and the likely position of sterling once it is inside the EMS. For my part I find it very difficult to predict what political and economic conditions are going to be like in different countries in Europe, as well as the United States, over the next few years. What is going to happen to France? Will a renewed threat of chaos in Poland cause great difficulties with Germany and the deutschemark? And suppose the price of oil does fall through the floor?

 7. If the EMS showed signs of being a genuine central bank, de-politicised and running the European money supply with sensible rules for stability etc, then I would take a very different view from that which I take now. But the EMS as it stands is riven with political bargaining and is simply an extension of the acrimonious debate that goes on at present in Brussels. Contrary to what Christopher Johnson suggests that if we joined there would be an increase in the popularity of Common Market membership, I would guess that any Government would tend to use the EMS as a scapegoat.

 8. Broadly speaking then my position is that if we want to fix exchange rates we can with almost as much efficacy as being in the EMS. If we don't, however, and we join the EMS and want to move our parity, then we have the most acrimonious debate on our hands and all sorts of bargaining problems with our partners. My own view is it's best to let the exchange rate float more or less freely. We should then concentrate on putting our own house in order.
- A

CONFIDENTIAL



Foreign and Commonwealth Office

London SW1A 2AH

6 October 1981

*Carrington
There seems every reason to
invite Lord C*

Dear Michael,

EMS

On second thoughts, it seemed worth summarising for the record our telephone conversation this morning.

I mentioned that Lord Carrington has seen Tim Lankester's letter of 23 September to Peter Jenkins, and has said that he hopes the Prime Minister will agree that he should attend her proposed meeting with the Chancellor.

I am copying this letter to Peter Jenkins.

Yours ever.
Francis Richards

(F N Richards)
Private Secretary

Michael Scholar Esq
10 Downing St

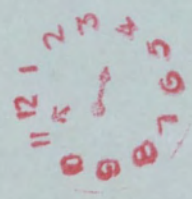
CONFIDENTIAL

Patricia and Christopher Smith

London SW17 5JH



1009-6



cc Mr Walters (2)

Prime Minister

To note

Hes 8/10



Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

5 October 1981

Rt. Hon. Humphrey Atkins, MP.,
Lord Privy Seal

ms

A handwritten signature in dark ink, appearing to read 'Humphrey Atkins'.

EMS REALIGNMENT: 4 OCTOBER

You might like to have an account of the realignment conference in Brussels yesterday. It was the first such negotiation that we have participated in, and proved an interesting experience. Even though a realignment conference is not a meeting of the Finance Council it fell to me, as the current Chairman, to secure an agreement before the markets opened on Monday morning.

The ground was prepared by the Monetary Committee at a long session on Saturday night. The Germans and French announced that they had decided that the correct adjustment between their two currencies was a revaluation of the deutschemark by 4.75 per cent and a devaluation of the French franc by 4.75 per cent (against what was not specified). They then attempted to brow-beat the Italians, the Belgians and the Irish to go down with France. The Belgians and Irish - who had clearly not been consulted in advance - resisted strongly and the Italians said they would go down only by 2 per cent. The Dutch - who equally clearly had been consulted by the Germans - announced their firm intention to stay with the deutschemark and then took part in the pressure on the Belgians to devalue. This was in sharp contrast with the attitude of the Dutch in 1979 when they agreed to devalue with the Belgian franc in order to avoid creating trade barriers in agricultural produce within Benelux.

At the start of the Ministerial meeting on Sunday morning it was announced that the Benelux countries had reached agreement that the guilder would stay with the deutschemark and that the Belgian and Luxembourg francs would remain in a neutral position, i.e. neither moving up nor down. The Irish and the Danes also said they would stay in a neutral position. No-one pressed these countries further - in the Belgian case, not because anyone was convinced by the logic of their position (the Belgian economy is in severe disequilibrium), but because it was acknowledged that their domestic political disarray meant they were not in a position to agree to anything else.

/After a couple



After a couple of hours' debate the Ministerial meeting was adjourned, and I retired metaphorically to my Chambers, where a prolonged and at times acrimonious negotiation took place between Germany, France and Italy. Officials and Central Bank Governors were present for part of the time, but tactfully withdrew as the political temperature rose. The Italians resisted a declared devaluation of the lira of more than 2.75 per cent and a depreciation against the deutschemark of more than 7 per cent. The French fought hard for a depreciation against the deutschemark of at least 8.75 per cent and insisted that the Italians move with them. Delors spoke of having to introduce import controls if the franc depreciation was insufficient. The Bundesbank (rather uncharacteristically) resisted a revaluation of the deutschemark of more than 5 per cent. There was much telephoning to capitals, and one particularly emotional exchange between Matthofer (who was pretty rough) and Andreatta (who seemed to have strict riding instructions from Spadolini, and clearly resented the way in which the initial Franco-German proposal had been cooked up in private). But in the end the three Ministers agreed on a compromise that I had earlier suggested, whereby the deutschemark and guilder go up by 5½ per cent and the French franc and the lira down by 3 per cent.

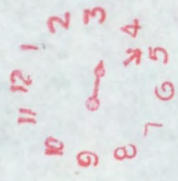
A resumed plenary session in the early evening accepted my compromise without further dissent, and - rather to the general surprise - we all got home late last night.

The Commission circulated figures for the consequences of the realignment for agricultural MCA's and the further implications will be sorted out this week in consultation with the relevant management committees. It is likely that in due course Agricultural Ministers will be considering proposals to devalue the green French franc and the green lira. I restated for the record that the position of HMG on sterling and the EMS remained unchanged - no-one else mentioned the point. The market seems to have accepted the new pattern of rates reasonably well. Even so, it was sobering to watch exchange rates being determined by quite such a crude process of political bargaining.

I am sending copies of this letter to the Prime Minister's office and Peter Carrington's, in case they may be interested to see it on their return. Copies also go to Peter Walker, Gordon Richardson, and Sir Robert Armstrong.

GEOFFREY HOWE

57 OCT 1981



CONFIDENTIAL

jfh

cc to Econ M
Part 9
Dom. Man Policy

These files
to be BFD on
return from
Australia.

X (B) for meeting

23 September 1981

We spoke on the telephone earlier today about the possible decision to issue a derestricted indexed gilt.

I have drawn the Prime Minister's attention to some of the wider implications of this decision, on the lines we discussed; but she has decided that, in view of all her other immediate preoccupations, she will leave the final decision on this to the Chancellor and the Governor.

I have also drawn the Prime Minister's attention to the Bank's interest in the C Chancellor's minute of 18 September on EMS, and I am sure she will want the Bank to be represented when she discusses the issue with the Chancellor in due course. This will probably not be before she returns from Cancun towards the end of October.

no - she does not. X
MCS

TPL

C.W. McMahon, Esq.

CONFIDENTIAL

jfh

Euro PA

23 September 1981

JP to Mr. G.

The Prime Minister has read the Chancellor's minute of 18 September about EMS, and she will wish to discuss it with the Chancellor, probably after Cancun. We will be in touch with you to arrange this. Could you please in the meantime send a copy of the minute to the Foreign and Commonwealth Office.

TPL

Peter Jenkins, Esq.,
HM Treasury.

JP

MR ALEXANDER

R Whitmore: 'A' is probably right, tho' it is not the best way to get a decision. You may like to discuss with the Prime Minister.

Attached is the Chancellor's minute of 18 September about EMS. We agreed it would be helpful if you could discuss with the Prime Minister during the trip overseas how she would like this carried forward.

And

The Prime Minister and the Chancellor agreed that it would be a good idea to have a small meeting to discuss the issue. Obviously we need the Foreign and Commonwealth Secretary (and I have asked the Treasury to send a copy of the minute to the FCO). We also ought to have the Governor and possibly the Deputy Governor: the latter telephoned me this morning to say that the Bank were not very happy with the Chancellor's minute and in particular they think it does not bring out sufficiently the advantages in terms of greater exchange rate stability that we might have from being a member of the EMS. I should add, for my part, that the minute says nothing about the possibility of joining with the 6 per cent margin, nor about the possibilities of changing the parity while remaining a member of the EMS (or indeed other countries' experience in doing so).

The Prime Minister told the Chancellor that she might also wish to include Mr. Lawson and Mr. Nott in the discussion. Apparently, Lawson is moving towards favouring our joining; I imagine Nott remains opposed.

A | I think the meeting should take the form of a seminar, presumably some time soon after Cancun, including officials with a view to having all the arguments properly thrashed out. Michael Franklin has a copy of the Chancellor's minute, and will - I understand - be preparing a note for Robert Armstrong.

Note Informed J Kerr (Ch/Ex's office) by telephone of the Prime Minister's views. He has recorded these for me Treasury's purposes. MCS 12/10

① I should prefer a meeting without the Bank in the first instance. ② ? Alan Waller view?

23 September 1981 *③ Personally, I do not think the case for joining has been made. I am ... against, not*

Prime Minister ^C to see
 N.P.C. Mitchell
 Duty Clerk
 19/9/81

17

cc. RTA

A. Walters

 Treasury Chambers, Parliament Street, SW1P 3AG
 01-233 3000

A handwritten signature in black ink, appearing to be 'M' or 'W'.

PRIME MINISTER

We had a word on 14 September, and again on 16 September about EMS, and I undertook to let you have a note on the current Treasury view. As I mentioned, I have throughout ensured that we keep under regular review the balance of advantage between joining and remaining outside the exchange rate mechanism. This assessment takes account of the most recent developments.

2. The background is that after a year and a half of appreciation of the dollar against the DM, markets are expecting a recovery of the DM: this has indeed begun. They foresee the American current account moving into deficit while the German deficit falls substantially. While Poland still counts against the DM, the decline in dollar oil prices helps the German currency. It looks as if this market view could be broadly right, though political developments (eg in Poland) could upset it. The counter inflationary determination of governments, in the United States and Germany as in the UK, will also continue to influence currencies.

3. Against that background one can consider UK membership of the EMS under two headings. First, would membership keep sterling stronger and the exchange rate more stable? Secondly, could it be both ~~operated~~ operated and presented as a continuation and extension of our present counter inflation policies?

Sterling: Stronger and more stable?

4. On the first question, you are familiar with the risk that, if we entered the system while sterling was falling, the market

S E C R E T



might not accept the entry rate or regard the decision to join as an adequate substitute for policy steps. Under more normal circumstances however we could expect some initial benefit in the market from the determination to defend the rate which entry would imply. That part of British industry which trades with Europe would get an exchange rate which fluctuated within narrower margins and changed from time to time in steps rather than experiencing more continuous change. In the longer term successful defence of the exchange rate, in the EMS as out of it, would depend on policies which convince markets. In the wrong circumstances defence of a fixed exchange rate could increase the strains rather than reduce them.

5. Whether on average sterling would be stronger inside the EMS in the next 2 years would therefore depend on the future of the DM and our ability to keep up with it. Keeping up with it might well mean increasing our effective rate if the dollar fell as the DM rose. But the scale and nature of policy measures we would have to take to secure a generally appreciating currency would be much the same inside the EMS or out of it. Those now in the EMS have had to take policy measures to maintain their parities, eg the French had to increase interest rates to 22 per cent, and introduce new exchange controls, following their elections.

6. You and I have discussed the complication of the petro-currency status of sterling, which remains important. Given the international status of sterling, it pulls our currency in the opposite direction from those of our main Community partners, eg the DM or the French franc. We have declined against the EMS currencies in recent weeks because of the oil factor, just as we rose against them earlier for the same reason. This factor, though not necessarily decisive, could oblige us to accept more frequent realignments in the EMS, and it could also demand more frequent policy action to steady our rate.



7. The conclusion must be that EMS membership could produce a higher average exchange rate if the DM rose and if we took policy steps to keep up with it. Such policy steps might in any case be intrinsically right, whether or not we were members, but they would be domestically unpopular, and this unpopularity might well be enhanced if they carried a Community label. Provided we took them, membership should produce more stability in sterling rates against the currencies of our major European trading partners - though not against the dollar.

Continuation of, or conflict with, current policies?

8. Turning to the second question, I am sure that we could present EMS membership as an extension of present policy, but the continued credibility of that would depend on events. We have said we would join in due course. We have made progress on inflation. We have taken increasing account of the exchange rate in interest rate decisions. The present constellation of exchange rates against sterling is probably not wildly unacceptable to industry and could improve further in coming months (though if we joined and we went up against the dollar with a rapidly improving DM there would no doubt be protests).

9. Accepting and defending an exchange rate link (or any public exchange rate target) is however very different from taking account in one's policies of the exchange rate position, as we do now. There would also have to be clear acceptance within the Government that if steps were needed to prevent the exchange rate falling, policy action would have to be taken promptly, including action on public expenditure as well as on interest rates or taxes. Delay in the EMS means intervention. Rates of \$1 billion a day are not unknown. In practice that would tend to mean additions to external indebtedness in reversal of present policies. If entry to the EMS became an easy option in this way it would indeed be a reversal of present counter inflation policy.



10. As we know, there could be conflicts between policies needed to hold the exchange rate and those needed to meet a monetary target. We have already seen this conflict when the exchange rate was high and rising but on monetary grounds we needed to raise interest rates to meet the target. This could happen again. We can balance these conflicting situations outside the EMS; it would be more difficult inside it. The Germans and Swiss have had the same problems - and in extreme situations have sacrificed their monetary targets to their exchange rate targets, in the knowledge that their absolute inflation rates were then low. We have to remember too that the most important exchange rate link for the Germans (and for the international system) is the DM-Dollar rate, which is outside the EMS. Their position as masters of the key currency of the system is different from (and stronger than) the position of other members.

11. It is possible to argue that EMS membership would not make major differences to our overall policy stance because we could always realign our way out of unforeseen developments. To the extent that we could rely on shocks in the oil market as an excuse there could be some truth in that. But clearly we could not in practice go beyond a certain point without making our membership meaningless. And we should not want to do that. If we went in, we would have to accept the rules of the game.

12. Opponents of our monetary policy would obviously seek to interpret joining the EMS as moving away from monetary targets and the MTFS. It would in fact be essential to retain the MTFS; and the taunt that we were not in practice doing so would not stick if our counter inflation policy succeeded, with the exchange rate playing a part. But that comes back again to the question of what policy measures we were prepared to adopt.

Relations with the Community

13. I of course have in mind the possibility that UK entry might bring wider political dividends within the Community. We ought at some stage to examine in detail what they might be.



I myself am inclined to doubt whether it would be realistic to think in terms of any direct quid pro quo e.g. in the Budget context: our partners would reasonably argue, if we decide to go in, that our decision, like our previous decision to stay out, was based entirely on our assessment of our best interest, and that they owed us no favours. On the other hand, UK entry would be generally seen in political terms as a positive step, consistent with the widespread wish to inject a new momentum into the Community's development: it would certainly bring at least the benefit of an improvement in the atmosphere of Community discussion, e.g. on the Budget problem.

Conclusion

14. To sum up, my view is that - as I said to you earlier in the week - the case for joining is now probably stronger than it was last year, not least because of the deceleration of inflation and, more important than that, the much lower level of the exchange rate. But our petro-currency status still differentiates us from our partners. The key point is that EMS membership would not of itself provide an additional buttress to our counter-inflationary policies: the success of which would still depend on policy action. Certainly the case for policy decisions could be reinforced by the wish to avoid a realignment within the grid. But it might become politically harder to take the necessary action in what the public would see as a more European context. There would be new constraints on our decisions, which would sometimes conflict with the monetary constraints we have already accepted, and we would have a more direct responsibility for exchange rate levels and movements. In short, entry would not be a soft option. But neither of us would wish to join it for that reason. On the contrary.

15. For the present, I am not yet convinced that the political benefits of joining, and the likely benefit to UK business from greater stability vis a vis the European currencies, and the possible strengthening of our counter-inflation policy, outweigh

S E C R E T



the risks and disadvantages. But the balance has shifted and may shift further. Nigel Lawson is close to taking the opposite view. But Leon Brittan - like Sam - remains against a decision to enter.

16. This is the basis on which we might like to arrange a further talk in a few weeks' time, when we both return from our travels.

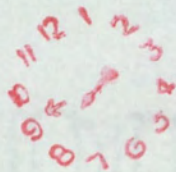
17. I am sending a copy of this minute to the Governor of the Bank of England.

(G.H.)

18 September, 1981



19 SEP 1987



COPIES

Extract from meeting record between the Prime Minister
and the Chancellor of the Exchequer on Wednesday 16 September
1981.

Top copy:

Gout Mack

CSO/HMT. P. 4.

(ii) EMS

The Chancellor said that he hoped to let the Prime Minister have a paper on the EMS before the weekend. He did not wish to rush into a decision: at present he still thought the economic arguments were marginally against our joining, but he recognised the political arguments in favour. At the same time, there were also important political arguments against which had to be fully considered - it could well be unpopular domestically, and it would provide the trade unions with another stick with which to beat the Government. The Prime Minister said that she too did not wish to be rushed into a decision; she would want to be convinced that there were positive arguments in favour of our joining, rather than that there were no longer sufficiently strong arguments against ~~for us to~~ ^{our} continuing ~~staying~~ ^{to} out. She also recalled that Mr. Nott was a strong opponent of our joining; she would want him to be involved in any preliminary discussion of the issue. It was provisionally agreed that there should be a

meeting sometime in October to consider the Chancellor's paper - the meeting should include Lord Carrington, Mr. Nott and probably Mr. Lawson.

SUBJECT

SECRET

1700 ^{econ} ^{1st} VS 16

Le Master

Correct to

Domestic Monetary

Econ Policy No 9



by Mr. Walters

Original file on:-

Econ Pol: Exchange Rate: May 79

10 DOWNING STREET

From the Private Secretary

14 September 1981

Dear Tim.

As you know, the Chancellor and the Governor called on the Prime Minister late this morning to discuss interest rates and the exchange rate. They were accompanied by Sir Kenneth Couzens.

The Chancellor said that towards the end of the previous week he had become increasingly concerned about the fall in the exchange rate. It had continued to fall this morning; and at noon the effective rate was 86.6, which was below its level at the time of the General Election, and the DM rate was just over 4.21. These rates compared with 98.6 and 4.66 respectively on Budget Day. He and the Governor now believed it would be appropriate to raise the undisclosed interest rate band - probably by 1½% - with a view to bringing about a 2% rise in base rates. This was partly with a view to arresting the fall in the exchange rate; but it was also justified to some extent by the domestic monetary situation. The latest money supply figures and their medium prospects, and in particular the strength of bank lending to the personal sector, were a cause for concern.

The Governor explained that sterling had been weakening for several months, but the fall against the DM had accelerated over the last few days. One reason for the decline was the widening of the interest rate differential between sterling and the dollar; another was the weakening of oil prices, which particularly favoured the DM. He supported the Chancellor's view that, on both exchange rate and domestic monetary grounds, a 2% rise in base rates was required.

The Prime Minister said that, if interest rates were to be raised at all, the increase should be sufficient to achieve a steadying of the exchange rate. She therefore agreed with the proposal that the undisclosed band should be raised so as to bring about an increase in base rates of 2%; anything less would be likely to be insufficient. The Prime Minister went on to say that recent developments on the exchange rate front raised the question once again of whether the UK should join the EMS. She hoped that the Chancellor would reconsider the options. The Chancellor said that he was already looking at this question, and he hoped to be in a position to advise the Prime Minister further before he went away later in the week.

I am sending a copy of this letter to Tim Allen (Bank of England)

John Kerr, Esq.,
H. M. Treasury

SECRET

Tim Lambert



Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

14 September 1981

*original filed on:-
Econ Pol: Exchange Rate: May 79*

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

New Tim,

EXCHANGE RATE AND INTEREST RATES

As you know, the Chancellor discussed the exchange rate situation with the Governor this morning. Although the situation was put to the Prime Minister later this morning, and the decision has now been taken, you may like to know for the record a note of the arguments and their presentation.

The Governor said that the external arguments for raising interest rates were now very strong. The fall in the exchange rate had persisted over many months: in view of the inflationary impact it was now necessary to act. Intervention alone would not be enough. We now needed to do more on interest rates than had been agreed earlier in the summer, when the external situation had not seemed to call for a rise in bank base rates, and the prospect of lower American rates seemed both stronger and more likely to be sufficient. The rapid fall of sterling this morning added to the force of these arguments. The key figures are as follows and a fuller table is annexed.

	<u>Election</u> <u>day</u>	<u>Peak</u>	<u>Today</u>	<u>% change since</u>	
				<u>Election</u>	<u>Peak</u>
				<u>day</u>	<u>day</u>
Effective	86.7	105.6 (28 Jan '81)	86.6	-0.1	-18.0
£/\$	2.08	2.47 (24 Oct '80)	1.77	-14.6	-28.1
£/DM	4.0	5.07 (16 Feb '81)	4.21	+5.3	-17.0

Domestic monetary arguments pointed in the same direction, though here the situation was less clear-cut. The most threatening element was the rapid increase of bank lending particularly for housing. But it was also right to be cautious in view of the statistical fog generated by the Civil Service strike which would

/continue



continue to distort the CGBR and hence the £M3 figures for months ahead.

Treasury officials agreed with the Bank's analysis on both external and domestic fronts.

The Governor therefore proposed that the undisclosed band for very short term interest rates should be raised, from 11½-13½ per cent to 13-15 per cent. This rise of 1½ per cent was likely to lead to a rise of 2 per cent in bank base rates and a similar rise in mortgage rates, though the extent of these changes was uncertain.

The Chancellor agreed with the Governor's proposal, which he recognised was given with reluctance in view of the impact on the recovery of the economy and the obvious political difficulties. But as you know the threat to the Government's inflation strategy is in the Chancellor's view too great for inaction on interest rates to be a tolerable option in current circumstances.

Although there will be no announcement of the kind familiar when MLR was in use, it will of course be apparent that the rise in interest rates is being brought about by the authorities' action. The briefing which has been prepared will say that the action has been taken primarily in response to the external situation, but that in view of the rapid expansion of bank lending and of the obscurity surrounding the monetary figures as a result of the effects of the Civil Service strike which will continue for months ahead, a rise in interest rates will also be in line with the appropriately cautious conduct of domestic monetary policy.

I am sending a copy of this letter to Tim Allen at the Bank.

*Yours ever,
J.O. Kerr.*

J.O. KERR

Recent sterling exchange rates

(Percentage changes are calculated from Election Day)

<u>Date</u>	<u>US\$</u>	<u>Effective Exchange Rate</u>	<u>DM</u>
3. 5.79 (Election Day)	2.0759	86.7	4.0

15.11.79 (MLR increased to 17%)	2.1420 (+3.2%)	88.8 (+2.4%)	3.81 (-4.8%)
3. 7.80 (MLR to 16%)	2.3455 (+13.0%)	94.7 (+9.2%)	4.12 (+4.6%)
24.10.80 (\$/£ peak)	<u>2.4650</u> (+18.7%)	101.4 (+16.9%)	4.60 (+16.7%)
6.11.80 (1980 ERI peak)	2.4426 (+17.7%)	103.4 (+19.3%)	4.75 (+20.5%)
24.11.80 (MLR to 14%)	2.3485 (+13.1%)	98.9 (+14.1%)	4.50 (+13.9%)
28. 1.81 (Peak ERI)	2.4117 (+16.2%)	<u>105.6</u> (+21.8%)	5.01 (+25.3%)
16. 2.81 (£ peak against continentals)	2.2570 (+8.7%)	103.5 (+19.4%)	<u>5.07</u> (+28.5%)
5. 6.81 (£'s June trough)	1.9150 (- 7.8%)	93.8 (+ 8.2%)	4.64 (+ 16.0%)

14-9-81			

% changes from
peak

13/9/81

15
14

- 1. MR RYRIE
- 2. CHANCELLOR

- cc Chief Secretary
- Financial Secretary
- Sir D Wass
- Sir K Couzens
- Sir A Rawlinson
- Mr Burns
- Mr Middleton
- Mr Hancock
- Mr Britton
- Mr H Evans
- Mr Lavelle
- Mr Bridgeman
- Mr Kemp
- Mr Peretz
- Mr Turnbull

original filed on:-

Econ Pol: Exchange Rate: May 79

R

INTEREST RATES
JOINT NOTE BY HF AND EF

There is now a strong case both on domestic monetary grounds and on exchange rate grounds for a rise in short term interest rates. The HF and EF sides of the Treasury are agreed on this and for logistic reasons we are letting you have this note in advance of Mr Ryrie's Monthly Monetary Meeting with the Bank early next week. We think you will need a meeting with the Governor which will only be possible in the first three days of next week. If there is no decision then, it may not be possible to get one before the end of the month. We cannot yet say how the Bank's thinking has moved since the August monetary meeting, but this note will give you more time to consider the issues. The key points are summarised below.

Domestic Monetary Policy

- 2. The key points are:-
 - a. the prospects for hitting the monetary target have looked bad since the weakening of the exchange rate and the last forecast in the summer;
 - b. despite the decisions in July and early August to allow upward movement in very short market rates, bank base rates have not changed and in the last month market rates have come down somewhat;

S E C R E T

- 2 -

- c. the August monthly meeting concluded that a strong case could be made in favour of a rise in interest rates but that the interest rate band should be centred on 12½% so that the launch of new monetary arrangements would not be associated with a rise in interest rates;
- d. the £M3 increase in banking August and the continued rapid expansion of bank lending were bad signs. We no longer claimed that the underlying growth rate was within the target range;
- e. we expect the rapid growth in bank lending particularly to persons, to continue. The Civil Service strike will add to the CGBR for banking September and October. The new 3 months forecast (see annexed table) shows high monthly increases in £M3 and rising cumulative figures for these months in both recorded and underlying terms. Banking November looks better but even after that we expect the cumulative underlying growth to be at an annual rate of 13%. The actual growth for February to November (not at an annual rate) would be about 9½%. That would mean that any further growth in underlying terms would take us over the top of the target range. The size of the effect of higher interest rates on monetary growth is uncertain. But on the basis of such figures in action on interest rates would be incompatible with the Government's monetary policy in substance and this would become increasingly apparent to commentators and markets. It could not be explained either by reference to the exchange rate (see below) or by the movement of most other monetary aggregates;
- f. we are making no net debt sales at present. A rise in interest rates would help partly because it would signal

- 2 -

adherence to the monetary policy and partly because it would provide cover for raising the yield on conventional gilts.

The Exchange Rate

3. The key points are:-

- a. over much of the period since the budget the exchange rate has been falling; we have allowed the exchange rate rather than interest rates to take the pressure. The forecast at the time of the budget was for an effective rate remaining more or less steady throughout 1981 at around 100. At the end of May the effective rate stood at 99, the £/\$ rate at 2.08, and the £/DM rate at 4.82. Since then the rate has come down in a series of falls, first against the dollar and more recently against the continental currencies:

	<u>Jan 1980</u>	<u>10 Mar 1980</u> (Close)	<u>1 June</u> (Close)	<u>1 July</u> (Close)	<u>3 Aug</u> (Close)	<u>11 Sept</u> (Noon)
Effective	100.2	98.6	98.3	93.1	91.5	87.8
£/\$	2.38	2.21	2.06	1.90	1.81	1.79
£/DM	5.02	4.66	4.80	4.60	4.55	4.31

- b. the oil factor which earlier had insulated us against external pressure has clearly been moving against us, and the current account may have been in less gross surplus than earlier in the year;
- c. there has been an undertone of sentiment against sterling, with uncertainty about the direction of UK economic developments, and how to interpret those figures that have been available;
- d. at the same time, the interest rate differential between sterling and the dollar has widened from around 2-2½%

W (three month rates) in the period immediately after the budget: it has been around 4½-5% in recent weeks. Others who have been vulnerable, like the French with their EMS commitments, have been unable to ignore this rising differential, and had to raise their interest rates some time ago;

- e. the rate is now below the level assumed for 9% inflation factor you have proposed for public expenditure in 1982/83. That was based on a forecast effective rate through next year of just under 90. Were the rate now to fall much further it must increase the difficulty of containing spending within the increase proposed;
- f. it would be unwise to expect that a modest rise in the unannounced interest rate band would have a marked effect on the exchange rate, or even prevent further falls, given the nature of the factors at work. But it might be expected to exercise a helpful influence in the short run, which could be more long lasting if it were taken as a sign of the Government's resolve.

Method of Raising Interest Rates

4. We envisage that an increase in rates would be achieved in the normal way - by reducing the scale of the Bank's money market intervention and raising the rate at which it operates (by at least 1%). It would nonetheless be clear that the authorities had decided to raise interest rates since this could not be represented as a move in line with market pressures. The rise in base rates, and perhaps also in long rates, might be higher than the rise in the Bank's intervention rate.

Other Factors

5. We shall be making a substantive recommendation on interest rates after discussion with the Bank early next week. In the meantime you will wish to consider the case for higher interest rates from the point of view of the Party Conference and of the public expenditure discussions on 20 October. Those who are critical of the present strategy may have their views about its costs strengthened by an interest rate move, but those who support the strategy will be heartened by clear action and to them the need for public expenditure cuts will be highlighted.

NM

N MONCK

11 September 1981

THE NEW THREE MONTHLY MONETARY FORECAST

Percent change in £M3 (banking months)

	Actual	Forecast		
	<u>August</u>	<u>Sept</u>	<u>Oct</u>	<u>Nov</u>
Monthly Increase				
Recorded	1.1	2.5	2.7	0.6
Underlying	1.5	2.3	1.7	0.8
Increase since February at annual rate				
Recorded	16.7	19.1	21.4	19.7
Underlying	9.3	12.1	13.4	13.0
Actual Increase since February (not at annual rate)				
Recorded	8.0	10.8	13.8	14.4
Underlying	4.5	7.0	8.8	9.6

European Col
Prime Minister

72
2571

MR. T.P. LANKESTER ✓

HERR SCHMIDT AND THE EMS

The Prime Minister may have seen the report on page 2 of today's Financial Times that, in "remarks at" a meeting with the Press Association (date not specified) Chancellor Schmidt "urged" Britain to join the EMS margins arrangement, and made some disobliging remarks about our not being ready "to put long term currency stability ahead of short term interests", something "which successive British Governments have failed to do".

We have only this press report: and it would be unwise to overreact to it. But if the occasion offered, the Prime Minister might say

- she has seen reports of the Federal Chancellor's interest in sterling and the EMS margins arrangements.
- She fully understands the importance which Herr Schmidt attaches to the margins arrangements, and his earnest wish that the Community should do whatever it can to foster exchange rate stability, particularly at this awkward time when the increase of US interest rates has been causing problems for Community countries, including the UK.
- But that it is quite wrong to impute to Britain any disinterest in the health of the EMS, or the Community's role in help to calm market turbulence. The Government is persistently striving towards a better balance in the economy here with a severe Budget to reinforce the fiscal side of the fight to control the monetary aggregates: and with better success in reducing inflation than most other countries. This is all about long term stability.

- Our own belief is that the presence of Britain would not have benefited the margins arrangements, and thus the Community, in the last two years or so. We believe that this judgement is widely respect in other member states. As we have repeatedly made clear, it is our intention to join at the right time.

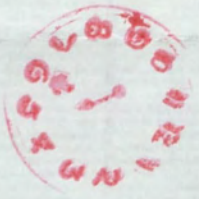
R.I.T.

R.I. TOLKIEN

25 June 1981



50000



25 JUN 1984

Schmidt urges Britain to join EMS

BY JONATHAN CARR IN BONN

BRITAIN HAS been urged publicly by Chancellor Helmut Schmidt of West Germany to become a full member of the European monetary system by bringing sterling into the system's exchange rate mechanism. In remarks at a foreign Press Association meeting in Bonn, Herr Schmidt stressed that he believed sterling's inclusion would make the EMS more capable of withstanding international currency shocks.

The Chancellor's comments show he remains interested in the further development of the EMS—which some have questioned recently—and that he

does not accept that sterling is an inherently unstable petrocurrency.

The remarks are also felt to be of particular interest coming at a time of strong fluctuation both of the dollar and of U.S. interest rates, together presenting serious strains for the EMS participants.

It is felt in Bonn that Europe is facing a new phase of that "benign neglect" of the dollar which caused considerable problems during the early years of the Carter Administration and which was a key stimulus for establishment of the EMS. It is argued here that, whereas

before, the sharp falls of the dollar reflected an indeterminate policy line by President Jimmy Carter, the dollar's strong swing the other way reflects the conscious decision of the Reagan Administration to leave the currency to the play of market forces.

Either way, it is reckoned that this brings particular problems for the D-mark as the world's second reserve currency, and that this compounds the problems of maintaining the exchange rate discipline within the EMS.

The addition of sterling, it is

felt, would increase the weight and stability of the system, provide a further important currency for intervention purposes and could exercise an extra psychological pressure on Washington to look after the dollar.

In spite of his appeal, Herr Schmidt is even more pessimistic than he used to be about Britain joining the EMS. He is said to feel that it would imply a readiness to put long-term currency stability ahead of short-term interests. In his view, this is something successive British Governments have failed to do.

des
Ref: A03681



RESTRICTED

MR. ALEXANDER

European Monetary System

I understand that, during the Prime Minister's dinner for M. Werner the other evening, there was some discussion about the possibility of ECU denominated loans. The Prime Minister may care to have the attached note by the Treasury which summarises the idea and explains why, if it is to be pursued, both the borrowing and the on-lending e.g. by the European Investment Bank would need to be denominated in ECU.

2. The proposal is still under consideration in the Monetary Committee in Brussels. The Treasury and the Bank of England are participating fully in the discussions; are not hostile to the idea; but think it should not be launched unless the market is likely to respond favourably.

D. J. Wright

(D. J. Wright)

28th November 1980

RESTRICTED

2

Prime Minister

Euro Pd.

Jan 28th

mf.

ECU-DENOMINATED LOANS

The Commission and some Member States would like the various Community bodies, including the European Investment Bank, which at present raise money by borrowing the currencies of Member States or of third countries (such as Swiss francs and US dollars) to raise some of their funds ^{for on-lending} by borrowing denominated in ECUs. The procedure would be for lenders to these institutions to lend in currencies as at present, but to receive an asset denominated in ECUs. Thus when the loan was repaid, the lender would receive more or less currency than he had originally subscribed, depending on how the exchange rate between the ECU and the currency in which he had subscribed had moved over the life of the loan.

2. From the point of view of the lender, the advantage of such ECU denominated borrowings is that his exchange risk is spread over all the currencies in the ECU basket, rather than being concentrated on a single currency. However, there is no evidence that this advantage is considered by borrowers to be sufficiently great to outweigh the disadvantage that an ECU denominated borrowing would be an unfamiliar financial instrument in a market where there are many conventional instruments available to lenders.

3. The Community institutions concerned would need to ensure before undertaking an ECU denominated borrowing, that they would be able to on-lend the proceeds in the form of an ECU denominated loan. If the form of the loan were different from the form of the borrowing the institution would incur the risk that the repayments made by the ultimate borrower would be insufficient to enable the institution to repay the original lender. There is no evidence that ECU denominated loans would be ^{particularly} attractive to the bodies which borrow from Community sources.

4. This suggests that the Community should experiment cautiously with ECU denominated borrowing, and should not undertake to press ahead with a succession of such borrowings without regard to the reception they had had both from potential lenders and potential borrowers.

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14.

ExHact Record of mtg PM/Chancellor Schmidt
Chequers, Friday 28 March, 09.45 hrs.

EMS

Chancellor Schmidt repeated that the UK could not declare that it had certain vital national interests and simply ignore the fact that her eight partners also equally had such interests. Whether the Community would be able to solve the problem of the budget and the other outstanding issues was a question of political will and whether that will would develop would be strongly affected by the UK's readiness to solve the other issues such as fish and energy. He accepted that we were not going to join the EMS at the present moment, but it was a pity that we had missed the chance to demonstrate, by joining the EMS, our will to settle other issues.

/The Prime Minister

SECRET

Original on Germany, visit by Chancellor Schmidt, Pt 2.

SECRET

- 10 -

The Prime Minister said that the UK would like to join the EMS when we had established clearly that we had the money supply under control.

The International Context

Chancellor Schmidt reiterated that France and Germany did not want the UK to make all the sacrifices while everybody else benefited. President Giscard was as aware as he was that in the present world situation we could not allow the Community to break up because of the problems now facing it. He knew that the UK had to do something about its budget problem: he understood the pressures on the Prime Minister. But he did not want the UK to do something which would prevent the Community, and in particular France, Germany and the UK, holding together.

said

The Prime Minister that she agreed. It was the political significance of the Community which was our main reason for joining it.

The meeting ended at 1145 hours.

JMS.

SECRET



PM/80/22

PRIME MINISTEREuropean Monetary System

1. You referred at our meeting on March 26 to the draft statement prepared by the Chancellor about our attitude to the EMS.
2. As I mentioned at your meeting, I do not think that this fully reflects the conclusion of our discussion on March 19, which was in favour of option (vi) in the Treasury paper. The statement as drafted is really on the lines of option (vii). The difference between the two is that (vi) did add an expression of our willingness to discuss with the Community, how membership of the exchange rate arrangement might be combined with the control of inflation through a strict monetary policy.
3. I think it would be desirable to add an expression of willingness to discuss the issue on these lines to the Treasury brief, for use when you see the Federal German Chancellor. I believe that this would appear to Herr Schmidt as a sign of our willingness to approach the question in a more open-minded way: and that this would help him to move towards us on the budget.
4. I am sending copies of this minute to the Chancellor of the Exchequer, the Secretaries of State for Trade and Industry, the Governor of the Bank of England and to Sir Robert Armstrong.

(CARRINGTON)

Foreign and Commonwealth Office

Envoys 13.

Seen by

PM & MODBA - pa

AJ 31.3.



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

24th March, 1980

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

Prime Minister

*You will wish to be
aware of this in the context
of the briefing for Chancellor Schmidt's
visit.*

Dear Tim,

EMS

In your letter to me of 19th March, you asked that the Treasury should prepare the draft of a statement about the UK attitude to the European Monetary System, on the lines agreed at the the Prime Minister's meeting on 19th March.

Am

.....

I now attach a draft approved by the Chancellor, on which Ministers could draw in discussion with our Community partners.

I am copying this letter to the recipients of yours.

yours

John

A.J. WIGGINS

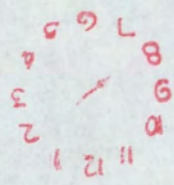
cc Germany Schmidt Visit P+2.

The UK Government fully supports closer monetary co-operation in the Community in the interests of the fight against inflation. It is in close sympathy with the European Monetary System as a very important development of the Community and as a Community instrument for resisting inflation.

The United Kingdom is participating fully in the discussions on the future European Monetary Fund and it is our wish to bring sterling into the exchange rate mechanism of the EMS when conditions permit. The UK Government wishes to do this in circumstances and at a time which are best for the Community and for the System, as well as right for our own economy.

It is for these reasons that we feel that we should first apply ourselves single-mindedly to gaining control of our own monetary conditions, achieving our monetary targets and bringing our rate of inflation much nearer to that achieved in most other Community countries. In those conditions we would have more room to reconcile monetary and exchange rate objectives and the stability of our exchange rate would be reinforced, to the advantage of the System. We need also to have regard to the differential impact which oil developments can have on sterling and on other Community currencies.

The UK is still engaged in a major effort to reassert control of its money supply, public borrowing and inflation, of which the March Budget is an important stage. The Government looks forward to the time when the success of this effort, which it believes has the support of its Community partners, will enable us to join. But we feel it would not be in the best interests of ourselves or our Community partners for us to join at the present time.



24 MAR 1980

subject copy filed on Community Budget Pt 7.
Euro PA.

SECRET PERSONAL

Ref. A01784

MR. ALEXANDER

We have learnt * ~~~~~ * when President Giscard and Chancellor Schmidt met at Hamburg, President Giscard told Chancellor Schmidt that, on the question of the British budget contribution, the French Government was ready to accept a package which should also include sheepmeat.

President Giscard seems to have argued that the French position on sheepmeat was not a violation of Community law: we do not know the basis of that argument.

President Giscard also said that the French were against the British entry into the exchange rate arrangements of the EMS at this time.

ROBERT ARMSTRONG

24th March, 1980

SECRET PERSONAL

* ~ * Passage deleted and retained under Section 3(4).
O'Wayland.
20 September 2012

SECRET



Heath

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Euro Pol.

10 DOWNING STREET

From the Private Secretary

19 March 1980

cc. Master - etc.

Dear John.

The Prime Minister held a meeting at 1500 hours this afternoon to discuss the Government's attitude to the European Monetary System. The following were present: the Chancellor, the Foreign and Commonwealth Secretary, the Secretary of State for Trade, the Governor of the Bank of England, Sir Kenneth Couzens, Lord Bridges, Sir Robert Armstrong and Mr. Franklin. They had before them the paper circulated under cover of your letter of 7 March.

The Prime Minister said that her starting point was that domestic monetary policy must remain paramount, and she would be opposed to our joining the exchange rate regime if this were to interfere with our ability to control the money supply and bring down inflation. Had we joined at the outset, even with a 6% margin, we would either have had to revalue - or else, we would have had to intervene on a large scale with adverse monetary consequences. Sterling seemed likely to continue to be volatile, and therefore it would only seem wise to join if we were able to negotiate a wider margin than 6%. Even if it were the case, as Chancellor Schmidt had suggested, that we could change our central rate without too much difficulty, she disliked the idea of our having to obtain other Members' agreement before doing so.

The Chancellor said that he thought it extremely unlikely that our Community partners would agree to a wider margin for sterling than 6%. Although he could see some potential value politically from saying that we would join in due course, he did not think it would be right to take a decision in favour of joining for the time being. There was no doubt that there was an underlying tension between sticking to monetary targets and holding to a particular exchange rate. The Government had decided that monetary policy was to be the main weapon against inflation. So far, we were not achieving our announced target for the money supply. If we were to join the exchange rate regime now, this would be taken as a sign of weakness. On the other hand, once we had got the money supply under control and inflation began to come down, it might be possible to reconcile the two approaches: there would still be some tension, but it might be manageable. Accordingly, it might be possible to join in due course.

/ The Foreign and

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The Foreign and Commonwealth Secretary said that, while he could see the economic arguments against joining, there was one disadvantage of staying out which should not be lost sight of - namely that we would have less influence in the setting up of the European Monetary Fund. Even though there were uncertainties about the timetable for the EMF, it would surely be worth our having a say in its establishment. As for the political advantages of joining immediately, these in his view should not be exaggerated. Not even the Germans - with the exception of Chancellor Schmidt himself - seemed particularly keen on our coming in. On the other hand, our Community partners would still take advantage of our continued non-membership to criticise us for being anti-communautaire. He hoped therefore that we could at least say that we intended to join when conditions permitted on the lines of paragraph 25(vi) of the Treasury paper - but in a rather more positive way and explaining why it would not be right either for us or for our partners for us to join at the present time.

The Governor said that he agreed with the Chancellor that it would be unwise to join the exchange rate regime until we could show greater success with our monetary policy but we should keep open the option of joining. It was quite possible, in his view, to conceive of a situation in which we would be meeting our monetary targets and at the same time benefitting from the greater exchange rate stability which should follow our being a full member. The Germans and the French both regarded currency stability as being important for intra-Community trading. It ought to remain our objective to become a fully fledged member of the EMS. Other governments and other central banks found it difficult to understand our position. If we did join, it would not be as difficult as perhaps the Prime Minister feared to obtain other Members' agreement to a revaluation or a devaluation. As regards the political considerations, the Governor of the French Central Bank had told him that France would welcome our joining as a major political initiative. Mr. Franklin added that our continuing non-membership had become a considerable political issue for several countries - and particularly for Denmark. On the other hand, Sir Kenneth Couzens pointed out that the EMS grid was under considerable pressure at the present time owing to the strength of the dollar, and most members would prefer to keep sterling out for the time being: the inclusion of a strong pound would add to the strains at the bottom of the system.

The Secretary of State for Trade said that another reason for our not joining at the present time was that it would weaken our bargaining position on the CAP.

Summing up a brief discussion, the Prime Minister said that it was agreed that it would not be worth our joining the exchange rate regime in the immediate future, but we should leave open the possibility of doing so when we had achieved greater success with our monetary policies. Of the possible courses of action set out in paragraph 25 of the Treasury paper, we should opt for a statement on the lines of (vi) but modified in the way

/ suggested

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- 3 -

suggested by the Foreign and Commonwealth Secretary. The Treasury should accordingly prepare a draft statement for Ministers to draw on at the appropriate time in discussions with our Community partners.

I am sending a copy of this letter to George Walden (Foreign and Commonwealth Office), Stuart Hampson (Department of Trade), John Beverly (Bank of England) and David Wright (Cabinet Office).

See memo.

Tim Laker.

SL.

A.J. Wiggins, Esq.,
H.M. Treasury.

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9

PRIME MINISTEREuropean Monetary System

Chancellor Schmidt has more than once emphasised to you the importance he attaches to our joining the exchange rate arrangements of the European Monetary System. There is negotiating currency there, if we are able to use it, which could be useful when you see him at the end of the month and in the European Council.

2. The Chancellor of the Exchequer has sent you a Treasury paper on this, which concludes with a list of options, descending from joining soon to saying that we cannot do so yet but still intend to join when conditions permit.

3. In theory a commitment to a fixed exchange rate would not be consistent with a strategy which gives overriding primacy to a target for growth of money stock: the measures required to counteract upward pressures on the rate tend to increase the money supply, and the measures required to counteract downward pressures on the rate tend to diminish the money supply.

4. But there are elasticities in the EMS exchange rate arrangements which would significantly mitigate those rigidities. There is first the margin: $2\frac{1}{4}$ per cent for most of the currencies, 6 per cent for the Italian Lira. And there is secondly the ability by agreement to change the parity.

5. As I read what Chancellor Schmidt said to you last time you met him, he was saying that you do not need to worry that joining the exchange rate system will be a straitjacket on your ability to maintain monetary control, because:-

- (a) joining the system will itself make the movements of sterling less volatile (this appears to have happened so far with the French Franc and the Italian Lira);
- (b) || the partners will not put difficulties in the way of your changing ||
|| the parity of sterling if and when you need to do so. ||

6. The Treasury's Option iii. is that we should secure a formal understanding that they would be ready to agree without difficulty to changes in our central rate. The objection to that is that it looks like another British demand for special treatment; this would reduce the value of that Option in terms of negotiating currency.



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7. We should substantially minimise the risk of substantial intervention to hold the rate if we went in to the arrangements on the wider, 6 per cent, margin. If we had joined last September, for instance, we might just have stayed within that margin in spite of the strong upward movement of the pound.

8. Predicting movements in the exchange rate is a hazardous business. But it makes sense to try to foresee the most likely trend. There is general agreement that our present exchange rate is really too high for our own competitiveness - though we should not welcome the effects of a substantial depreciation in the rate of inflation. So long as our inflation rate remains higher than that of our competitors, the exchange rate should have a tendency to decline. On the other hand it will tend to be sustained by the high level of interest rates accompanying the monetary strategy, and by the position of sterling as a petro-currency. There will be times when threats to Middle East oil supply will push the sterling rate up; otherwise the balance of forces seems to point to a declining trend.

9. If that view is accepted, and if we were to go into the exchange rate arrangements with a 6 per cent margin, and if we can accept Chancellor Schmidt's implicit assurance that we should in practice be able to change the central rate if we needed to, the conclusion could be that joining the exchange rate arrangements of the EMS need not in practice significantly inhibit the pursuit or effectiveness of the monetary strategy.

10. There are two caveats to that. First, it would be more credible if we joined at a central rate which was generally regarded as more real than our present rate. What that might be is not a matter of mathematical certainty, but I would suggest it would be a rate 5 to 10 per cent below the present rate: say, about 65 to 68 (compared with 72) for the effective Smithsonian rate, and 2.00 to 2.10 \$/£. Secondly, our joining would be more credible at a time when the monetary strategy was seen to be working.

11. On this basis, a position you might take with Chancellor Schmidt and at the European Council on 31st March might be that the Government had taken a definite decision of principle to join the exchange rate arrangements with a 6 per cent margin (at any rate in the first instance), as soon as possible; and



SECRET

that we should like to discuss the timing with our partners but should be inclined to suggest that, in their interests as well as ours, it would be sensible to enter the arrangements at a central rate rather lower - say 5 to 10 per cent lower - than our present rate, and therefore at a time when the current spot rate had fallen by that sort of amount; and at a time when there was clear evidence that the monetary strategy was being effective.

RA

(Robert Armstrong)

17th March 1980

Tracy note
Ems file Ms.

Do the monetary effects of intervention depend on which Central Bank does the intervention?

R.

19/5

In general, the monetary effects of intervention to peg the sterling exchange rate will be the same whether the intervention is carried out by the Bank of England or foreign Central Banks.

Suppose there is upward pressure on the sterling/DM exchange rate. If the Bank of England intervenes to hold the rate, the UK reserves will rise and the UK Government's need for sterling finance will be correspondingly increased. The effect on £M3 depends on the form in which this extra sterling is held by the purchaser. If it is invested in British gilts, then the Government's need for finance is automatically satisfied and there can be no increase in the money supply. If not, extra Treasury bills must be issued, increasing the reserve assets of the commercial banking system. The counterpart increase in the bank's liabilities may or may not score as an increase in £M3 . Only to the extent that the extra sterling ends up in UK resident sterling bank deposits will there be a matching increase in £M3 (since both foreign currency deposits and non resident sterling deposits are excluded from our definition of the money supply).

Suppose the Bundesbank intervenes instead to supply the extra sterling needed to hold down the exchange rate. It may have the sterling in its reserves already, or it may obtain it directly from the Bank of England. Official reserves will probably be invested in UK Government Treasury bills, or gilts, or held on overseas sterling deposit with a bank. If the Bundesbank sells British government securities, or obtains sterling directly from the Bank of England, in order to fund intervention, the effect is exactly as if the Bank had done the intervention itself. The UK Government's need for sterling finance, to fund the PSBR or a change in the reserves, is increased. As before, the additional sterling supplied to the market may be invested in a range of

sterling assets: there is no more - or less- probability that the funds will end up in UK resident bank deposits if the sterling is routed through the Bundesbank than if it is supplied by the Bank of England. The situation is only slightly different if the Bundesbank gets the sterling by drawing down its sterling bank deposits. This will reduce UK banks' liquidity, though (for definitional reasons) it will not reduce £M3. Whether or not there is a net increase in £M3 (as a result of intervention) will depend, as before, on whether this sterling is switched into assets which go to make up £M3 ie. UK resident bank deposits.

DOWNING ST.

CONFIDENTIAL

(EMS)

Subject on Euro PDL: calls on the P.M.
by Roy Jenkins: May 1979

- 5 -

- (b) the United Kingdom should seek to create a conciliatory atmosphere in which the Budget negotiations might be pursued with France.

These two objectives were mutually contradictory.

Mr. Jenkins asked about the Government's attitude towards full entry into the EMS. The Prime Minister said that she would be reluctant to enter the EMS unless she could be sure that it would leave her freedom to manage the currency unimpaired. She was concerned lest the effort to hold a rising pound within EMS prescribed margins should affect the money supply in this country. Mr. Jenkins expressed some doubt as to whether the pound was likely to go on rising. He was less sure than the Prime Minister that the fact that Britain's exchange rate was determined by sterling's role as a petro-currency rather than by the country's industrial performance was relevant to the issue of entry into the EMS. Differential exchange rates were what counted. The problems of the DM were at least as difficult to cope with as those of the pound. The political fact which mattered was that Chancellor Schmidt was violently in favour of British membership of the EMS. A British decision in favour of full membership of the EMS would greatly improve the atmosphere in which the budgetary discussions would take place. Mr. Franklin pointed out that the French were unenthusiastic about British membership. Mr. Jenkins said that in so far as the tactical objective in the present negotiations was to isolate the French, French hostility to British membership of the EMS was a very good reason for joining. The Prime Minister said that the question of British membership of the EMS was being looked at again. The final decision would depend on a judgement as to how far our freedom to manage the currency would be limited. She did not wish to have to spend money holding the exchange rate down. Mr. Jenkins said it was arguable that membership of the EMS would in itself help to hold the exchange rate down.

/ Mr. Jenkins

CONFIDENTIAL

BF 18.3.80

Euro 98 (1)



Ref. A01687

MR. ALEXANDER

Prime Minister: if you agree I will try to fix a seminar discussion as soon as possible.

Agreed not.

Am 14/3

EMS

The Prime Minister has had a paper from the Treasury which sets out recent developments and outlines a number of possible options ranging from joining the exchange rate mechanism within the narrower 2 1/4 per cent margin to saying that, after review, we are still not ready to say when conditions will permit us to join.

2. The Prime Minister said at OD on Monday that she would discuss the issue with the Chancellor of the Exchequer and the Foreign and Commonwealth Secretary. You should also invite the Governor of the Bank of England. Ideally, this discussion should take place before next Thursday, when the Cabinet will be discussing the Community budget issue; it could wait for a few days after that, but it would be useful to have it before the Prime Minister meets Chancellor Schmidt.

3. This is a highly technical subject, as well as one with considerable political implications, and there would be something to be said for having one of the informal, seminar-type discussions, with officials as well as Ministers, which the Prime Minister has had on questions of financial and monetary management.

RA

ROBERT ARMSTRONG

K. Coonan + 1
Lp: for: Lee; ^{papers}
Gov: RA, Michael Franklin.
+ officials:-
no official

14th March, 1980

Meeting on Wednesday:—
Chancellor (+ officials)
For Secy (+ officials)
Governor
RTA

ET. 7/31/80

Germany cautious on EMS trade-off

£2

BY PETER

THE ABOLITION of controls resulting in a flow of about half of last year's flows. But they were set by flows attracted by rates relative to the pound. Controls were relaxed in October 23.

Central Statistical Office published yesterday part of the outline of the new repayment currency for the finance over the period. The end of the year yet appear to have an effect on it directly in favour of the portfolio.

By Jonathan Carr in Bonn

WEST GERMAN Government officials believe an early decision by Britain to become a full member of the European Monetary System could improve the atmosphere on negotiations on Britain's EEC budgetary problems.

But neither Bonn nor its EMS partners would regard the step as a major concession which would merit meeting Britain's budgetary demands. Britain is seeking a substantial cut in its EEC net contributions, estimated at over £1.2bn this year.

A British decision to join the EMS would be welcomed by Bonn as a helpful gesture, as would a British statement stressing that its North Sea oil prices will stay in line with those for comparable oil from elsewhere. But neither move is seen as a precondition for a Brussels settlement, or as assuring success.

Important role

The Germans point out that as a full EMS member, Britain would have an important role to play in shaping the development of the projected second stage, which is due to include the establishment of a European Monetary Fund and fuller use of the European Currency Unit (ECU) as a reserve asset. But Bonn is not disposed either to pay larger sums through the EEC budget simply to purchase Britain's EMS co-operation, or to urge others—notably the French—to do so.

The budget negotiations at the European Council in Brussels on March 31 and April 1 are likely to be very tough indeed. The Germans agree with France that a package deal should be sought combining accord on a smaller British contribution with savings on agricultural expenditure and an EEC regulation on lamb for the French.

Both the EMS and the budget problem were raised in talks in London last month between Chancellor Schmidt and Mrs. Thatcher. Herr Schmidt is said to have been interested to learn first hand about Britain's attitude, in view of reports that the Government felt the strength of sterling raised grave problems for participation in the EMS's exchange rate mechanism.

Before the EMS began last year, the British had appeared to fear that it was sterling's weakness which spoke against participation.

Stable EMS highlight of gloomy EEC report, Page 2

Nko

BY TONY HA

MR. JOSHUA Nkomo of the Patriotic Front indicated that he would leave the post of President of Zimbabwe.

Mr. Robert Mugabe, Prime Minister yesterday in company with members of his cabinet, central committee and holding talks with Lord Soames, in order to form a Cabinet to take account of regional and international developments. In addition, he has the expectation of his party will be younger, oftentimes.

But although

Pow

BY PAULIN

THE PROSPECTS in the electricity industry appeared yesterday when

attorneys for the industry recommended an increase to

Shop staffs give their views, however, a detailed report on their national March 15.

The brief meeting between the Electricity Company although it is to have given

The deal is a 2 per cent response in recognition of labour cuts

WGBAM

Prime Minister

C.C. Chamelle
Mr. Tony Burns

I do not always agree with my own colleagues, but I would put my money on this report rather than on the F.C.O.

S. Drake

Emo PBL 2



Primi Amish 8

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

7th March, 1980

R

7/3

Dear Tim,

EMS

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In response to the request in Michael Alexander's letter of 26th February I now attach a paper which the Treasury has prepared in consultation with the FCO, Cabinet Office, Departments of Trade and Industry and Bank of England.

I am copying this letter and enclosure to the Private Secretaries to the Secretaries of State for Foreign Affairs, Trade and Industry, to the Governor of the Bank of England and to Sir Robert Armstrong.

*yours
John*

(A.J. WIGGINS)

T.P. Lankester, Esq.,
Private Secretary,
10, Downing Street

THE EUROPEAN MONETARY SYSTEM

This paper re-examines in the light of subsequent developments the analysis contained in the paper circulated by the Chancellor on 24 September.

2. The September paper had 3 main sections. It examined the history of the EMS, the main issues for consideration by Ministers in reaching their view on whether sterling should become part of the exchange rate arrangements, and the questions for decision. The paper was considered at a restricted meeting of Ministers on 17 October. Summing up the discussion the Prime Minister concluded that the time was not yet ripe to join the exchange rate regime. She said that she was particularly concerned about the potential conflict between the Government's monetary targets and the EMS interim requirements. Adherence to the monetary targets was absolutely crucial if inflation was to be brought down and the Government's monetary objectives must remain paramount.

3. This paper considers developments since the autumn under the same main headings as the earlier paper.

History of the EMS and present UK position

4. The September paper described the current UK position of membership on aspects of the EMS other than the exchange rate arrangements. There has been no change in this. The Dublin Council communique reaffirmed March 1981 as the latest date for the establishment of the European Monetary Fund

It is not now clear whether the French or the Germans intend to adhere to this objective.

5. The EMS itself has experienced two realignments since the September paper was written though there has been only one major change - the change on 23rd September which

~~Final~~
 appended 14
 the 15
 my
 proposal
 at last
 meeting
 on EMS.
 G.S.

involved a deutschemark revaluation of about 2% and a Danish Kroner devaluation of about 3%. The market pressure leading up to this realignment were reasonably heavy. Total purchases of foreign currency by the German authorities amounted to about \$350 million in the 2 weeks prior to the realignment, and total sales of foreign currency by the Belgian and Danish authorities amounted to over \$1.6 billion, much of which would have tended to expand the German money supply. The Ministerial meeting to determine the new pattern of exchange rates was a lengthy affair, lasting until the early hours of 24 September. The Belgians sought a 4% devaluation against most other Community currencies but had to be content with a 2% revaluation of the Mark.

6. The second realignment involved a further 5% devaluation of the Danish Kroner on 30 November in the context of a package of economic measures to protect the Danish balance of payments. No other currency changed, and no realignment conference was held.

7. The Danish devaluation was accepted by the other members of the EMS (including ourselves) without the need for a meeting partly because the devaluation was part of an economic package, partly because there had been a recent general realignment and no other currency was under strain, and partly because the weight of the Kroner in the ECU basket is so small that the agri-monetary consequences of the devaluation were minimal. The last point would certainly not apply to sterling which has a weight of 14%, and it would not necessarily be the case that the other two factors would apply. These seem unlikely to be repeated even for a small country like Denmark.

8. The consequences of EMS exchange rate changes for agricultural prices are becoming increasingly important in realignments. The French in particular have a strong interest in reducing price competition by German farmers, whose positive MCAs are now the

most important example of a "green rate" in the Community. They extracted from the Germans agreement to accept a 1% farm price reduction (but no more) on the occasion of any DM up-valuation in the EMS. This is liable to complicate realignments. The 2% revaluation of the DM which emerged from the difficult realignment of September 1979 produced a 0.9% reduction in German farm prices. If we joined the EMS we would be bound by the rule which applies to the Germans if a sterling revaluation created positive MCA's.

The International Environment

9. The international environment has been particularly unsettled over the last year and for the reasons advanced in the September paper sterling remains more exposed to it than all other EMS currencies except the Mark. Since September we have abolished our remaining exchange controls. This has increased sterling's exposure to downward pressure. The doubling in the price of the oil, the consequential massive increase in OPEC's financial surplus, and the US freeze of Iranian assets have all been major influences in the market, as, perhaps, has also the general worsening of the international political environment following the Soviet invasion of Afghanistan. These factors have been reflected most dramatically in the price of gold, but they have probably also contributed to sterling's attractiveness (as a haven for funds relatively protected by North Sea oil) in relation to EMS currencies and the dollar.

10. The increase in the gold price has not affected the EMS as such, but has led to more ECUs being issued against the gold swapped by EMS members (including ourselves). Weaker countries who have gold in their reserves are enabled to defend their rates for longer. As stronger countries accumulate ECUs they may be forced to revalue faster to reduce inflows.

Future Prospects and the outlook for Sterling

11. The future remains unsettled. Interest rates in other currencies are now rising, and if relative interest rates move against sterling then its attractiveness will be reduced.

The OPEC surplus and the longer-term implications for OPEC investors of the freeze of Iranian assets will continue to affect the market, not necessarily in predictable ways. If an easier oil market were to develop later this year and our relative inflation continued high the foreign exchange market might shift its attention to other factors and tend to give less weight to the benefits for sterling of North Sea oil. A new Middle East crisis could have the reverse effect.

12. International perception of domestic economic policies is another major uncertainty affecting the future prospects for sterling. Confidence is likely to depend primarily on the credibility of the Government's monetary policy. But even assuming that tight monetary control is maintained, the risk of a sharp reassessment of sterling cannot be ruled out. The exchange rate is currently very high in relation to domestic costs; the market could be unsettled by a combination of continuing high inflation rates, poor competitiveness and current account deficits. For all these reasons we would expect sterling to continue to fluctuate sharply in relation to EMS currencies even if we can be less sure of the direction of movement.

Relationship to Domestic Economic Policy

13. To the extent that the various factors affecting sterling have been working in the recent past they are reflected in the movements in the exchange rate as shown in the annexed chart. This shows how sterling has fluctuated against the weakest member of the EMS - the Belgian franc - since last September. If we had been in the system sterling might have been more stable because the market accepted our commitment to defend a named rate and judged we could hold it. But if the market became convinced that we could not hold the rate, speculation would be intensified by our commitment to intervene at a particular point, as has often happened in the past. We might have experienced both effects at different times, depending on the circumstances.

What seems virtually certain is that if we had entered in September at the then prevailing rate with a $2\frac{1}{4}\%$ margin we would have had to intervene last November to support sterling, and, very heavily indeed, since January to hold the rate down.

14. The Government's overriding commitment to monetary targets will be reaffirmed in the Budget and may be underlined by the simultaneous publication of a statement outlining the Government's medium-term financial strategy. This will emphasise, in general terms, that other policies will be adjusted as necessary to keep the money supply on target. On a more technical plane, any decision that the Government may take on new methods of monetary control could have a bearing on our ability to hold sterling within the EMS.

15. If sterling had to be defended at its lower intervention point, industrial interests would be likely to advocate a step change downwards in its central rate in order to offset some of the loss of competitiveness that has occurred in recent years. The direct effect of purchases of sterling from the foreign exchange market is to reduce $\text{£M}3$ so that intervention to prevent sterling from falling does not create a conflict between exchange rate policy and the monetary targets unless it is sustained on a massive scale to defend a rate that has lost credibility. In that case the monetary consequences would be likely to be destabilising for the reasons explained in paragraph 33 of the September paper.

16. Repeated attempts to defend sterling would progressively impair the Government's ability to discharge the commitment to reduce the outstanding quantity of external official debt substantially during the life of this Parliament.

17. It is highly unlikely that large scale and sustained intervention to prevent sterling rising above its upper intervention point would be compatible with the Government's monetary targets. The monetary position for the next 6-12 months is likely to remain very tight.

If Ministers decided on entry, the announcement of the decision would have to reconcile it with Government's central economic policy. If Ministers decided against immediate entry, one possible approach would be to say that the right time for sterling to join would be when basic economic conditions in the United Kingdom were compatible with those elsewhere in the Community and especially when our inflation rate had been reduced towards the Community average. In the meantime the approach most consistent with the Community objective of economic convergence would be to leave the UK free to give absolute priority to getting our inflation rate down.

Rate of Entry

18. A very important question on entry to the EMS would be the rate at which sterling joined the system. The chosen rate would affect inflows and outflows, and therefore influence the monetary aggregates and the course of interest rates; it would have direct effects on inflation and interest rates; and it would affect MCA's. Discussion of these effects would bring out the point that the Government were assuming much more direct responsibility for the exchange rate.

19. The presumption would be that we would enter at the market rate, which is what the 8 present members did in 1979. If the sterling rate were regarded at the time by our partners as very high relative to underlying factors like domestic inflation and the balance of payments, it is possible that they might agree to a step devaluation on entry. There is no guarantee that the market would accept the new rate. In any event, it would be a very important step for the Government to announce that it had sought a devaluation, and to accept the monetary/inflationary effects. It could say however that the devaluation improved the immediate competitiveness of industry. On the other hand if entry were at a market rate regarded as high, industry would be unhappy about entrenching such a rate by a policy commitment to defend it in the EMS.

Relations with the Community

20. The absence of sterling from the EMS exchange rate arrangements causes minor technical difficulties both in the operation of the divergence indicator and in the procedures to be followed when a realignment takes place. But ways have been found of overcoming these, and there has been no pressure at a technical level for sterling to join the exchange rate arrangements to eliminate the difficulties. Indeed there has been considerable understanding of our position, and the other Member States and the Commission have recently been very keen to strengthen consultations with the UK authorities to avoid the technical problems posed by sterling's absence from the exchange rate arrangements.

21. At a political level, our absence from the exchange rate arrangements does not appear to have been a factor in the discussions at the Dublin European Council. Recently, however, Chancellor Schmid has shown considerable interest in the question of UK membership of the exchange rate arrangements, and has linked it indirectly with the negotiations over our contribution to the EEC budget, saying that sterling's membership would improve the atmosphere in the Community and thus help to bring about a settlement. Herr Genscher has said that such a step "would have a great impact". Schmidt's desire to see us full members of the EMS is not new: he advocated it strongly last autumn. What is new is the fact that he has linked it, albeit tenuously, with a satisfactory outcome of our negotiations over the budget.

22. Entry would probably enable us to get some interest rate subsidies like the Italians and Irish. (The Italians now get about £85 million a year). More generally, entry would not ensure us a better deal on the Budget but it would improve the atmosphere in which the Budget issue was discussed.

23. The next European Council will receive a report on the technical problems of establishing a European Monetary Fund (EMF) but there is unlikely to be any substantive discussion. The UK is taking an

active part in these discussions. For electoral reasons, the French and the Germans seem to have agreed to make haste slowly on the EMF. If they try to blame us for the delay, the rest of the Community will know that it is nonsense.

24. Summarising, the main change in the international and domestic economic scene since Ministers last considered the matter in September has been the abolition of exchange controls. This remains a factor, though sterling has so far not suffered from it. The political aspects have developed as in paragraphs 21 and 22.

Possible Courses of Action

25. There is no chance of persuading the rest of the Community to change the formal arrangements of the existing scheme. The main possible courses of action are summarised below. They are arranged in descending order of obligation and degree of conflict with the monetary objectives:

i. join soon with a 2 $\frac{1}{4}$ % margin; this entails a high risk of substantial intervention;

ii. join soon with a 6% margin; experience suggests that we would stand a much better chance of avoiding sustained intervention;

iii. say we wish to join [soon] with either a 2 $\frac{1}{4}$ % or 6% margin, but wish first to seek an understanding from our partners that, as sterling is unusually exposed, they would agree to movements in our central rate imposed by that characteristic. Developments in the oil market would be one example but not the only one. Some degree of formality for this understanding would ^{be necessary} it would be negotiable: We cannot say whether it would be negotiable: or whether it would be criticised as another British attempt to gain special treatment;

- iv. say we would "travel alongside" the system for a few months, with a view to joining at the end of the trial period. France did this in the first weeks of 1979 and
 (Chancellor Schmidt suggested it to the Prime Minister in Strasbourg. However, the September paper advised that this option had few advantages except for a short period;
- v. say we intend to join within 12-18 months (Genscher formula). We could link the timing with the announced intention (which the French and Germans may or may not intend to honour) to move to a new stage on the European Monetary Fund by March 1981. This is however a hostage to fortune;
- vi. repeat, perhaps more formally, the statement that we intend to join when conditions permit, elaborate more on "conditions permit" and invite the Community to join us in studying the problem of combining control of inflation through a strict monetary policy with membership of the exchange rate arrangement;
- vii. say that after a very careful review of the situation we cannot yet join the EMS exchange rate arrangements but that we still intend to join when "conditions permit": we are struggling through our monetary policy to converge towards lower Community inflation rates.

26. Ministers may not wish to complicate the problems of monetary management by joining immediately. If so, they will wish to concentrate on the later options in the above list. These are intended either

- i. to avoid a clear commitment to join at an early date but to display a more positive attitude than now to the idea of eventual entry; or
- ii. to confirm our present policy but to explain it as tactfully as possible.

£/BF

CHART-1

Chart of Sterling - Belgian Franc cross-rate
from 24 September 1979 (last realignment of EMS)

67
69
63
61
59
57
55

6% upper intervention point
2 1/4% upper intervention point
Central cross-rate
2 1/4% lower intervention point
6% lower intervention point

£900m support for sterling

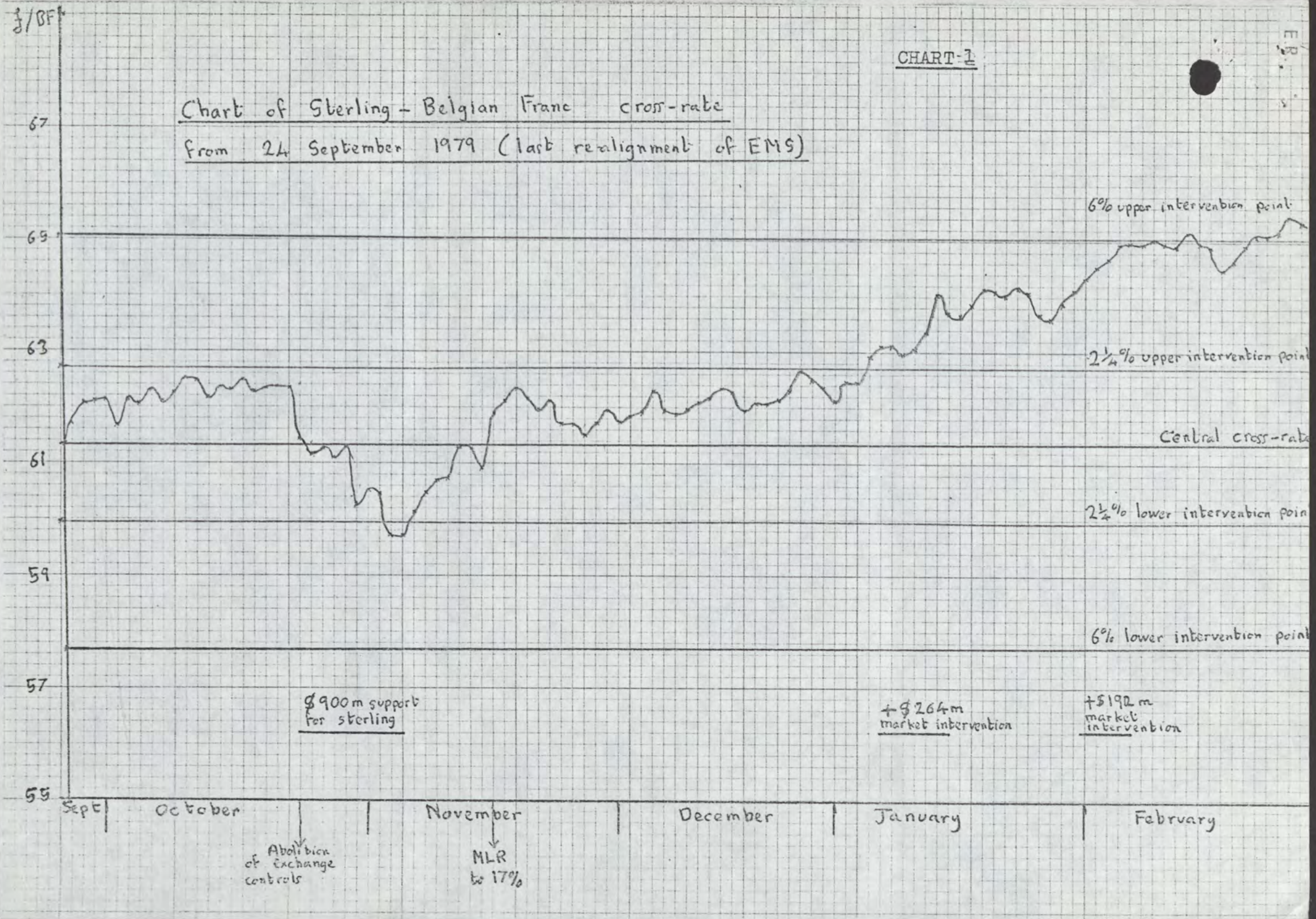
+£264m market intervention

+£192m market intervention

Sept | October | November | December | January | February

Abolition of exchange controls

MLR to 17%

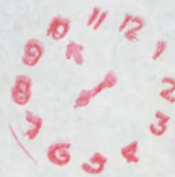


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7 MAR 1980



MEMORANDUM

To: Jim Scott-Hopkins

Date: 5th March 1980

From: Fred Catherwood

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1. There is now general agreement (British Overseas Trade Board, CBI, OECD and reliable economists) that the pound is about 20% too high for British manufacturing industry. CBI estimates that current wage awards are levelling out at an average of about 17%, but the effect of this is lagged and not yet apparent, so the overvaluation of the pound will get worse through the year. The 1979 trade deficit was over £3.000 million (almost fully accounted for by our deficit with the Community partners) and, quite apart from the effects of the steel strike the deficits will worsen and jobs will be lost as imports rise. This will harden the case put by an increasing number of the Labour Party for import controls and the pressure for Britain to pull out of the European Community. There is nothing in present government policies which will affect these trends before they take hold on public opinion and this will make the position of the 60 Conservative members of the European Parliament exceptionally difficult.
 2. The ideal for the Conservative MEPs would be an agreed adjustment of the value of the pound to a competitive level and the pegging of this agreed new rate to the European Monetary System, so that we had the full weight of our partners behind us in holding the rate at the agreed level. The entry of Britain into the EMS would both help us in the settlement of our contribution by giving our partners a "communitaire" peg on which to hang concessions to us. The adjustment of the rate of sterling without which we obviously could not join the EMS, would give us a potential improvement in our trading balance which would more than compensate for any remaining net contribution to the Community budget. At the very least it seems necessary to have some material extra factor to offset against an otherwise stark shortfall in the negotiations in our contributions.
 3. It is also desirable to put any adjustment of the sterling rate into these negotiations because a unilateral reduction would involve quite heavy open market sales of sterling which could make government's control of the money supply more difficult. On the other hand an adjustment agreed beforehand between the principle central banks - and supported by them when the new rates were announced - would minimise the open market transactions needed to make the change.

4. The adjustment of the sterling rate is the major single instrument left to the United Kingdom to improve the competitive position and cashflow of our industry. The latest figures show a substantial company sector deficit (this week's Economist) when industry badly needs the funds to invest in new equipment in order to compete against the much better equipped industry of our Community partners. No amount of funds from a regional budget could provide the cash-flow on the scale required even if HMG wished to make the matching contributions on which the Community would insist.
5. It is possible that the growing volume of oil coming from the North Sea will continue to attract heavy capital inflows on the grounds that the £ was "undervalued" in relation to our autonomous energy reserves. This is a risk, but, we already have reached a substantial level of independence in oil supplies and the markets should accept the underlying soundness of the parity adjustment, in the light of the forecasts for persistent high levels of inflation and trade deficit at the present parities.
6. What is more likely is that if we do not negotiate an agreed adjustment now, the market will shortly impose its own adjustment. The pound is not a petro-currency because there is a substantial and rising deficit despite the rising income from North Sea oil and the £60.000 million which we have to earn from visible and invisible trade is far more important to us than the improvement of about £8.000 million which we have received from oil. This will become clear to the currency markets following some set of monthly trade figures at which it becomes clear that our deficit is much more likely to deteriorate than to improve. At that point the markets will almost certainly over-react and we will have all the familiar problems of a very weak currency.
7. A sharp deterioration of the pound will pose two problems which an agreed adjustment would avoid.

First, we would have to negotiate support from the EMS from a position of weakness in which we had to ask them to buy pounds in the face of full-scale flight from the pound. Second, either voluntary or involuntary adjustment has the effect of passing on excessive wage claims in full in prices as the barrier of the strong pound is removed. However, voluntary adjustment enables Government to ask the Trades Unions for wage restraint in return for a policy which is providing export-led growth, cash-flow for company investment and the climate for fresh inward investment from other countries. But voluntary adjustment especially if the adjustment is excessive makes the whole process of curtailing the wage monopolies much more difficult and it is only too easy for the wage-price spiral to accelerate uncontrollably.

8. Experience of previous economic cycles suggests that the rate of sterling is often maintained for quite a time beyond the point at which underlying economic conditions no longer justify that rate. This gives the misleading impression that there are confidence or other factors which justify the higher rate and the break, when it comes - as it always has come - is that much more unexpected and difficult to deal with. The lesson of experience would seem to be that the value of the currency should be kept roughly in line with the underlying competitive position of manufacturing and service industry on which the country's trading balance depends.
9. It has been argued that a high value for the pound forces British companies up-market and ensures that British exports sell on design quality and delivery and not on prices. The British Overseas Trade Board encourages companies to move up-market, but discussion in the Board always came to the conclusion that in the vast majority of exports, even the most sophisticated exports, price was a major factor and when the pound was too high and export cash flow is cut, so was the investment needed to provide newly designed products, more flexible and sophisticated equipment and sheer capacity to meet deliveries.
10. There are arguments for and against adding wage restraint to existing policies of restraint in public spending and on the money supply. There is doubt about unions' willingness to cooperate, about the concessions which might have to be made to them and whether in the long term wage restraint adds anything to monetary restraint. However, the shop-floor labour monopolies are especially resistant to all other policies and yet incapable without a Government initiative of organising any truce to their leap-frogging claims. Because most trade unionists recognise this and recognise the damage done by competing shop-floor monopolies where "most money goes to those who can pull the plugs" there is always in the end acceptance in the Trade Union movement of wage restraint.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

29th February, 1980

fn
Paul

Dear Michael,

VISIT OF CHANCELLOR SCHMIDT: EMS

In your letter of 26th February you said that, arising out of her discussion with Chancellor Schmidt, the Prime Minister had asked that a re-appraisal of our attitude to the EMS should be put in hand in the light of developments since the autumn in the domestic and international economic scene.

We have set in hand the preparation of such a note on a timetable which would enable the Chancellor, if he approves it, to send it to the Prime Minister during the second week of March. As you say, we shall consult the FCO and the Bank; we expect also to consult the Departments of Trade and Industry, which joined in the preparation of the main paper on this subject last autumn.

I am copying this letter to the recipients of yours.

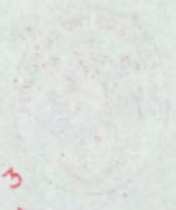
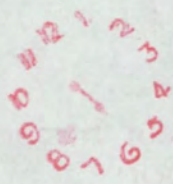
yours sincerely

John Wiggins

(A.J. WIGGINS)

M. O'B Alexander, Esq.,
Private Secretary,
10, Downing Street

29 FEB 1950



COPIES

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FM BONN 281420Z FEB 80

TO PRIORITY FCO

TELEGRAM NUMBER 201 OF 28 FEBRUARY

INFO EC POSTS, WASHINGTON

Read in full

MT

EMS: FRG VIEWS ON BRITISH ENTRY

1. YOU WERE NO DOUBT STRUCK, AS I WAS, BY THE FACT THAT, IN THEIR CONVERSATIONS WITH YOU HERE ON 26 FEBRUARY ABOUT CURRENT PROBLEMS OF THE EUROPEAN COMMUNITY, INCLUDING THE UK BUDGET PROBLEM, GENSCHER AND THE FEDERAL CHANCELLOR SEPARATELY ADVOCATED UK MEMBERSHIP OF THE EMS AS DESIRABLE, BOTH IN ITSELF AND TO IMPROVE THE ATMOSPHERE FOR THE RESOLUTION OF OUR BUDGET PROBLEM. IN SO DOING, THEY BOTH INVALIDATED THE SIGNALS WE HAVE BEEN RECEIVING FROM GERMAN OFFICIALS.
2. GENSCHER MADE THE CASE FOR UK MEMBERSHIP AS A SYMBOL OF POLITICAL SOLIDARITY: HE SUGGESTED THAT WHILE A DECISION TO JOIN IMMEDIATELY WAS NOT PERHAPS NECESSARY, HMG SHOULD GIVE THEIR COMMUNITY PARTNERS THE PERSPECTIVE OF A FIRM INTENTION TO JOIN WITHIN, SAY, 12 - 18 MONTHS. SCHMIDT WAS MORE DIRECT: HE REPEATED THE VIEW HE HAS TAKEN FROM THE BEGINNING: THAT THE EMS IS NECESSARY FOR DEVELOPING THE COMMUNITY AND FOR ESTABLISHING A DISTINCT EUROPEAN IDENTITY IN THE FINANCIAL FIELD. HE Poured SCORN ON THE QUOTE EXPERTS UNQUOTE ON BOTH SIDES. EXPERTS EXISTED, HE SAID, TO ADVISE MINISTERS ON HOW BEST TO DO WHAT MINISTERS HAD DECIDED TO DO, NOT TO TELL THEM THEY COULDN'T DO IT.
3. SCHMIDT WENT ON TO ARGUE THAT IN PRESENT CIRCUMSTANCES THERE WERE STRONG ECONOMIC AND MONETARY ARGUMENTS FOR EMS MEMBERSHIP FROM THE UK POINT OF VIEW. IF WE WERE WORRIED ABOUT THE UPWARD FLOAT OF THE POUND, MEMBERSHIP OF THE EMS WOULD HELP TO KEEP THE POUND DOWN. IF WE WERE WORRIED THAT THE VALUE OF THE POUND AS A PETRO-CURRENCY WAS OUT OF LINE WITH THE REAL ECONOMIC PERFORMANCE OF THE ECONOMY, MEMBERSHIP OF THE EMS WOULD CUSHION ANY CHANGING VIEW THE MARKET MIGHT TAKE: THERE WERE MOREOVER ARRANGEMENTS WITHIN THE EMS TO ALTER THE PARITY WITHOUT DIFFICULTY. IF HMG'S POLICY REMAINED FIRM TO ESTABLISH MONETARY DISCIPLINE AND CONTROL INFLATION, THEN MEMBERSHIP OF THE EMS WOULD HELP NOT HINDER THESE OBJECTIVES. HE DISCUSSED THE VALUE THE BELGIANS ATTACHED TO THE EMS IN REINFORCING MONETARY DISCIPLINE. MEMBERSHIP WOULD REDUCE SPECULATIVE FLOWS INTO AND OUT OF STERLING: GENERALLY, IT WOULD PROMOTE THE STABILITY OF THE POUND AND CONFIDENCE IN IT. HE REJECTED ANY SUGGESTION THAT THERE WERE VALID FINANCIAL ARGUMENTS FOR OUR REMAINING OUTSIDE THE SYSTEM. OUR OPPOSITION WAS POLITICAL: OUR FINANCIAL EXPERTS WERE SIMPLY NOT READY TO ACCEPT ANY DIMINUATION IN THEIR ABSOLUTE CONTROL OVER THE POUND STERLING. HIS MANNER INDICATED THAT HE HAD NO REGARD FOR THIS ARGUMENT AND THAT OUR REFUSAL TO JOIN IN MAKING A SUCCESS OF HIS OWN BRAINCHILD MADE HIM DOUBTFUL OF OUR EUROPEAN CREDENTIALS AND KEPT US ON THE SIDELINES OF EVENTS.

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4. SCHMIDT'S REMARKS INDICATE THAT HE HAS CHANGED IN NO WAY HIS APPROACH TO THE EMS AS DESCRIBED IN MY TELEGRAM NO 566 OF 8 OCTOBER, NOR HIS VIEW OF OUR ATTITUDE AS DESCRIBED IN MY LETTER TO YOU OF 20 SEPTEMBER. HE STILL SEES IT PRIMARILY AS A POLITICAL ACT OF EUROPEAN SOLIDARITY THOUGH ONE WITH BENEFICIAL ECONOMIC CONSEQUENCES. HE IS ALSO INCLINED TO SEE BRITAIN'S CONTINUING ABSENCE FROM MEMBERSHIP OF THE EXCHANGE-RATE MECHANISM AS A POLITICAL ACT, EXPLAINED BUT NOT JUSTIFIED BY THE TECHNICAL ARGUMENTS ADDUCED IN SUPPORT OF IT, A POLITICAL ACT MOREOVER WHICH IS UNHELPFUL TO THE EUROPEAN UNITY HE IS TRYING TO BUILD. HE IS NOT PLEADING WITH US TO JOIN THE EMS: THAT IS NOT HIS STYLE: WE CAN TAKE IT OR LEAVE IT. IT IS FOR HMG TO MAKE THEIR OWN DECISION. BUT HE IS POINTING OUT THAT THE DECISION IS AN IMPORTANT INDICATION FOR HIM OF BRITISH INTENTIONS, NOT ONLY TOWARDS HIS AND GISCARD'S FAVOURITE CHILD BUT ALSO TOWARDS THE CONCEPT OF EUROPE WHICH LIES BEHIND IT. IN THIS SENSE HE IS CLEARLY INDICATING A LINK BETWEEN UK SUPPORT FOR HIS MONETARY INITIATIVE TO PROMOTE EUROPEAN SOLIDARITY AND OUR OWN APPEAL TO THAT SOLIDARITY FOR SOLUTION OF OUR SPECIAL BUDGETARY PROBLEM.

5. THE UK ATTITUDE TO EMS MEMBERSHIP IS ALSO VERY IMPORTANT TO SCHMIDT IN RELATION TO THE FRENCH. GISCARD, AS WELL AS SCHMIDT, HAS INVESTED MUCH POLITICAL CAPITAL IN EMS, CLAIMING IT INDEED AS HIS OWN INITIATIVE. SO LONG AS BRITAIN DECLINES TO BECOME A FULL MEMBER, GISCARD AND THE WHOLE FRENCH FINANCIAL ESTABLISHMENT CAN AND WILL ARGUE THAT THIS SHOWS BRITISH LACK OF INTEREST IN THE FRANCO-GERMAN CONCEPT OF EUROPEAN SOLIDARITY AND IS AN ADDITIONAL REASON FOR NOT BENDING OVER BACKWARDS TO SOLVE THE UK BUDGETARY PROBLEM. IF, HOWEVER, THE UK WERE TO DECIDE TO JOIN THE EMS EXCHANGE MECHANISM, THESE ARGUMENTS WOULD APPLY IN REVERSE. SCHMIDT WOULD THEN HAVE A STRONG ARGUMENT IN HIS HAND, FOR DEMOLISHING THE FRENCH ANTI-BRITISH CASE AND PRESSING UPON GISCARD THE GERMAN DESIRE FOR A FAIR SETTLEMENT OF OUR BUDGETARY PROBLEM IN THE LONGER TERM INTERESTS OF THE COMMUNITY ITSELF. SCHMIDT WILL NOT MENTION THIS ASPECT TO YOU: HE CONSIDERS HIS PERSONAL RELATIONS WITH GISCARD AS VERY MUCH A PRIVATE AFFAIR. BUT I HAVE NO DOUBT AT ALL THAT, ON THIS AS ON OTHER MAJOR COMMUNITY ISSUES ON WHICH THE FRENCH ARE BEING DIFFICULT, SCHMIDT IS LOOKING FOR SOLID FACTS AND ARGUMENTS TO DEMONSTRATE THAT FRENCH INTRANSIGENCE IS UNREASONABLE, AND TO MOVE THE FRENCH TO A MORE COOPERATIVE POSITION.

6. I THEREFORE MAINTAIN AND INDEED UNDERLINE IN THE LIGHT OF THIS CONFIRMATION OF GERMAN MINISTERIAL THINKING THE RECOMMENDATION IN MY TELEGRAM NO 566 OF 1979.

WRIGHT

FRAME ECONOMIC
ECD (I)

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European
L.C. (EMS) Policy

Ans - 27/2



Foreign and Commonwealth Office
London SW1A 2AH

Telephone 01- 233 3648

Your reference

M Mercer Esq
IG3
HM Treasury

Our reference

Date 27 February 1980

CHANCELLOR SCHMIDT'S VISIT TO BRUSSELS: 16-16 FEBRUARY

1. Sir Michael Palliser has suggested that the Treasury and No 10 might find it useful to see a copy of Brussels Saving Telegram No 2 about Chancellor Schmidt's visit to Brussels on 15-16 February. MOD and the Department of Energy might also find it useful. Since the routine distribution has already been made, I am exceptionally sending direct to you and other addressees a copy of this Saving Telegram, with the request that you and they arrange further distribution of it as appropriate.

J S Laing
Western European Department

cc M O'D B Alexander Esq
10 Downing St

J E Walsh Esq
DS12
MOD

J G Carr Esq
CIP Division
Department of Energy.

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SAVING TELEGRAM

BY BAG

FROM BRUSSELS TO FCO

NO 2 SAVING

22 FEBRUARY 1980

REPEATED FOR INFORMATION SAVING TO ALL EC POSTS

Our telno 53: CHANCELLOR SCHMIDT'S VISIT TO BRUSSELS 15/16 FEBRUARY

1. We have already reported the more significant aspects of this visit in our TUR. This savingram covers the other subjects which the Belgians told us were discussed.

Energy

2. Discussions ranged over the Belgian participation in the German fast breeder programme at Kalkar, the Belgo/German coal underground gasification project at Thulin (near Mons), and the Belgian interest in taking part in a German coal liquifaction project in the Federal Republic. With few indigenous sources of energy and a substantial nuclear programme which is beginning to encounter opposition from environmentalist groups, the Belgians identify closely with the Germans on energy issues. Their participation in the multi-national Kalkar project is part of a general reinsurance policy while their interest in underground gasification and coal liquifaction is a natural consequence of the contraction of their former coal industry

EMS

3. Schmidt explained that because of the election to be held this year in France and the Federal Republic it was not realistic to expect that phase 2 could be brought into operation by the target date 31 March 1981. We do not know if the Belgians discussed the vulnerability of the franc though disobliging remarks have appeared in the Press complaining about the leverage this gave the Federal Republic in its relationship with Belgium. Schmidt went to some

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length during his after dinner speech to dispel the widespread belief in socialist quarters here that the Belgian Government was obliged to toe the common line over TNF in December because of German threats to destabilise the franc if the Belgians stepped out of line. During his press briefing Schmidt also said that he could not understand why the UK remained outside the exchange rate mechanism. In the 1980s the UK would be the Community country best equipped to withstand shocks to its currency and the balance of payments arising from higher oil prices. (We have been told by reliable sources that when speaking to the Belgian Finance Minister the Chancellor was particularly bitter about the UK's failure so far to become a full member of EMS. He also referred pointedly to the present favourable UK balance of payments position.)

TNF

4. The Belgians rehearsed their position on this issue and asked for German support. Desmarets made it quite plain that the Belgians were now going ahead with full financial and technical preparations to implement the NATO December consensus, despite the publicly announced visit by Simonet to various East European capitals to conduct soundings. On the other hand several of the Flemish Socialist Ministers present at the talks asked Schmidt to bring his influence to bear on the rank and file Flemish Socialist through SPD Party links.

5. Apart from these subjects, the talks covered aid to Turkey, NATO budgetary problems (centred mainly on the question of fulfilment of the 3% target increase in spending) and minor bilateral issues.

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10 DOWNING STREET

→ Euro Pol (June 79)
'EMS'
[Handwritten signature]

From the Private Secretary

26 February 1980

Top copy filed on Germany (pt 2) Chancellor
Schmidt Visit to the UK.

Visit of Chancellor Schmidt: Economic Issues

I enclose a brief extract from the record of that part of the Prime Minister's talk with Chancellor Schmidt yesterday dealing with world affairs. You already have the record of their discussion of the Community budget.

I did not include in the main records any account of a brief discussion between the two Heads of Government about the performance of the British economy. The Prime Minister described the course of events since the final removal of exchange controls last autumn and the subsequent rise in the sterling exchange rate. Chancellor Schmidt expressed some scepticism both about the consequence of the rise in the value of sterling and about the possibility of controlling it. He said that the rise had been predictable and in the long run would do Britain no harm. The German Government had been told repeatedly by their own industrialists that an increase in the exchange rate would be disastrous. They had ignored the advice and had never regretted it. In any case it would be impossible for the British Government to resist the rise for long. We would have to accept the consequences of being oil rich. Devices such as negative interest rates might help for a short period but in the end the market would prove stronger. Chancellor Schmidt agreed however that it was important to hold the domestic money supply down. The German Government professed to control the country's monetary base although there was, perhaps, more pretence than reality in this policy. It was designed to keep the trade unions in line (Chancellor Schmidt noted ruefully that in Germany the Government had more difficulty in controlling the entrepreneurs than in controlling the trade unions).

The Prime Minister said that the rise in the exchange rate had a very damaging effect on British exports. Unlike German manufacturers, who sold on the basis of quality, design and delivery, the British manufacturers sold primarily on price. Chancellor Schmidt said that in the long run it was essential to make manufacturers sell on the basis of quality. Those who did not do so would go to the wall. The Prime Minister said that she agreed where private

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-2-

sector manufacturers were concerned. For her the difficulty lay with the large nationalised sector. Chancellor Schmidt admitted that this was indeed a "bad heritage".

Chancellor Schmidt then returned to the question of British membership of the EMS. You already have a record of this part of the discussion. Arising from that conversation, the Prime Minister has asked that a re-appraisal of our attitude towards the EMS should be put in hand in the light of developments since the autumn in the domestic and international economic scene. Such a re-appraisal might conveniently cover the question of participation within the narrow and wider bands; and policies short of outright acceptance or rejection of membership e.g. a declaration of intent coupled with an invitation to the other members to discuss the timing and conditions of British membership or a discussion of modifications to the existing scheme which would make it easier for us to participate

No doubt in preparing such a note you will consult the FCO, the Cabinet Office and the Bank. I think it would be helpful to the Prime Minister if your paper described the full spectrum of views on the question of full participation in the EMS.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office) and David Wright (Cabinet Office).

Yours sincerely

Nicholas Alexander

A.J. Wiggins, Esq.,
HM Treasury.

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Ke. Nind

SIR ROBERT ARMSTRONG

EMS

You were going to reflect on how we might get further views.

2. One possibility would be, if the Prime Minister agrees, for Mr Alexander to write to the Treasury saying that the Prime Minister has noted e.g. Chancellor Schmidt's recent talk with Mr Roy Jenkins and would like further advice. He could refer back to the papers produced last autumn and ask for a reappraisal in the light of subsequent developments in both the domestic and in the international economic scene. He might ask for the opposing considerations to be set out, perhaps systematically, with the case for and against:-

- i. participation within the $2\frac{1}{4}$ per cent margins;
- ii. participation within the 6 per cent margins;
- iii. declaring our firm intention to join and inviting discussion with our Community partners about the timing and conditions;
- iv. suggesting modifications to the existing scheme which would enable us more readily to participate.

3. Mr Alexander might ask for the note to be prepared in consultation with the Bank of England, the FCO, *CPRS* and the Cabinet Office. I do not think it would be feasible, as Sir Michael Palliser suggested, to get the differing views of economists; but we can make sure that if e.g. the Bank has a different view that it is at least recorded. Nor, on past experience, do I think it worth while wresting this task away from the Treasury and trying to put it into committee.

M.D.

M D M FRANKLIN

25 February 1980

Top copy filed on Germany
(Pt 2) Chancellor Schmidt's
Visit to the UK

Partial Record of a Discussion between the PM and Chanc. Schmidt

© No. 10 on 25 February 1980

The Prime Minister said that she would but that she considered the chances of getting support from the others would be small. Chancellor Schmidt said that the Prime Minister might be right but the effort would have to be made. Failure to reform the CAP would be more painful and more damaging than any reform. He agreed with the Prime Minister that it might take three or four years or even a little longer to put through an effective programme of reform. The Prime Minister repeated that she would be willing to make the effort but observed that it would be easier if the Commission's own proposals in the area did not invariably damage British farming.

Chancellor Schmidt said that if Britain could make a gesture on fish and find a way of solving the sheepmeat problem it would enormously improve Britain's negotiating position. He recognised Britain's views on the latter subject but sometimes it was necessary to acquiesce in things that were wrong. It would also be very helpful if Britain were to join the EMS. The Prime Minister said that Britain would continue to press ahead in good faith with the negotiations on fish and sheepmeat - as indeed we had done immediately after Dublin where fish was concerned. As regards EMS, if Britain had joined in the autumn, the present exchange rate would have taken us well out of the grid. The effort to have stayed within the grid would have resulted in a major increase in the money supply. Chancellor Schmidt said that whether or not Britain was in the EMS, the exchange rate was going to rise. He did not think that membership of the EMS would alter the fate of British currency one way or the other. There might be some difficulties. Indeed the Federal Republic had experienced some itself. But British membership of the EMS would help Europe as a whole greatly. He hoped that the Prime Minister would think seriously about it.

Chancellor Schmidt asked whether the Commission should be instructed to produce a possible package solution to the Budget problem. He and Lord Carrington had discussed the idea with President Jenkins at dinner two days previously. Mr. Jenkins had said that the Commission bureaucracy was probably incapable of producing such an approach. All that he could do would be to write a personal letter setting out a solution to the nine Heads of Government.

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Extract from a meeting with the Chancellor of The Exchequer 6.12.79

(d) The Chancellor said that he was a little worried about the FCO's public posture on EMS. In particular, Lord Carrington's recent speech in Brussels had indicated that we were rather more positive about EMS than he would have liked. It was certainly a more bullish line than the draft which the Treasury had prepared for the Prime Minister's Luxembourg speech (and which in the event had not been used). The Prime Minister said that she did not think the FCO were quite as far out of line as the Chancellor suggested, but she agreed that they should be pulled back a little. The line should be that we hope to be in a position to join EMS sooner or later, but the time is not ripe yet. (The Chancellor asked whether he could have this recorded in writing for the benefit of the FCO: the Prime Minister said she did not think this was necessary. However, I will mention the point to the FCO orally).

Subject file
Iran Situation - May 1979

Original on:- France: July 1979

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Euro Pol: EMS

PM/ Giscard Discussion at 7615 on 19 Nov 79 at No 10

cheap cars from the British market. Lamb was one case where the British product was better than others. Both the British Press and British sheep farmers were up in arms. President Giscard said that if the market were organised, British producers would not suffer. The income of France's sheep farmers was half the national average. They had to be protected. It was difficult for the French Government to defend the disruption of the previously existing arrangements by Britain at a time when Britain was seeking substantial adjustments in her favour in the Budget.

The Foreign and Commonwealth Secretary asked about the willingness of the French Government to reimburse their sheep farmers through national measures. President Giscard said that the French Government would be willing to pay but could not do so efficiently until there was an organised market. M. Francois-Poncet said that the free flow of agricultural goods within the Community had only begun following the establishment of a Community market. Since in the case of lamb no such market existed, it followed that there was no commitment to free trade in lamb. Britain wanted the free flow without an organised market. France wanted the organisation. If the British Government wanted to lay so much stress on the decision of the European court, they should be prepared to abide by other Community decisions, e.g., that agreed in Dublin on the budgetary mechanism. The Chancellor of the Exchequer said that the Court had ruled in favour of free movement. Their ruling had to be respected. The Prime Minister said that the sheepmeat problem ought to be soluble. But she stressed that New Zealand was in many respects an extension of the United Kingdom. New Zealand was a primary producer of butter and lamb. New Zealanders had little protection against such events as the recent oil price rise. Britain was bound to be concerned about New Zealand's position.

International Monetary Situation

In response to a question from the Prime Minister, President Giscard said that the European Monetary System

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presented no particular problem at present. He recognised that there was no desire on Britain's part to re-open the question of full adherence to the exchange rate mechanism, at present. The Prime Minister recalled what Chancellor Schmidt had said at Strasbourg about the desirability of the abandonment of exchange controls by Britain. The British Government had now taken this step. Partly as a result and partly for other reasons, there had been considerable fluctuation in the value of sterling. Ultimately the British Government would like to enter the mechanism, but there had to be greater stability first. President Giscard asked what the British Government expected to happen to the exchange rate of sterling vis-à-vis the other European currencies in the year ahead. The Chancellor of the Exchequer said that there were conflicting influences. The performance of the economy and the differential rate of inflation had tended to push the value down while sterling's petro-currency status tended to push it up. The broad assumption for the year ahead was that the rate would remain more or less stable though there might be fluctuations week by week. The Prime Minister said that the Government would take a much closer look at the question of joining the exchange rate mechanism if exchange rate stability persisted for some time.

/ Energy

~~Mr. Alexander~~
 I'm not sure if I'm
 sure to be.
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RECORD OF A CONVERSATION BETWEEN DEPUTY SECRETARY, CABINET OFFICE
 AND ECONOMIC ADVISER TO THE FEDERAL CHANCELLOR AT THE FEDERAL
 CHANCELLOR'S OFFICE: 31 OCTOBER 1979

PRESENT

Mr M D M Franklin

Dr Horst Schulmann

Mr J D I Boyd

Dr Rüdiger Thiele

Herr Otto von der Gablentz

EMS

1. In response to a question Dr Schulmann said that he was no longer involved day to day: the EMS was working satisfactorily. Mr Franklin referred to the realignment. In London there were two schools of thought. One held that the realignment showed the flexibility of the system, the other that the strains had been exhibited. Dr Schulmann said that he belonged to the first school of thought. The delay in the realignment negotiations had reflected only the internal Benelux problem. Mr Franklin pointed out that the divergence indicator had not functioned as planned. Dr Schulmann said that this was a fair point. It had created surprise all round: an irony when one considered how hard the point had been fought at the outset. He anticipated certain difficulties for EMS in future: no-one wanted to devalue these days. But there would be no need for a further adjustment for some time. The Germans were quite content with the situation.

2. Mr Franklin referred to the meeting in Brussels. The failure of the Federal Finance Ministry to issue an invitation to the UK had created difficulties. It had been agreed that the UK should be consulted over exchange rate adjustments as it made sense for the UK

to attend the meetings. Most people now accepted the recent episode had been a misunderstanding which would not be repeated. Dr Schulmann said he was not aware that the UK had not been invited.

Monetary Committee

3. Dr Schulmann said that it was desirable to strengthen the Committee's role. Sir K Couzens might for instance attend as a full time member, with eg. his French opposite number. The Committee was presently too large and indulged in set pieces. Mr Franklin saw merit, personally, in strengthening the Committee. Dr Schulmann mentioned the advantage of contacts in the margin. Possibly a new Chairman was needed? Mr Franklin said that we would not wish to push van Ypersele out. He had been a good Chairman.

The Dollar

4. Dr Schulmann said that he did not understand complaints about EMS participants' lack of a dollar policy. Dollar policy was in the first instance a matter for the US. No amount of European intervention could beat the trend. Leaving aside September, the EMS/Dollar rate was pretty stable. He expected it to remain so in the near future. Market sentiment had stabilised. There was confidence in Volckers monetary line. If the US entered deep recession in 1980, with a dramatic shift in the trade balance, then the Community would have to ask itself whether, on the assumption of a stronger Dollar, this should be fully or only partly reflected in the rate. It would be necessary to discuss this with the Americans.

Sterling

5. Dr Schulmann enquired about the recent drop. Mr Franklin mentioned the CBI report on industrial confidence and the delayed reaction to the ending of exchange control or possible explanations. While some downward movement was not unexpected, Ministers would be concerned about the effect on inflation. Dr Schulmann said that the

IMF surveillance role did not operate when it came to competitive revaluation. Mr Franklin said that the proposed Substitution Account was a good thing but would not fundamentally change matters. Dr Schulmann agreed.

European Monetary Fund

6. Dr Schulmann said that the two year time-table for the establishment of EMF was, even given the late start of EMS, a bit ambitious. It had been established before the recent oil increase prices. But the Monetary Committee was addressing itself to the subject and the Commission would table a new paper. Not much could be expected before the French elections.

VAT Ceiling

7. Mr Franklin observed that a lot seemed to hinge on these and the German elections. Were the Germans, and French committed to holding the 1% ceiling? The Prime Minister had made a firm statement in her Luxembourg speech. Dr Schulmann Added that S. Pandolfi had told him after the UK/Italian Consultations that Italy would also stick to the 1% ceiling. Cossiga had been very outspoken in Bonn. The FRG would hold the line, indefinitely. The Government's hands were tied by the recent Bundestag resolution. There was no time limit. Mr Franklin said that a squeeze on the ceiling was unavoidable. The French would not wish to face the consequences. Dr Schulmann said that the problem was for the Commission in the first place. Commissioner Gundelach's latest comments on the CAP had to be taken seriously. It was not possible to reconcile maintenance of the ceiling with both UK ideas on budget reform and ever increasing agricultural expenditure.

CAP Reform

8. Mr Franklin said that we should have to see what the Commission produced. The UK was willing to examine a variety of ideas but there was no substitute for a vigorous price policy. Any co-responsibility

levy must be nondiscriminatory. Did debudgetisation offer an alternative? Dr Schulmann said that it had not appealed to the FRG in the past and the position had not changed. It was not a promising path. But one should focus on the behaviour of Agricultural Ministers and their propensity to write cheques. In face of the budget constraint something had to give. Mr Franklin said that the UK supported the Italian approach (to shift expenditure away from the CAP). But how could this be monitored year by year? He did not advocate Joint Councils. Should Agricultural Ministers be subjected to a financial ceiling on their policy decisions. In principle, it might be possible for ECOFIN, the Budget Council or even the European Council to lay down at the end of each year limits of operation for Agricultural Ministers in the next year. Dr Schulmann found the proposal "tempting" but still saw problems in quantification. Experience showed that the Commission always returned for a supplementary farm budget. Mr Franklin accepted this; but both sides were looking for ways out of an unsatisfactory position. Personally, he thought only the European Council could place limits on Agricultural Ministers. This was after all what Governments did nationally. Dr Schulmann asked whether this was really the lesson of the Luxembourg Agricultural Council. Mr Franklin said that under his proposal this could not have happened. Dr Schulmann said that Gundelach should perhaps have resigned after Luxembourg.

9. Mr Franklin said that the FRG could count on the UK to be as tough as anyone, and perhaps tougher, over prices; but we could not take the whole burden alone. He would like to kill the idea that the UK would lose interest in CAP reform if its needs were met on the Community budget. This was nonsense. First the CAP was politically most unpopular in the UK. Second, even if the budget problem were solved, the UK would still face non-budgetary resource costs. Dr Schulmann said that he was glad to hear this. On the German side CAP reform posed a problem for the Coalition, with the prospect of one of the toughest election campaigns in German history yet to come: so it would be difficult to proceed quickly. In reply to a question

Dr Thiele confirmed that the advantage of the co-responsibility approach for the Germans was that domestic agricultural support could be increased without infringing the 1% ceiling, since the co-responsibility levy counted as negative expenditure.

Community Budget

10. Mr Franklin said he did not accept that the 1% VAT ceiling should be an obstacle to solving the UK budget problem could not a refund be financed outside the budget. Dr Thiele said that this was impossible. It raised the issue of a new key and posed problems for France, Ireland and Italy. Mr Franklin said that it was nonsensical that the financing of a solution should appear as an increase in the total Community Budget. Dr Schulmann referred to the principle of truth in budgeting. Mr Franklin pointed out that this was breached in the co-responsibility levy. Dr Schulmann said that this was for different reasons. Mr Franklin said that it would not be possible to tie up all such details before Dublin, but the 1% ceiling should not be an obstacle to a resolution of the UK budgetary problem. Dr Schulmann disagreed. Mr Franklin said that there were others like the Dutch who were disposed to make abandonment of the ceiling a condition for solving the budget problem. Surely the FRG would not wish to push the UK into this camp. Dr Schulmann said that the ceiling would be held come what may.

11. Dr Thiele pointed out that there was still some latitude before the ceiling was reached. Mr Franklin agreed: how much would depend on how successfully the cost of the CAP could be continued. Dr Schulmann said it also depended on the size of the UK reduction. Mr Franklin hoped that this would be settled in Dublin, whereas the active claims on the 1% ceiling in 1980 would not be apparent until eg. the size of the harvest was known. Dr Schulmann said that Gundelach had a fairly specific idea of when the ceiling would be reached. At Dublin other partners would of course table demands. The Germans thought it helpful to keep these arguments grouped together. The UK desire to isolate the budget contribution problem was understood but this did not suffice for the Germans. Mr Franklin saw no virtue in complicating the discussion.

Dr Schulmann said whatever the FFG's view, others were more extreme and would want douceurs. The French had specific ideas. The Germans were not trying to complicate the discussion. They wanted to help, but it was not simply an Anglo-German problem. Mr Franklin said that Lahnstein's rejection of linkage at the Finance Council had been encouraging. Dr Schulmann said that the Germans would not link a budget solution with other problems, but others would. "Flexibility" by the UK would be helpful. No doubt we should get a first hand view from Giscard.

12. Mr Franklin said that linkage with CFP would be particularly unhelpful. Dr Schulmann said that the Germans had no such idea, whatever the report in the Daily Telegraph. Mr Franklin drew attention to Mr Walker's flexibility at the latest Fish Council. But the domestic background was difficult. Dr Schulmann said that the fishing industry accounted for only 0.5% of the UK GNP. Mr Franklin referred to marginal seats, the Scottish problem and the Prime Minister's own political commitment. Nevertheless we had been helpful over the Canadian agreement and there had been movement at the Council on the internal regime.

Further Work

13. Mr Franklin said that the Dublin negotiation would be difficult. Dr Schulmann said Community Finance and Foreign Ministers would have a role in the interim. Meanwhile could Mr Franklin define "broad balance" and "at worst"? Mr Franklin did so. We were not asking to be net beneficiaries. Operating on excessive contributions alone did not answer the problem. Dr Schulmann accepted that one could not get broad balance without approaching the problem from both ends. Mr Franklin pointed out that, with no disrespect to ressources propres, the doctrine had in practice been dented by the Financial Mechanism. Why should the receipts side pose a doctrinal problem? Dr Schulmann rejected the concept of "inequitable". The budget problem was political not legal. Mr Franklin pointed out that however this might be the position was

unfair. Dr Schulmann mentioned purchasing power parities. Mr Franklin replied that we were nevertheless below average. Dr Schulmann did not dissent, but the Treaty of Rome did not spell out rights for countries in particular positions. Mr Franklin referred to the Preamble. The UK had a problem. A solution could not be achieved by inflating the budget via eg. the Regional Fund. Dr Schulmann thought it unnecessary to go over the arguments again. Whatever the German decision, others would insist strongly on Community principles. Mr Franklin said that the German decision would nevertheless be crucial.

14. Mr Franklin added that he wished to make it clear that an instalment solution, ie. a solution providing an improvement of the financial mechanism now and an expectation that the greater problem would solve itself say over 10 years, would be impossible to sell in the UK. A promise had been made to the UK in the past that the CAP's share of the budget would decline but this had not happened. The act could not be repeated. Dr Schulmann said that in 1972 the UK had expected to be a net contributor in 1977. Mr Franklin said that the remarkable growth in CAP expenditure had not been anticipated. Nor indeed had the UK's failure to achieve a higher growth rate. Dr Schulmann said that low growth after 1973 was not unique to the UK. Mr Franklin said that we were nevertheless the lowest.

EESPRI

15. Dr Schulmann referred to the reversal of the UK position following a General Election. He would regret a failure to establish the institute. He believed there were still good arguments for it. There was now a good head of steam behind the project in Bonn and it would be difficult to go into reverse. Mr Franklin explained HMG's determination to avoid waste and duplication, and the background of forthcoming public expenditure cuts. However, if the Germans or other partners were to propose a radically slimmed down institute this would be examined in London. Dr Schulmann was grateful for this explanation. He saw no virtue in a mere umbrella organisation. He accepted that

an institute should be of high quality. It should be free from Commission control and should thus not be situated in Brussels. The Germans had opposed the Ortolí scheme partly for this reason, and to avoid an institute which simply provided a home for lame ducks from the Commission staff.

cc
Mr Jordan-Moss Treasury
Mr Fretwell FCO
Mr J H V Davies MAFF
Mr M D Butler UKREP
Mr Boyd HM Embassy Bonn
Mr Alexander No 10

SECRET



10 DOWNING STREET

File. Ems PA 6
cc Master set
Econ Pol:
Exchange Control

From the Private Secretary

17 October 1979

Dear Tony,

The Prime Minister held a meeting at 0945 hours this morning to discuss the EMS and the Chancellor of the Exchequer's proposals for further dismantling exchange controls. The following were present: the Chancellor, the Foreign and Commonwealth Secretary, the Secretaries of State for Industry and Trade, the Governor of the Bank of England, Sir John Hunt and Sir Robert Armstrong. They had before them the paper on EMS circulated under cover of the Chancellor's minute of 24 September and the Chancellor's minute of 11 October on exchange control.

EMS

The Chancellor said that he was opposed to full membership of the EMS for the present. There was considerable uncertainty about the future path of the exchange rate, and this could make it difficult to reconcile strict adherence to monetary targets with the fixed rate obligations of EMS. One of the uncertainties on the exchange rate front related to his proposals for further dismantling exchange controls: if these were accepted, it would be necessary to wait several months at least before joining the EMS so as to allow time to see the consequences of future liberalisation for the exchange rate. He did not believe that a decision to join would make any significant difference to the UK's bargaining position in relation to the Community budget. On the other hand, it was a fact that the UK's continued exclusion from full EMS membership tended to isolate UK Ministers in their discussions in Europe; and he felt that full membership should remain an objective for the medium term. The Governor said that he supported the Chancellor's position, though he would like to feel that the UK was moving in the direction of full EMS membership.

The Secretary of State for Trade said that, while he acknowledged the political case in favour of joining, the economic arguments against early membership were strong. In any case, the dismantling of exchange controls must come first. The Secretary of State for Industry said that he too was opposed. The Foreign and Commonwealth Secretary pointed out that if the Government could be sure that sterling would be under pressure in a downward direction, there would be advantage in the UK joining. In that situation, there would be no conflict with the policy of holding the money supply, and the UK would benefit from the network of support under the EMS arrangements. However, he agreed that it would not be right to join for the time being.

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/ Summing up

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Summing up this part of the discussion, the Prime Minister said that she agreed that the time was not yet ripe to join the exchange rate regime. She was particularly concerned about the potential conflict between the Government's monetary targets and the EMS intervention requirements. Adherence to the monetary targets was absolutely crucial if inflation was to be brought down, and the Government's monetary objectives must remain paramount. She herself was not optimistic that sufficient stability in the exchange rate would be achieved to make joining possible even over the next year. She did not intend to mention EMS in her Luxembourg lecture the following day, nor did she intend to offer any kind of commitment to the UK's joining EMS as a full member at the Dublin Council.

Exchange Controls

The Chancellor said that he had considered long and hard the final dismantling of controls, and had come to the conclusion that action next week would probably provide the last opportunity for some time. If the decision were postponed beyond next week, it would have to wait for at least two months until after the sale of the BP shares. By the New Year, it could well be more difficult, and it would probably be hard to present the abolition of controls at the time of the next Budget since the background to the Budget was likely to be difficult. He believed it was inherently right to dismantle the remaining controls. Failure to do so would be represented as a failure of confidence by the Government in its own policies; and there was a strong economic case for using part of the benefits of North Sea oil to purchase overseas assets which would yield foreign exchange earnings when North Sea oil began to run out. There were admittedly risks for the exchange rate and possibly for monetary policy; but on balance he was sure that it was right to go ahead.

The Secretary of State for Trade said that he strongly supported the Chancellor. In addition to the points which the Chancellor had made, he added that the Government were rightly trying to create a new climate of greater freedom, and it would be illogical to refrain from the final dismantling of exchange controls: to do so now could well unsettle the markets. A decision in favour would enable the Prime Minister to say something positive at the Dublin Council; it should also help the Government's position vis-a-vis the trade unions, by showing that the Government were determined that investors should be allowed to put their money where they can earn the best return. The Governor said that he, too, was strongly in favour of the Chancellor's proposals.

The Prime Minister said that, while she accepted the advantages of further dismantling of the controls (and, in particular, she favoured overseas investment in general), she was worried about the risks of moving at this time. The Chancellor's minute had suggested that the outlook for the money supply in the next few months was favourable; and that therefore the risk of an adverse impact on the money supply should be accepted. However, she understood that the October money supply figures were likely to be a good deal worse than the figures for September - and, moreover, worse than the Treasury had been forecasting.

/ Commenting on

SECRET

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Commenting on this point, the Governor said that the latest estimates for the Central Government Borrowing Requirement suggested that the October figure was going to be perhaps £1 billion higher than had earlier been forecast; this was indeed likely to make for worse money supply figures for October. The reasons for the high Central Government Borrowing Requirement for October were not yet entirely clear but it appeared that delays in VAT payments were a substantial contributing factor, and also possibly repayment of debt by nationalised industries. Both of these factors were likely to be temporary. On the other hand, the September figures for lending to the private sector were well down on earlier months' figures, and there was still a reasonable prospect that - notwithstanding the high Central Government Borrowing Requirement - the money supply figures for October would be within the Government's target range. It was important not to concentrate simply on one month's figures: looked at on a three-monthly basis, M3 was moving in the right direction. Against this background, the Governor did not think it would be right to hold up the decision on exchange controls because of worries about the money supply.

Asked by the Prime Minister about the exchange rate risks, the Governor replied that these too were not sufficient to postpone a decision. The relaxation of controls in the summer had not resulted in a weakening of sterling. There was no indication that the institutions were likely to take precipitate action in moving funds out of sterling into currencies on which the controls still operated; for Wall Street in particular was not immediately attractive. Moreover, if there were to be a loss of confidence in sterling, this would result in movement into other currencies in any case: the Chancellor's proposals would not add very much overall to the scope for sterling outflows in the short term.

The Foreign and Commonwealth Secretary pointed out that exchange controls in relation to Rhodesia could not be lifted separately from sanctions generally. It would have been better from his point of view if the decision could have been held over until after a decision on sanctions had been taken in November; but in view of the difficulties which this would pose for the Chancellor, he would not press for any delay. There would remain a presentational problem which would have to be resolved.

Summing up, the Prime Minister said that - despite the risks involved - she agreed with the Chancellor's proposals.

As a postscript to the discussion on EMS, I should add that the Prime Minister has decided that she does not wish there to be a further discussion of this issue in OD Committee, and that the Chancellor's paper should not after all be circulated to OD.

I am sending copies of this letter to George Walden (FCO), Stuart Hampson (Department of Trade), Ian Ellison (Department of Industry), John Beverly (Bank of England) and Martin Vile (Cabinet Office). It goes without saying that the decisions recorded in this letter are highly sensitive, and therefore it should be circulated on a strictly "need to know" basis only.

Home cov.

Tim Lankford

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Ref. A0428

PRIME MINISTER

*I also attach a brief note
about the question of a reference to
EMS in your Luxembourg speech.*

EMS

The paper which you are to discuss with the Chancellor, the Foreign and Commonwealth Secretary, the Secretaries of State for Industry and Trade and the Governor tomorrow was prepared by the Treasury and, as you had agreed, discussed at a meeting of Permanent Secretaries under my chairmanship. I think it sets out the various considerations clearly. No-one at my meeting argued that we should go in at the then prevailing rate of sterling but the point was made that, generally speaking, industry attaches more importance to stability than to a lower exchange rate. There was also some unease that once again we might be failing to catch a European train.

2. Since the paper was prepared there has been a realignment. Our own exclusion from the discussion of that is now generally admitted to have been a mistake. As to the realignment itself, it can be argued that this demonstrates the flexibility of the system and that agreement was reached without too much difficulty. On the other hand, compromises had to be made and no-one is sure that the outcome will be particularly durable. No firm conclusions can be drawn from this experience.

3. You will want to ask the Chancellor of the Exchequer to give his views first. He seems to have been rather more anxious to keep his options open than Treasury officials. The key to his position is in paragraph 35 of the paper. The Governor is probably in favour of joining before very long but he does not think we can do so until exchange controls have been dismantled. The Chancellor's minute to you on this subject is therefore highly relevant. The Foreign and Commonwealth Secretary, if he follows the advice of FCO officials and the views of the Lord Privy Seal, may argue that the economic case for and against is sufficiently evenly balanced for the decision to be taken on political grounds. There is growing evidence that Chancellor Schmidt and several of our other Community partners would consider a decision to join as an important indicator of

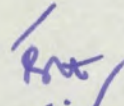
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the Government's attitude to Europe. Sir Donald Maitland reports that our partners will almost certainly be looking for a more definite statement from us on EMS before, or at the time of, the Dublin European Council. Clearly the more positive this can be (even if short of being a firm commitment about when), the more helpful this will be in the context of our fight over our contribution to the budget.

4. Paragraph 52 of the paper sets out two options. There may be intermediate solutions e.g. telling Schmidt privately that we intend to join soon or announcing publicly at the Dublin meeting (if we get our way on the budget) that "Her Majesty's Government has decided to join and will discuss the timing with its partners".

5. You have already agreed (Mr. Lankester's letter to Mr. Hall of 26th September) that following this meeting the Chancellor should circulate the paper to OD under cover of a note of his own. We have provisionally scheduled this for 24th October when OD will be taking another look at the Community budget question. Whatever the immediate decision on EMS you will want to consider carefully the tactics in relation to our objectives on the budget and it would therefore make a lot of sense to take the EMS paper at the same time. This means circulation to OD by the evening of Friday, 19th October.


JOHN HUNT

16th October, 1979

PRIME MINISTER

cc/ Econ PSI;
Exchange Control.

EMS : Reference in the Luxembourg Speech

You may wish to consider, briefly, with your colleagues tomorrow morning the question of whether or not to include a paragraph about EMS in your Luxembourg speech.

It is probably not worth saying anything if you agree with the line put forward by Treasury officials that we could go no farther now than the words to the effect that "we are reviewing the prospects for sterling in the light of the development of our new policies and of external factors"; and that we will take a decision about entry into the Exchange Rate Mechanism in the light of that review.

If, on the other hand, you felt able to say:-

- (a) that the EMS is an essential part of the Community's defences against monetary instability; and
- (b) that Britain's objective is to enter the Mechanism when the position of sterling has stabilised sufficiently (~~to~~ repeat the line you took in Rome),

the impact of your speech would undoubtedly be enhanced.

I attach a copy of a recent telegram from Sir O. Wright on the EMS question. It was in a batch of telegrams which I do not think you have seen. His argument, in brief, is that the EMS is a vital piece of Community machinery and that it is difficult to claim that we are full members of the Community so long as we stand aside from the Exchange Rate Mechanism.

Ant

16 October 1979

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GPS O 1040

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FM BONN 081654Z OCT 79

TO PRIORITY FCO

TELEGRAM NUMBER 566 OF 8 OCTOBER

AND TO ROUTINE EEC POSTS

Prime Minister

It would, of course, guarantee headlines for your Luxembourg speech if you feel able to go further on this subject: at the moment it says "our objective is to enter the mechanism when the position of sterling has stabilised sufficiently" in the form of words you used with Cossiga. More importantly, it would help on the Budget.

ANGLO-GERMAN CONSULTATIONS: EMS

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Prud - 9/11

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DOLLAR

CONFIDENTIAL

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WRIGHT

Fco / WH DISTN

WED

SECRET

4



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

15 October, 1979

Dear Ian,

12.

EMS

... Your Secretary of State and Mr. Nott will be attending the Prime Minister's meeting at 9.45 a.m. on Wednesday, 17th October, at which EMS and exchange control will be discussed. I am sending the Chancellor's minute on exchange control under separate cover; enclosed with this letter is a minute covering a paper on EMS, which the Prime Minister has now agreed can be copied to your Secretary of State and to Mr. Nott. I need hardly emphasise the sensitivity of these papers.

I am copying this letter to Stuart Hampson, and to Tim Lankester, George Walden, and Martin Vile for information.

Yours ever,

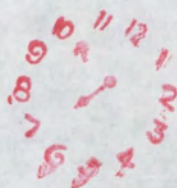
M.A.H.

M. A. HALL

I. Ellison, Esq.,
PS/Secretary of State for Industry

SECRET

15 OCT 1979



[Faint, illegible handwritten text]

S E C R E T

cc PS/Financial Secretary
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Sir Kenneth Couzens
Mr Barratt
Mr Littler
Mr Bridgeman



Mr Middleton
Mr Shepherd
Mr Unwin
Mr Hodges
Mr Gill
Mr Ilett
Mr Ridley
Mr Cardona

5

D J S Hancock

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

15th October, 1979

Des Geary,

*B
187*

EXCHANGE CONTROL

.....
As you know, a meeting has been arranged to discuss exchange control under the Prime Minister's chairmanship on Wednesday, 17th October. The Secretaries of State for Industry and Trade, the Governor of the Bank of England and Sir John Hunt will also be present. The Chancellor of the Exchequer who is in Luxembourg today has asked me to send to their Private Secretaries copies of a minute on this subject which he sent to the Prime Minister last week. This is attached.

As you will appreciate the fact that plans exist for announcing the virtual abolition of exchange control on 23rd October is market sensitive - so also are the plans for a sale of BP stock referred to in the opening paragraph of the Chancellor's minute. I should therefore be grateful if you and the other recipients would ensure that further distribution of this minute is confined to those who really need to be consulted.

I am sending copies of this letter and its attachment to the Private Secretaries to the Secretary of State for Industry, the Secretary of State for Trade, the Governor of the Bank of England and Sir John Hunt, with a copy also for information to Tim Lankester at No.10.

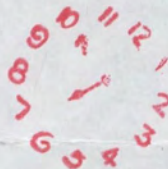
Yours ever,

M.A.

(M.A. HALL)
Private Secretary

G. Walden, Esq.,
Private Secretary,
Foreign and Commonwealth Office

15 OCT 1979



M ②

GPS O 1040

CONFIDENTIAL

FM BONN 081654Z OCT 79

TO PRIORITY FCO

TELEGRAM NUMBER 556 OF 8 OCTOBER

AND TO ROUTINE EEC POSTS WASHINGTON UKDEL CECD

It would, of course, guarantee headlines for your Luxembourg speech if you feel able to go further on this subject: at the moment it says "our objective is to enter the mechanism when the position of Sterling has stabilised sufficiently" in the form of words you used with Cossiga. More importantly, it would help on the Budget.

Top copy of Germany. PMS meeting with Schmidt June 79

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Prints - 9/4

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WRIGHT

Fco / WH DISTN

WED

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Exact Plenary Session Record
PM/Cossiga Rome 5 October
1979.
LVO JOL

European Monetary System

Signor Cossiga said that Signor Pandolfi had just returned from the meeting of the IMF in Belgrade where he had been elected Chairman of the Interim Committee. It might be useful if he were to say something about the EMS and then about the international monetary situation in general. The Prime Minister congratulated Signor Pandolfi on his appointment.

Signor Pandolfi said that the Italian Government had been unhappy about the fact that when the EMS had recently decided to adjust its central rates, Britain had not been represented. He had spoken very frankly to the Germans about the need to observe Article III(2) of the 1978 Brussels declaration. It was wrong that meetings on such sensitive subjects should be held at such short notice and in the absence of a major member Government. The Italian Government would insist on improvements in the consultative procedure.

As regards the central rate adjustment, Signor Pandolfi said that they had opted for a modest change but the interest rate situation was still under stress. It was essential for the members of the EMS to achieve a common policy. The weakness of the Dollar meant that there would have to be day to day consultation on the rate. Otherwise the EMS would be unable to maintain a common position on rates vis-à-vis the Dollar. The modest re-alignment agreed in Brussels would suffice for a short period only and constant surveillance of the evolution of the market would be required.

Signor Pandolfi said that the United Kingdom should in due time join the system. Without the UK, the system was incomplete. The Prime Minister said that the British Government would like to join the EMS but that the present fluctuation in the value of sterling was a problem. The value of sterling was being determined by our oil reserves rather than by our economic performance. It was the British Government's objective to join the EMS when conditions were sufficiently stable. The adjustment of the central rates had gone well but the Prime Minister did not expect it to last

/very long.

CONFIDENTIAL

BF 16/10/79

European Rel.

CAROLINE (O.R.)

Could you canvass 17 October for this meeting? The Governor and the Chancellor ought to be free, but I have not tried it on the Foreign and Commonwealth Secretary. Sir John Hunt would also like to attend, but has a previous (important) engagement at 1145 on 17 October.

MJS

Confirmed for
October 17:
10.15 - 11.45.

EJ.
01/10.

28 September 1979

JAL ✓
FSV ✓
CE ✓
GLE ✓



10 DOWNING STREET

Prime Minister

[Handwritten signature]

We have fixed the
meeting for after the
Party Conference - not
possible to fit in before
then. But you may
want to look at the
paper as - which I think
is excellent - again now.

[Handwritten initials]
28/9



Prime Minister 2.
You said that this should go to OD, but you first wanted to discuss with the Chancellor, the Governor and the Foreign Secretary.
Shall I -

Treasury Chambers, Parliament Street, SW1P 3AG i) send copies to the Governor and Lord Corryngton.

PRIME MINISTER

Yes please no

ii) arrange a meeting for as soon as the Chancellor returns from Belgium?

EMS

(Perhaps I could do this and then return the paper to you for w/end reading).

The letter of 12th July from your Private Secretary to mine set out the procedure you wished us to follow for considering further our position on the EMS.

TL 25/1

..... 2. I now attach a paper which has been prepared after meetings at which the Cabinet Office, FCO, Departments of Trade and Industry and the Bank of England were represented under Treasury chairmanship. As you proposed, it has also been discussed in a meeting of Permanent Secretaries under Sir John Hunt and some changes have been made in the light of that.

1 copy to MODBA

3. You will wish to consider when we should discuss this paper. I would then like to circulate it under cover of a short note of my own. Our experience with the Belgians last week shows that the question of our position on the EMS is likely to come up with increasing frequency in the weeks ahead; perhaps the next really important stage will be at your bilateral meeting with Chancellor Schmidt at the end of October.

4. I am copying this letter at this stage only to Sir John Hunt.

(G.H.)

24 September 1979

THE UK AND THE EMS

Form of Paper

1. The first part of this paper (paragraphs 2-10) is a brief history of the EMS and description of the present UK relationship to it. The second part (paragraphs 11-43) identifies and discusses three main issues which Ministers will wish to consider in deciding whether to put sterling fully into the EMS. They are first, the international monetary environment and its bearing on managing sterling in the EMS; second, the relationship of EMS obligations to domestic economic policy, especially to the money supply and thirdly, the Community factor - the significance of the EMS for our relations with the Community. A final part of the paper (paragraphs 44-52) deals with certain specific questions which require a Government view, or would require a decision if Ministers decided to join the EMS: the relationship to the budget problem, the present low-key review of parts of the EMS, the question of "travelling alongside" and the possible use of a 6% margin. The conclusions list the options which we think are effectively open to the Government and also lists again the main considerations bearing on the choice.

HISTORY OF EMS AND PRESENT UK POSITION

2. The European currency system which became known as the "snake" began to operate on 24 April 1972. For the then six members of the EEC it linked currencies with 2 $\frac{1}{4}$ % margins and was seen as part of the movement towards European Monetary Union. Britain joined the "snake" in May 1972 but left again after 6 weeks. France left in 1974 and again, after a second period of membership, in 1976. Italy, Sweden and Norway also had periods of membership or association, but felt obliged to leave in periods of balance of payments difficulty. By 1977/78 the "snake" consisted of Germany and the smaller countries economically closely linked to her - Benelux and Denmark.

3. In 1978 several economic and political factors combined to give rise to proposals for a European Monetary System. The Germans were concerned about the upward pressure on the German mark produced by a weak dollar; and felt that it could be mitigated if the mark formed part of a larger block less readily moved by dollar weakness. That would protect German competitiveness and make for more currency stability in Europe, which accounted for more than half of German trade. President Giscard was a believer in fixed rates and their value as a counter inflationary discipline to the French economy. Other factors were some general disenchantment with floating exchange rates, a distrust of the future of the dollar and a desire to restore momentum to European integration.

4. The discussion between April and December 1978 for the formation of the EMS, on the basis of an outline agreed between Chancellor Schmidt and President Giscard, repeated elements of earlier arguments in the IMF about the operation of fixed exchange rate systems. The potential new members (France, the UK and Italy) argued that the system should be constructed so as to place on the strong members (ie Germany) an obligation to play a full part in keeping exchange rates together through domestic policy measures and intervention; and that if all the

obligation fell on weaker members, the effect would be deflationary. The Germans resisted what they regarded as inflationary proposals. The UK, Italy and Ireland also argued for better treatment of the weaker member countries through the Community Budget. They said this was necessary to the "convergence" of EEC economies without which such an exchange rate system would not succeed.

5. As agreed in December 1978 the EMS included the following elements:

- i. a parity grid of exchange rates with $2\frac{1}{4}\%$ margins as in the snake, but with a 6% option for new members (France, Italy, UK, Ireland);
- ii. within the parity grid, a "divergence indicator" which could lead to policy measures when a currency was diverging significantly from its partners. Divergence is measured against a basket of Community currencies (the ECU);
- iii. enlarged short term and medium term credits to assist intervention and balance of payments adjustment;
- iv. a revolving swap of reserves against ECUs, which would then be the unit for accounting between EMS central banks.

There was provision for creating a European Monetary Fund after 2 years with a full transfer of reserves, further development of the ECU and absorption of existing credit arrangements.

6. The "divergence indicator" was the main concession in the working of the exchange rate mechanism to the arguments of the "candidate members" described in paragraph 5. Its working has been reviewed this autumn. Such imperfections as the review has revealed have not been considered sufficient to justify any changes in its mechanisms, at least on the basis of experience so far. It is not clear that the indicator has so far had any notable extra effect in triggering policy reviews.

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7. Italy and Ireland reserved judgement at the December 1978 European Council but agreed to join the EMS shortly afterwards when given certain assurances about resource transfers. Italy alone used the 6% margin. France delayed the start of the EMS from January 1979 until 13 March 1979 by seeking assurances about "green rate" changes in countries whose currencies appreciated within the EMS ie Germany. A specific assurance was not obtained. The then UK Government decided not to participate in the EMS exchange rate arrangements on the ground (as Mr Callaghan said to the House of Commons) that they were too "close to the original snake" and that "it would be imprudent to join the exchange rate mechanism" when the EEC economies had in recent years not converged

Present UK Position

8. The UK already has links with the EMS:-

- i. sterling is included in the European Currency Unit (ECU);
- ii. we participated in the EMS expansion of the Community medium term credit;
- iii. we are entitled to join the exchange rate arrangements at any time under the conclusions of the December 1978 European Council;
- iv. there is provision for mutual consultation on changes of exchange rate policy between ourselves and full EMS members;
- v. at the Strasbourg European Council in June 1979 the Prime Minister announced that we would participate in the "swap" of reserves for ECUs. She made it clear that this was without prejudice to our decision on the EMS exchange rate mechanism, but reflected our interest in the development of the ECU and the European Monetary Fund;

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vi. we participate in Community discussions about the closer co-ordination of economic and financial policies which is intended to provide the underlying conditions for the successful operation of the EMS.

9. On 26 June the Prime Minister said in answer to a Supplementary Question in the House that we should not make a final decision on whether to join the EMS for some time. She made a reference to the review of the EMS "divergence indicator" after 6 months working which was scheduled to begin in September, saying that "we would be in a position to make some preliminary observations when this matter was dealt with again in September".

10. On 16 July the EEC Finance Council agreed that the review should be conducted by the Monetary Committee and Committee of Central Bank Governors in an "undramatic way" and should be limited in scope.

The review has now been terminated by the Finance Council on September 17. This was primarily at the instance of the Germans. They argued that, since the specialist committees in Basle and Brussels had reported that, on the basis of experience so far, there was no need to change the mechanisms of the system, and since the markets appeared to be nervous in expectation of some change, it would be advisable to express satisfaction at the Committee's reports and to declare the review completed. Although the UK expressed doubts, the participants all decided to approve the German proposal. The conclusion of the review (though it was only of "certain aspects" of the EMS) could be said to remove one answer to those who might press for an early decision on whether or not the UK will join. But the mere conclusion by the participants that, on experience to date, the mechanisms do not at present need to be changed does not in itself greatly affect the more fundamental considerations underlying the UK's choice.

THE MAIN ISSUES

11. The main considerations raised for the Government by the decision whether or not to join the EMS exchange rate mechanism are:

- i. first, whether an attempt to hold sterling to a fixed but adjustable rate (within a 2 $\frac{1}{4}$ % or even a 6% margin) is likely to succeed in the present international monetary environment. This includes the special problems of sterling as a "petro-currency". ("The International Monetary Environment");
- ii. second, how far there is a conflict between giving priority to an exchange rate target and the present economic policy of the Government, with the priority it gives to control of the monetary aggregates. ("Relationship to Domestic Economic Policy");
- iii. thirdly, the relationship between our decision on the EMS and the whole complex of our relations with our partners in the EEC. This includes the clarity of our political commitment to the Community and any impact on the argument about our net budgetary contribution. ("The Community Factor").

The following paragraphs examine these in more detail.

THE INTERNATIONAL MONETARY ENVIRONMENT

12. This section discusses the situation and prospects of the dollar, the EMS group of currencies and sterling as the main factors bearing on our ability to manage sterling in an EMS fixed but adjustable system, and on the likely costs of doing so.

13. There have been two important policy moves towards greater exchange rate stability in the past 12 months. The first was the change of policy by the US on 1 November 1978 towards a much more deliberate effort to maintain the value of the dollar, enlisting at the time German, Japanese and Swiss help. The second was the establishment of the EMS, which has now functioned for 6 months without major crisis or realignment.

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14. Nevertheless, because the world economic situation, including oil supply and price, is uncertain, the foreign exchange and gold markets remain uneasy and volatile. The dollar, as the principal reserve and trading currency, reflects these uncertainties as well as the uncertainties of US domestic policy. Movements of the dollar affect both sterling and the present EMS.

15. The key dollar-deutschemark rate moved from 1.73 (marks to the dollar) in October 1978 to nearly 2.00 (+ 16%) in November 1978. After 1.81 in January 1979 and 1.92 in May it was again at 1.81 (10% below the peak of 2.00) on 7 September. The scale of exchange market intervention remains large. Central bank purchases of dollars were \$33 billion in 1977 and \$36 billion in 1978. In the first 5 months of 1979 the 7 most important countries sold \$19 billion net and in June and July they bought about \$11 billion. It is the scale of intervention involved in limiting currency movement which makes it important for money supply and credit conditions in the countries whose currencies are involved in it.

16. There will be factors operating in both directions on the dollar in the next 12 months. The US economy may move into recession; interest rates could be held tight or tightened; the real oil price might fall a little; the US current account deficit may be reduced. These factors could produce some dollar recovery. On the other hand inflation remains high; an election in 1980 may inhibit tough policies and create uncertainty; there could be more trouble over oil supply and prices, or disturbance in the Middle East; and Saudi Arabia could decide to sell its surplus dollars for other currencies instead of investing them in dollars. The most one can say is that change is at least as likely as stability.

17. The EMS has been influenced by the fortunes of the dollar and German reactions to them. In March, April and May when the dollar was firm the Germans sold dollars in order to hold up the mark and reduce domestic money supply, offsetting 1977/8 dollar purchases. By holding up the mark this policy put strain on the weaker EMS currencies.

When the dollar weakened in June the Germans began to buy dollars, but they also put up domestic interest rates, enforcing similar interest rate increases in Denmark, Holland, Belgium and France.

18. The Danish krone and Belgian franc have come under pressure on several occasions and there have been rumours about realignment, but this has so far been resisted by intervention and domestic policy measures. France has not wished to see any early realignment, no doubt partly because any change might raise questions about the French franc. All 3 countries have complained that the Germans have paid too much attention in their dollar intervention and interest rate policies to countering domestic inflation and not enough to obligations to other EMS members.

19. We cannot be sure how smoothly the EMS will operate later this year and in 1980. It is likely that after 9 months or a year market expectations of a realignment will grow stronger, if only because of the inflation differentials between partners. That could lead to speculative pressures. But the performance of the dollar is likely to be important. If it moves sharply in either direction there are risks to the EMS because the impact on EMS member currencies is likely to differ. Again, the German reaction to such movements, and German monetary policy generally, could be critical.

20. Despite the recent dip in the market, sterling retains most of the strength that has been manifest since March as a result of international oil developments and of the Government's monetary and fiscal policies. There might have been some check to this rise if we had been EMS members from 13 March 1979. But even with such a check, it is likely that we should have reached either a 2½% or a 6% limit within a few weeks. We would have had to intervene to hold the exchange rate and accept the risks to the monetary targets and to inflation; or there would have had to be an early realignment of rates, which our partners would have regarded as unwelcome so early in the scheme. They would also have criticised us if we had made an interest rate increase like that announced in the Budget. Indeed, it is very possible that we should have had to take a congé, or temporary period of leave, from the EMS.

21. Sterling tends to be a more exposed currency than any in the EMS other than the deutschemark because it is still widely used in trade, because of London's importance as a financial market and because as a currency it is easily accessible. It has been a relatively volatile currency recently. For example, in 1978 the sterling-deutschemark rate fell from 4.10 in January to 3.70 in October (-10%); by July 1979 it rose to 4.13 (+12%). In the next few months sterling will be exposed to a number of special uncertainties. They include the oil situation; the impact on the economy of the new monetary and fiscal policies of the Government, which will take time to show their effects; and also, very importantly, the effects after 40 years of control of the exchange control relaxations already announced or in prospect. In addition, the markets will watch, closely the development of pay increases during the winter.

22. Taking the international monetary environment as a whole, it is difficult to be confident that the next 12 months will be a period of relative stability for the dollar, for the EMS or for sterling. There are sets of circumstances which could make that 12 months more stable than the last - a quieter period on oil prices, some dollar recovery, smaller balance of payments differences between major countries. But plenty of other scenes are possible.

RELATIONSHIP TO DOMESTIC ECONOMIC POLICY

23. The essence of the EMS exchange rate mechanism is that it requires certain exchange rate objectives to be maintained at least until the members of the system agree that they should be changed. This implies a high priority for exchange rate policy, and some subordination of other policy objectives to it.

Benefits of the EMS

24. The possible benefits of such a policy can perhaps best be seen through the eyes of present members of the EMS. There is first a general benefit of greater stability which is seen as helpful to business confidence, especially for small firms. Much of industry in the UK would also see benefits in greater stability. It means greater predictability of returns and greater stability of profits if significant exchange rate changes happen only every year or two years. A more stable profit level may make credit easier to obtain. These are helpful factors, even if long term investment decisions still have to cope with the likelihood of relative exchange rate changes.

25. However the costs and benefits of exchange rate stability are different for Germany and for most of her EMS partners. For Germany the trading and industrial benefits of stability in the EMS are reinforced by benefits to competitiveness, and her objective is naturally to get these benefits with least damage to her inflation rate. Her currency is held down, those of her partners are held up, and the system requires the partners to join through intervention and domestic policy in achieving this result. Germany gets greater exchange rate stability in her most important trading area. But there is an inflation cost through a lower mark rate, more intervention, the giving of more credit and pressure to relax domestic policies.

26. For most other partners the benefits lie in countering inflation. This is how Holland, Denmark, Belgium and France see it. For them there is a price in lost price competitiveness in keeping their exchange rates higher than would otherwise be the case. But all these see the system as a counter-inflationary discipline imposing restraint on other policies and for several of them indexation of pay and benefits much reduces the competitive gains from devaluation.

27. On entering the EMS the UK could look for the benefits of stability for industry described in paragraph 24. In addition, at different times the UK might see advantage in holding its rate down for competitiveness or holding it up to counter inflation. If this were so, it could try to do this unilaterally and remain free to change policy at any time; or it could enter the EMS in order to carry more conviction because that would make the commitment more permanent and because we could seek help from our partners in holding our rate. We could not expect to gain much "advantage" in either direction on first joining the EMS because our starting rate would be agreed with our partners, but the system could act as a drag on our rate in either direction over a period. The first question this raises is however whether a fixed exchange rate can be held, with periodic agreed adjustments, in the volatile world described in the preceding section, and with a currency as volatile as sterling has recently been. The second question, discussed in the next section, is how far there is a potential conflict with present economic policy.

The Exchange Rate and Money Supply Targets

28. Joining the EMS could produce a conflict with the Government's approach to combating inflation through strict adherence to money supply targets and a progressive reduction in monetary growth.

29. Small self-balancing exchange market interventions are not likely to create serious problems for money supply targets, but they presuppose a rate which is naturally stable, perhaps in a rather stable world environment. That is not the situation of sterling. Large scale net intervention in either direction (like any unpredictable capital flows) makes it difficult to stick to a pre-stated monetary target. The scale of its effects on the money supply is uncertain and it is rarely possible to bring about adjustments in domestic monetary conditions to compensate in such a way that the target is met. The effect of gaining greater exchange rate stability in these circumstances is to push the instability back into the money supply. The possibility of meeting a target rather than overshooting or undershooting it is correspondingly reduced.

30. Substantial intervention to hold sterling down so as to keep within an EMS margin would almost certainly inflate our money supply.

The essence of this case is that we are creating (ie printing) sterling in order to sell it and thus making it cheaper by making it more plentiful. The effect is much the same as an increase in the PSBR: the intervention is in fact financed by borrowing from the National Loans Fund. After a while the extra sterling so created tends to find its way into the UK credit base. The previous Government changed its intervention policies in the autumn of 1977, and again to a lesser extent in the spring of 1979, because they considered that intervention was making it difficult to meet monetary objectives.

31. This has also been the experience of Germany and Switzerland. It was the classic German complaint in the three or four years before the dollar was floated in 1973 that the obligation on Germany to buy dollars at a fixed over-valued rate forced her to import inflation. More recently Germany has had a rate of monetary growth in the 11% to 12% range (much in excess of target) during the period of heavy intervention from mid 1977 to end 1978. Switzerland was obliged to abandon her monetary target altogether when she decided in 1978 to intervene massively to hold down the Swiss franc.

32. The other possibility is that we might need to intervene heavily to hold sterling up in order to keep within EMS margins. The direct effect of that would be to reduce the growth of the money supply. We would be using our foreign currency reserves to buy back sterling (and repay the National Loans Fund).

33. However the monetary consequences of intervention to defend a rate against heavy attack may differ from those where intervention holds up a rate which is not under severe pressure. The Germans sold large amounts of dollars in the spring of 1979 to hold up their rate and reduce their money supply. But they were not at their EMS margin. Intervention when downward pressure is heavy becomes unpredictable (it is not part of policy to undershoot a monetary target any more than to overshoot it). And if the market concludes that a devaluation is inevitable, holding a fixed rate can encourage speculators by offering them a one-way option. If then people borrow sterling in order to

speculate against it, that borrowing inflates the money supply. The reserves are used to buy back sterling created by our own banking system. Companies can lead and lag, and back this by extra resort to bank credit. This happened to the UK in 1976, and can become an important offset to the monetary contraction normally associated with selling reserves.

34. It may be argued that the conflict between money supply policy and a fixed exchange rate can be greatly mitigated by taking full advantage of the ability to change central rates which is an integral part of the EMS. But the EMS does not provide for, and could not work with, unilateral changes of rates. Frequent realignments are expressly not welcome because they undermine the stable currency zone and diminish exchange rate discipline on domestic policy. Rates tend to move together after countries concerned have put up a fight to defend their rate, and with due regard to the effect on competitiveness. Appreciation may be somewhat easier than depreciation in the system but the inhibitions on the frequency and timing of movement still apply. We cannot expect special terms on this point. The Italians wanted a "crawling peg" system. The answer to them was a 6% margin and we would no doubt get the same answer.

35. So long as strict adherence to monetary targets is an important part of Government policy, the risk of conflict with an EMS fixed rate obligation remains. However, this need not mean that the UK must remain indefinitely in a state of isolation from the exchange rate arrangements in the system, if, for example, there were a period of greater natural exchange rate stability and as it becomes clearer that the Government is succeeding in its monetary objectives.

The Exchange Rate and Community Economic Integration

36. There is an important argument that EMS membership obliges Community partners to align their domestic economic policies over a period and thus contributes to the closer economic integration of the Community.

37. It is certainly part of present Government policy to aim to match German rates of inflation and ability to compete, and generally to

enable the performance of our economy at least to match the Community average. The question is whether, given our starting point, entering an exchange rate system like the EMS in the near future would help us to do so. The Government have taken the view that the right way to make progress, given our inflation rate and the weakness of the supply side of our economy, is through strict control of the money supply and the restoration of market disciplines. There has been much acceptance of this economic approach by our Community partners, especially Germany. But under these policies the exchange rate responds to the money supply objective and is an instrument of it, whereas in a system like the EMS money supply control tends to be an instrument for supporting an exchange rate objective. We are back to the potential conflict of objectives discussed in earlier paragraphs.

38. It may be asked: why cannot we now accept the EMS if our 8 partners can, most of whom give a high priority to countering inflation? From an economic standpoint, the answer is probably that their situations differ. Germany can afford to pay some inflationary price for a major trading and political benefit. The circumstances of the smaller countries (some of whom are now in difficulty) are not comparable with ours. France is the most comparable case to the UK, though with a stronger industrial economy and a less exposed currency. It is too early to say how she will fare in the EMS : she left the "snake" twice.

39. As to the UK, it can certainly be argued that the implication of the Government's present economic policy is that we should apply the present policy strictly, especially in this first stage, in order to make progress on "the fundamentals". If this argument is right we would make better progress towards economic integration with Europe by reducing the inflation differential first than by an early linking of exchange rates.

THE COMMUNITY FACTOR: RELATIONS WITH THE EEC

40. Joining the EMS in full would obviously be seen as a significant step in reaffirming our commitment to the EEC. Our joining would be welcomed politically, especially by Germany, Italy, Benelux and Denmark, and might help some of these countries to justify in domestic political terms their share of the cost of resolving our budget problem. Conversely, our standing aside is often represented as casting doubt on our commitment to the EEC, and this doubt would clearly be intensified if we were to go so far as to declare an intention not to join (as distinct from saying "not now, but later").

41. This does not mean that we are not free to choose the moment when to join or that we are under special pressure to do so immediately. Present indications are that a number of countries would prefer us to wait for a moment to join when there was less risk that we would disrupt the system. They are very conscious of the existing pressures on it and of the strength and volatility of sterling.

42. This situation could change if the dollar stabilised and the pressure on oil prices abated; and if sterling also looked stable. However, when assessing the stability of sterling, some of our partners will look not only at the international oil and monetary situation, but at the industrial and pay situation in the UK during the coming winter. So there may be uncertainty until the end of the year or beyond.

43. It is clear, at all events, that unless or until circumstances change radically we should be careful as a minimum not to rule out eventual full membership for the UK, and should keep the question open. And we should also be careful to continue to make it clear that we wish the system well.

SOME SPECIFIC QUESTIONS

Relationship to our EEC Budget Problem

44. Given their present cautious attitude to our early membership of the EMS, it seems unlikely that the majority of our partners would want to link the solution of our budget problem with our full participation in the EMS. Attempts might be made in various ways to use the question as a debating point or delaying tactic, or perhaps even as an excuse for not making concessions which those concerned were determined to refuse anyway. But if there were such manoeuvres it ought to be possible to deal with them.

45. If nevertheless, on a balance of all the considerations, the Government decided to join by about the end of the year, we would obviously want to get all the leverage we could out of this decision in the budget context. Joining would not negative any of the particular arguments which our partners are likely to use against us on the budget and would not change the real interests in the debate. Its real bargaining value is therefore likely to be limited. Its contribution would be to the general atmosphere, mainly perhaps in the Benelux countries and Denmark: one or two of them might see our entry as an opportunity for an EMS realignment which they see as desirable or inevitable.

46. Joining would also enable us to argue for interest rate subsidies like those extended to Ireland and Italy. This would be unlikely to make more than a modest contribution to our budget problem however and we shall need to go on arguing that the loans themselves do not score at all for that purpose.

47. If the Government decided against early adherence, it would be important to state our position in terms most helpful, or least damaging, to our budget case. The line could be that we were for the moment exposed not only to the uncertainties of a "petro-currency",

but also to the exchange rate effects of the Government's radically new structural approach to the UK economy. That included the relaxation (perhaps abolition) of exchange controls in accordance with our Community obligations, after 40 years of tight control. We hoped that the new policies would bring us before long to the point where we could join the EMS with advantage to ourselves and our partners, but we had first to let sterling settle down to a level which reflected the new situation and where we could reasonably look forward to greater stability. It seems likely that in present circumstances this line would be accepted by our partners, especially if explained to them (notably to Chancellor Schmidt) in advance of the Dublin European Council.

48. Our partners might become more interested in early sterling membership of the EMS if the currency situation became more stable. One would have to look at all the circumstances at the time to assess the implications of that. At present however it seems best to assume that going beyond the formula in paragraph and announcing early adherence to the EMS would not have a really important bargaining value on the budgetary issue.

Travelling alongside

49. One possibility mentioned at Strasbourg is that we might behave for an experimental period as if we were in the EMS exchange rate mechanism (either at 2 $\frac{1}{4}$ % or 6%) without actually joining. It is not a possibility that need be ruled out in all circumstances. But it is best seen as a short prelude to joining, subject perhaps to extension if things go wrong in the trial period. As an arrangement for an indefinite period it offers few advantages. At worst it would involve us in policy constraints and intervention obligations without the benefits of full membership. At best, if it involved us in no greater constraints than we shall in any case face outside the mechanism, our partners would be less impressed by our gesture of co-operation than by our refusal to commit ourselves.

A 6% Margin

50. If Ministers decided to join, they could choose between a 2 $\frac{1}{4}$ % and a 6% margin. Given the circumstances in which Italy argued for a wider margin (desire for a "crawling peg") it was widely feared that a 6% margin might be regarded as a sign of weakness and invite speculation. In fact the lira has been strong and in present circumstances no such suspicion would attach to sterling. In view of volatility of sterling it might be wise to opt for the 6% margin. This might require close thought if we were joining at a time of sterling weakness however.

51. The wider margin gives some extra time and room for manoeuvre if the rate comes under pressure in either direction. However once the margin is reached, the position is the same with a 6% as with a 2 $\frac{1}{4}$ % margin and all the earlier arguments about speculation and intervention apply.

CONCLUSIONS

52. The options which we think are effectively open to the Government on the EMS this autumn are:-

i. to announce a firm intention to join the EMS at an early date. An "early date" for this purpose might be anywhere between the date of the Dublin Council (29-30 November 1979) and say, the date of the Spring Budget (probably April 1980). There would be a choice, which could be left open until the date of adherence, between a $2\frac{1}{4}\%$ and a 6% margin;

ii. to say that while we expect in due course to join the EMS, we think it is ⁱⁿeverybody's interest that we should first let the structural changes affecting sterling under the new Government work themselves out: the adjustment to oil self-sufficiency, the new monetary and fiscal policies and, as a very immediate and important point, exchange control relaxation. Meanwhile we would play a full part in work on the evolution of the system and of the European Monetary Fund.

53. The main considerations bearing on the Government's choice are:-

i. the risk that we might run into serious difficulty in holding a "fixed but adjustable" exchange rate obligation in the EMS, if it is undertaken in an uncertain international monetary environment, as with the snake in 1972;

ii. the benefits for industry of an exchange rate which fluctuates less, if we can achieve that in the EMS;

iii. the risk of conflict between the Government's policy for the monetary aggregates and an EMS exchange rate obligation;

iv. the bearing of the choice made on the clarity of our commitment to the EEC, on our relations with our Community partners in general and on the budgetary question in particular.

54. On procedure, the questions are:

- i. whether any further statement, either for or against early entry, should be reserved for the Dublin Council; or made earlier;
- ii. whether Chancellor Schmidt and President Giscard should be given advance warning of our position;
- iii. what should be said to the House of Commons.

These questions can perhaps best be considered separately in the light of the main decision.

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24 SEP 1979

CONFIDENTIAL



file B
L. P. Lankester
bc Mr Sanders

10 DOWNING STREET

From the Private Secretary

26 September 1979

EMS

I have shown the Prime Minister the Chancellor's minute of 24 September and the enclosed paper on the EMS. She will be considering the paper further, but in the meantime she has asked me to say that she would like to discuss it with the Chancellor, the Foreign and Commonwealth Secretary and the Governor as soon as possible in advance of its being considered in OD Committee. The Prime Minister would like the Chancellor to circulate the paper to OD - under cover of a note as he has suggested - after this small meeting has taken place. We will be in touch with you to arrange a time.

I would be grateful if you could arrange for the Governor to receive a copy of the paper if he has not done so already. I will ask Sir Michael Palliser's office to let the Foreign and Commonwealth Secretary have a copy.

I am sending a copy of this letter to Martin Vile (Cabinet Office).

T. P. LANKESTER

M.A. Hall, Esq.,
HM Treasury.

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→ Emu Post Emu
Original on Econ Post (Domestic Monetary Policy)

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NOTE FOR THE RECORD

c.c. Mr. Alexander

copy on Master Set

The Prime Minister had a brief discussion with the Chancellor and the Governor about recent intervention tactics and the EMS before the lunch yesterday. (Other main points discussed are recorded in my letter of today's date.)

Intervention Tactics and the EMS

The Governor explained the background to the Bank's substantial intervention between 13 and 17 September. The present agreed policy was not to "dig in" at any particular level but rather to "lean on" the rate to moderate marked changes in the rate one way or the other. But it had been thought right to intervene fairly heavily in order to moderate sterling's weakness. To have stayed out of the market would have risked a much sharper fall. While sterling had been too high when it reached \$2.30, it was important - in his view - that sterling should stay relatively high. This was on counter-inflation grounds and because a weak pound would make it more difficult to sell gilts and therefore to meet the Government's monetary objectives.

The Chancellor said that the recent instability of the pound - both up and down - was worrying. At some point, joining the EMS might help.

The Prime Minister said she agreed with the present policy of intervention, and that the Bank had been right to moderate sterling's fall. She also agreed that it was important to keep the pound strong if it could be achieved at reasonable cost. But she did not think our joining the EMS exchange rate regime was a starter until the Government's stabilisation policies began to see fruit.

B.

25 September 1979

SECRET

FCO - PS/LPS, BUTLER, FRETWELL

GAB - PS/LORD PRESIDENT, FRANKLIN

MAFF - D EVANS

TSY - SIR D WASS, JORDAN-MOSS, BARRATT, HANCOCK, MICHELL,
ASHFORD, BAKER

E/E - PS/GOVERNOR, MCMAHON, BALFOUR

NO 10 - ALEXANDER

GDS 432

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FM UKREP BRUSSELS 240931Z SEPT 79

TO FLASH FCO

TELEGRAM NUMBER 4871 OF 24 SEPTEMBER

AND TO FLASH VALLETTA (FOR CHANCELLOR OF EXCHEQUER'S PARTY)
INFO IMMEDIATE ALL EEC POSTS AND WASHINGTON (UKTSD).

EMS REALIGNMENT, 23 SEPTEMBER

M I P T: FOLLOWING IS THE TEXT OF THE COMMUNIQUE REFERRED TO
PARA 6 :-

TENSIONS ON THE FOREIGN EXCHANGE MARKETS OVER THE LAST FEW DAYS, CAUSED BY THE MOVEMENTS OF CURRENCIES OUTSIDE THE E.M.S., HAVE LED TO A MEETING OF THE MINISTERS AND CENTRAL BANK GOVERNORS OF E.E.C. MEMBER COUNTRIES PARTICIPATING IN THE EXCHANGE RATE MECHANISM AND THE COMMISSION IN BRUSSELS ON 23 SEPTEMBER, 1979.

MINISTERS AND GOVERNORS HAVE AGREED THAT TECHNICAL ADJUSTMENTS ARE NECESSARY. THEY LEAD TO THE FOLLOWING SHIFTS AS MEASURED BY THE CROSS-RATES :

- OF 5 PERCENT BETWEEN THE DM ON THE ONE HAND AND THE DANISH CROWN ON THE OTHER HAND
- OF 2 PERCENT BETWEEN THE DM ON THE ONE HAND AND FF, FB, F LUX, HFL, LIT., IR POUND ON THE OTHER HAND.

THE CROSS-RATES BETWEEN THE FF, FB, F LUX., HFL, LIT., IR POUND REMAIN UNCHANGED.

THE NEW BUYING AND SELLING RATES WILL BE COMMUNICATED BY THE CENTRAL BANKS IN TIME FOR THE OPENING OF FOREIGN EXCHANGE MARKETS ON 24 SEPTEMBER 1979.

THESE ADJUSTMENTS ARE DESIGNED TO MAKE A POSITIVE CONTRIBUTION

ADVANCE CO

X21

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FLASH

THE NEW BUYING AND SELLING RATES WILL BE COMMUNICATED BY THE CENTRAL BANKS IN TIME FOR THE OPENING OF FOREIGN EXCHANGE MARKETS ON 24 SEPTEMBER 1979.

THESE ADJUSTMENTS ARE DESIGNED TO MAKE A POSITIVE CONTRIBUTION TOWARDS A MORE ORDERLY DEVELOPMENT ON THE EXCHANGE MARKETS, AT THE SAME TIME AS HELPING THE STABILITY OF CURRENCIES NOT IN THE SYSTEM. CO-OPERATION WITH THE MONETARY AUTHORITIES OF THIRD COUNTRIES WILL BE COMBINED AND STRENGTHENED.

THE ECU CENTRAL RATES WILL NOW BE REVISED IN THE LIGHT OF THE REALIGNMENTS IN BILATERAL CENTRAL RATES. THE CENTRAL BANK GOVERNORS WERE REQUESTED TO TAKE THE APPROPRIATE ACTION IN CONSULTATION WITH THE COMMISSION. THE COMMISSION HAVE BEEN ASKED TO PRESENT PROPOSALS FOR APPROPRIATE ADJUSTMENTS AS REGARDS MCAS.

FCO ADVANCE COPY ADDRESSEES ONLY :

FCO - PS/LPS, BUTLER FRETWELL

CAS - FRANKLIN

MAFF - D EVANS

TSY - SIR D WASS, JORDAN-MOSS BARRATT HANCOCK, MICHELL

ASHFORD BAKER

B/E - PS/GOVERNOR MCMAHON BALFOUR

NO 13 - ALEXANDER

GRS 820

CONFIDENTIAL

FM UKREP BRUSSELS 240930Z SEP 79

TO FLASH FCO

TELEGRAM NUMBER 4878 OF 24 SEPTEMBER

AND TO VALLETTA (FOR CHANCELLOR OF EXCHEQUER'S PARTY)

INFO IMMEDIATE BRUSSELS COPENHAGEN THE HAGUE ROME LUXEMBOURG
DUBLIN PARIS BONN WASHINGTON (UKTSD)

PERSONAL FOR HEADS OF MISSION.

EMS REALIGNMENT : 23 SEPTEMBER

YOU MAY FIND IT HELPFUL TO HAVE A REPORT OF THE DISCUSSIONS BETWEEN THE IRISH PRESIDENCY AND OURSELVES DURING THE COURSE OF YESTERDAY'S MEETING OF FULL EMS PARTICIPANTS, WHICH LED TO A REALIGNMENT OF EMS PARITIES AT ABOUT 2.00 AM THIS MORNING. IN VIEW OF THE DELICACY OF THE SUBJECT, THESE DISCUSSIONS SHOULD BE TREATED AS CONFIDENTIAL.

2. WE UNDERSTAND THAT ON SATURDAY EVENING VAN YPERSELE (BELGIUM), IN HIS CAPACITY AS CHAIRMAN OF THE MONETARY COMMITTEE, TELEPHONED JORDAN-MOSS (TREASURY) WITH THE NEWS THAT A MEETING OF THE 8 EMS PARTICIPANTS AT FINANCE MINISTER/CENTRAL BANK GOVERNOR LEVEL WAS TO TAKE PLACE AT 11.00 AM ON 23 SEPTEMBER TO DISCUSS INTEREST RATE POLICIES, POLICY TOWARDS THE DOLLAR AND OTHER MATTERS: THAT THE INVITATIONS HAD BEEN ISSUED FROM BONN: AND THAT THE UK, AS A NON-PARTICIPANT IN THE EXCHANGE RATE MECHANISMS OF THE EMS, HAD NOT (NOT) BEEN INVITED. JORDAN-MOSS AFTER CONSULTING THOSE CONCERNED IN LONDON, EMPHASIZED THE UK'S INTEREST IN THE WIDE RANGING SUBJECTS UNDER DISCUSSION AND ASKED THAT WE SHOULD BE KEPT FULLY INFORMED.

3. ON SUNDAY MORNING, SOON AFTER THE MEETING BEGAN, DILLON (IRISH PERMANENT REPRESENTATIVE) TOLD MEMBERS OF MY STAFF THAT, AT THE REQUEST OF COLLEY (IRISH PRESIDENT OF THE FINANCE COUNCIL), THE MEETING HAD DECIDED TO INVITE THE UK TO BE REPRESENTED. DILLON

ADVANCE COPY

(2)

FILES

Prime Minister

1/2

2/6

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HO 618 X 4

FLASH

REQUEST OF COLLEY (IRISH PRESIDENT OF THE FINANCE COUNCIL), THE MEETING HAD DECIDED TO INVITE THE UK TO BE REPRESENTED. DILLON CONFIRMED THAT, THOUGH THE ORIGINAL INVITATIONS HAD BEEN ISSUED IN THE NAME OF THE PRESIDENCY, THEY HAD GONE OUT FROM BONN. HE IMPLIED, WITHOUT EXPLICITLY SAYING SO, THAT UNTIL COLLEY ARRIVED AT THE MEETING HE HAD NOT BEEN AWARE THAT NO INVITATION HAD GONE TO THE UK.

4. FOLLOWING TELECONS JORDAN-MOSS/FITCHEW, WE SPOKE AGAIN TO DILLON AT 1.00 PM LOCAL TIME. AFTER INFORMING HIM OF THE ADVANCE WARNING WE HAD HAD FROM VAN YPERSELE (SEE PARAGRAPH 1 ABOVE), WE SAID THAT, FOLLOWING CONSULTATION WITH THE CHANCELLOR, WE HAD DECIDED THAT AT THIS LATE STAGE IT WAS NOT PRACTICAL FOR A TEAM TO COME FROM LONDON FOR THE MEETING AND THAT IT WOULD NOT BE APPROPRIATE FOR MEMBERS OF UKREP TO PARTICIPATE, AS THEY WOULD NOT BE IN A POSITION TO GIVE THE UK'S VIEW. THE CHANCELLOR WAS, HOWEVER, GRATEFUL FOR COLLEY'S INITIATIVE IN RAISING THE QUESTION.

5. WE MADE THE FOLLOWING FURTHER POINTS :

(A) WE WOULD WISH TO BE KEPT INFORMED OF THE OUTCOME OF THE DISCUSSION BEFORE ANY DECISIONS WERE MADE PUBLIC. WE WOULD ALSO WISH TO BE CONSULTED IN ACCORDANCE WITH THE RELEVANT COMMUNITY DECISIONS ON ANY PROPOSALS FOR CHANGES IN MCAS OR FOR ANY CHANGE IN THE VALUE OF STERLING WITHIN THE ECU:

(B) WE WOULD WISH THE ARRANGEMENTS FOR ANY FUTURE MEETINGS OF THIS TYPE COULD BE REVIEWED IN THE LIGHT OF WHAT HAD HAPPENED:

(C) WE HOPED THE IRISH PRESIDENCY COULD CONSULT US ON WHAT, IF ANYTHING, SHOULD BE SAID TO THE PRESS ABOUT THE UK'S ABSENCE FROM THE MEETING.

6. DILLON SAW NO DIFFICULTY IN WHAT WE HAD PROPOSED AND UNDERTOOK THAT WE WOULD BE INFORMED OF ANY DECISIONS. IN ACCORDANCE WITH THIS, HE CONVEYED THE TEXT OF THE FINAL COMMUNIQUE CONTAINED IM NIFT TO US AT ABOUT 2.00 AM THIS MORNING, BEFORE IT WAS RELEASED TO THE PRESS. WE PASSED ON THE NEWS TO TREASURY AND BANK OF ENGLAND. WE UNDERSTAND THAT AT ABOUT THE SAME TIME VAN YPERSELE TELEPHONED JORDAN-MOSS WITH THE SAME MESSAGE. VAN YPERSELE ALSO TOLD JORDAN-MOSS THAT THE REASONS WHY THE UK WAS UNABLE TO TAKE UP THE INVITATION HAD BEEN WELL UNDERSTOOD: AND THAT THERE HAD BEEN SOME CRITICISM OF THE GERMAN ARRANGMENTS FOR THE MEETING, WHICH MATTHOEFER (GERMAN FINANCE MINISTER), HAD ACCEPTED.

OF THE GERMAN ARRANGMENTS FOR THE MEETING, WHICH MATTHOEFER
(GERMAN FINANCE MINISTER), HAD ACCEPTED.

7. THE COMMUNIQUE IN MIFT CONTAINS NO REFERENCE TO THE UK'S
ABSENCE. THE MEETING CONSIDERED THAT SUCH A REFERENCE WAS
UNNECESSARY IN VIEW OF THE FACT THAT IMMEDIATE DECISIONS WERE
CONFINED TO CHANGES IN THE BILATERAL CROSS RATES WITHIN THE EMS
MECHANISM.

FCO

PLUS FCO

PS/LORD PRIVY SEAL
PS/MR RIDLEY

RESIDENT CLERK

HD/EID (T) (4)
HD/NEWS
HD/FRD
HD/....
HD/....

(2)

MR BULLARD *Bullard*
MR FRETWELL
MR BUTLER
MR ~~THOMAS~~

Rennie Minister

Paul

CABINET OFFICE

D.O.T.

PLUS OGDS

MR M D M FRANKLIN
MR D M ELLIOTT
MR J THOMAS
MR HORNE

B/ENGLAND

H.M. TREASURY

M.A.F.F.

PS/GOVERNOR

SIR K COUZENS
MR ASHFORD

MR B D HAYES

McMAHON

*SIR D. WASS
JORDAN - MOSS*

N-D EVANS

BALFOUR

NO. 10 - ALEXANDER

~~RR LUXEMBOURG~~

MS

~~RR UKTSD WASHINGTON~~

GRPS 400

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FRAME ECONOMIC

FM THE HAGUE 241340Z SEP 79

TO IMMEDIATE FCO

TELEGRAM NUMBER 283 OF 24 SEPTEMBER

INFO IMMEDIATE UKREP BRUSSELS; ROUTINE OTHER EEC POSTS AND UKTSD WASHINGTON.

UKREP TELEGRAM 4871: EMS REALIGNMENT.

1. NETHERLANDS TREASURER GENERAL GAVE HEAD OF CHANCERY FOLLOWING BACKGROUND INFORMATION TODAY ABOUT THE MEETING IN BRUSSELS ON 23 SEPTEMBER.

2. THE FACT THAT THE UK HAD NOT BEEN INVITED TO THE MEETING SEEMED TO HAVE BEEN A MISTAKE ON THE PART OF THE GERMANS. WELINK SAID THAT THE MEETING WAS THE FIRST OF ITS KIND SINCE THE ESTABLISHMENT OF THE EMS, AND THE GERMANS HAD APPARENTLY NOT SHED THEIR QUOTE

THAT THE MEETING WAS THE FIRST OF ITS KIND SINCE THE ESTABLISHMENT OF THE EMS, AND THE GERMANS HAD APPARENTLY NOT SHED THEIR QUOTE SNAKE UNQUOTE HABITS. HE HAD ADVISED HIS MINISTER TO RAISE THE ISSUE AS SOON AS HE HAD REALISED THAT THE UK WOULD NOT BE PRESENT, SINCE THE DISCUSSION RELATED TO CURRENCY MOVEMENTS IN WHICH THE DOLLAR PLAYED AN IMPORTANT ROLE, IT WAS IN THE DUTCH VIEW QUITE INAPPROPRIATE FOR THE UK TO HAVE BEEN LEFT OUT. (HE REFERRED TO ARTICLE 3.2 OF THE BRUSSELS COMMUNIQUE). THIS WAS ONE OF MANY UNSATISFACTORY ASPECTS OF THE WAY THE MEETING HAD BEEN CONDUCTED WHICH WOULD HAVE TO BE REVIEWED.

3. WELLINK SAID THAT THE DUTCH HAD COME BADLY OUT OF THE MEETING. IT WAS CLEAR THAT THE FRENCH AND THE GERMANS HAD AGREED BEFOREHAND THAT THERE SHOULD BE A REALIGNMENT OF 2 PER CENT BETWEEN THE FRANC AND THE DM. THE GERMANS HAD WANTED DIFFERENTIATED REALIGNMENT, BUT THIS HAD PROVED IMPOSSIBLE. THE ITALIANS HAD MAINTAINED THAT THEY MUST PRESERVE THE LIRA/FRANC RELATIONSHIP. THE BELGIANS, FACED WITH SEVERE ECONOMIC AND POLITICAL PROBLEMS, HAD WANTED TO DEVALUE AGAINST THE DM AND HAD ALSO WANTED TO STAY WITH THE FRANC. THE TROUBLE WAS THAT THE BELGIANS HAD ALSO APPEALED TO BENELUX SOLIDARITY. THERE WAS NO OBJECTIVE REASON FOR THE GUILDER TO DEVALUE AGAINST THE DM: QUITE THE CONTRARY, SINCE THE NETHERLANDS ECONOMIC INDICATORS (ESPECIALLY THE PRESENT BALANCE OF PAYMENTS AND RATE OF INFLATION) WERE IF ANYTHING, BETTER THAN THOSE IN THE FRG. NONE THE LESS, BENELUX SOLIDARITY HAD WON THE DAY. THE MINISTRY OF FINANCE WAS NOW FACED WITH HAVING TO EXPLAIN TO PARLIAMENT WHY IT HAD AGREED TO A CURRENCY REALIGNMENT WHICH WOULD ADD ALMOST ONE PER CENT (CETERIBUS PARIBUS) TO THE COST OF LIVING INDEX, WORDS IN PARENTHESES UNDERLINED. THIS WAS BOUND TO HAVE AN ADVERSE EFFECT ON THE CURRENT WAGES ROUND AND THEREFORE ON THE ASSUMPTIONS ON WHICH THE BUDGET ANNOUNCED ON 18 SEPTEMBER HAD BEEN BASED.

TAYLOR

NNNNNNNNNN

SENT AND RECD AT 241442Z PM/

Elms P91

Fue

DSC



10 DOWNING STREET

From the Private Secretary

SIR JOHN HUNT

CABINET OFFICE

EMS

The Prime Minister has read your note of 12 September suggesting how we proceed with the handling of the EMS review. She agrees with your proposals.

L. P. LANKESTER

13 September 1979

GB

'Extract from the Prime Minister's talk with the
PM of Belgium 12.9.79

EMS

M. Martens said that his Government had accepted the full consequences of membership of the EMS. This had not always been easy. The central bank had been forced to intervene since May to the tune of some 70 billion Belgian francs. However, stabilisation of the Belgian franc was a major objective of budgetary policy for the Belgian Government. The EMS provided a useful extra discipline. M. van Ypersele said that the EMS divergence indicator had been an inducement to the Government to take the necessary drastic measures in regard to Government expenditure. The Chancellor of the Exchequer asked whether reference to the constraints imposed by the EMS was helpful to the Government in persuading Belgian public opinion of the necessity for financial stringency. M. Simonet said that the argument was not presented in quite those terms. The Belgians were aware that the performance, at least in balance of payments terms, of those Governments which had accepted fixed parities in the last six or seven years had been significantly better than that of those which allowed their currencies to float. The EMS was a bulwark against an unduly casual attitude towards one's currency. The Prime Minister said that she agreed about the value of a sound currency based on internal restraint. Sterling was a petro-currency whose value was not at present based on the country's economic performance. It was true that our oil resources gave stability for the moment. But it was unlikely that HMG would be in a position to take decisions about British adherence to the EMS by October.

The conversation returned to the EMS at lunch. The Chancellor of the Exchequer said that the present situation in the international monetary field was more unstable than it had been in the recent past. Sterling's petro-currency status, taken together with the instability of the dollar and the uncertainties about oil supply, meant that sterling at present had an unnatural magnetism. The EMS had been conceived at a period of relative stability between the Yom Kippur war and the latest jump in oil prices. He wondered whether in the present situation the EMS might not find it difficult to accommodate sterling. M. van Ypersele said that he favoured

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/entry

entry but at the 6% margin rather than at the 2½% margin. The Italian experience of operating within the broader band had been satisfactory. The EMS had managed to accommodate without difficulty an appreciation of between 4 and 5% in the lira. The Italians, he thought, had found ^{that} the EMS provided positive elements without imposing excessive restraints. However, M. van Ypersele agreed that inflation rate differentials had increased recently. The Chancellor of the Exchequer said that no early decision was likely on British entry into the EMS.

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1.
2. Prime Minister

Ref. A0217

MR. LANKESTER

Are you content to proceed as proposed?

EMS

Yes

TL

12/9

Flag A

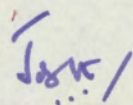
In your letter to Mr. Battishill of 12th July you said that the Prime Minister wished the Treasury to take the lead in producing a paper setting out the options as regards the exchange rate mechanism of EMS which should then be discussed at a meeting of Permanent Secretaries under my chairmanship before being submitted to Ministers by the Chancellor.

Flag B

This paper was discussed at a meeting which I held this morning. It is inevitably on the long side but it is tautly and clearly drafted and will, I think, provide a satisfactory basis for Ministerial discussion. After the meeting Sir Douglas Wass consulted me about the next step. Should the Chancellor of the Exchequer, if he was content with the paper, circulate it to OD in the near future even though, because of his absence overseas, it would not be possible to discuss it until mid-October? Having in mind your separate minute to Mr. Vile of 12th July (not copied to the Treasury) saying that the Prime Minister would want to have a preliminary discussion with the Chancellor, the Foreign and Commonwealth Secretary and the Governor I suggested to Sir Douglas Wass that the Chancellor should send the paper to the Prime Minister only in the first place and should, if possible, do so before his departure from this country. This would allow the Prime Minister time to reflect on what is inevitably a somewhat complicated question: and she could also arrange for copies to be sent to Lord Carrington and the Governor. The small meeting could then take place as soon as the Chancellor returns and be followed by an OD discussion in mid-October. It is important to adhere to this timetable both because of the Community's own review of the EMS and because it will be desirable to know where we stand before the Prime Minister's visit to Chancellor Schmidt on 31st October.

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I will not attempt to summarise the paper at this stage - indeed the Chancellor may himself want to alter it. There are nuances between the views of different Departments (and indeed some differences between the Treasury and the Bank) but clearly the majority view of those who attended my meeting was "not yet".


JOHN HUNT

12th September, 1979

PM/Lynch meeting
Wednesday 5 September

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Original on:
Ireland (Lynch)
May 79
Policy

- 3 -

The EMS

Mr. Lynch asked whether HMG had a timetable in mind for full adherence to the European Monetary System. The present situation was psychologically damaging in Ireland. People tended to think that the punt was doing badly. The Prime Minister said that she was not optimistic about the chances of an early decision on entry by HMG. The situation was at present unpredictable. Despite the easing of exchange controls, the value of the pound remained surprisingly high. Money had not flowed out of the country in the way that some had expected.

The Chancellor of the Exchequer said that the international currency world was markedly less stable than 12 months ago. Owing to the current problems of the dollar, to the OPEC price rise, and to sterling's petro-currency status, this would be a particularly difficult time for the UK to enter the EMS. HMG were not in any sense hostile to the EMS but were very conscious of the complexities of the present situation.

Mr. Colley said that it was clear that the sort of problem described by the Chancellor was likely to continue for some years. Would it prevent HMG joining the EMS throughout that time? Would HMG insist on a stable pound before taking a decision? The Prime Minister said that ^{much} would depend on our energy policy. If the UK became less oil dependent, it would be easier to control fluctuations in the currency. But this would be a long process. In general it was reasonable to say that a more stable pound would make it easier to join the EMS. The Chancellor of the Exchequer said that this was not simply a British interest. All the other members of the EMS had an equal interest in stability. To offer to join on the assumption that stability had been achieved and then to find that the assumption was false would be the worst outcome.

The lunch broke up at 1440 hours.

5 September 1979

AMS

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Top Copy

Eu Pol, May 79
Domestic Monetary Policy

cc Mr. Whitmore

Europe Pol

NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND THE GOVERNOR OF THE BANK OF ENGLAND ON FRIDAY 13 JULY 1979 AT 1630 HOURS

The following are the main points which came up when the Governor called on the Prime Minister:

I. EMS

The Prime Minister commented that, had the UK joined the Exchange Rate Regime, we would have been forced to change sterling parity in relation to the grid. The Governor said that this was not necessarily the case. There would certainly have been upward pressure against sterling's maximum limit; on the other hand, this pressure might have been limited to some extent by the fact that market operators would have thought it unlikely that sterling's parity would have moved so soon. On the other hand he thought that against the current background of turbulence in the exchange markets, which was likely to continue for a while, it was best that the UK had not joined the Regime.

II. June Banking Figures

The Prime Minister commented that the June figures were even worse than the Governor had predicted at the meeting on the mortgage rate the previous week. The Governor said that this was so - including the "acceptance leak", lending to the private sector had been £1,250 million against £1,200 million which he had forecast. The high figure seemed to be due primarily to the June spending spree, which was now reflected in the provisional retail figures. The Prime Minister said that she continued to be concerned about the stock relief provisions, which tended to exaggerate the need for working capital since there was an incentive for businesses to build up their industries; she was also concerned about the tax provisions on leasing which also stimulated bank lending. The Governor replied that the leasing provisions did encourage investment; however, he understood that the Inland Revenue were looking at them.

III. Interest Rates

The Prime Minister said that she was worried at the prospect of interest rates having to stay high, though she fully accepted that - while the banking figures continued bad - there was no alternative. The Governor commented that the future level of

/ interest rates

interest rates depended very much on what happened to wages. If wage inflation accelerated, interest rates would inevitably stay high. In addition, interest rates in other countries were moving up. The Germans had just announced a 1% increase in their discount rate, even though Dr. Emminger had been implored - at the recent Central Bankers meeting in Basle - to avoid this. The Dutch and the Belgians had been obliged to follow. The Germans were clearly trying to fight inflation by keeping the DM up.

IV. The U.S.

The Governor said that the US economy was almost bound to go into recession after four years of rapid growth and with inflation slowing the economy down. Inflation over the last six months was running at an annual rate of 14% - this was partly due to the oil price increase, but food prices were also rising rapidly partly because of fears about the Russian harvest. It was uncertain what the Administration would do. With the election coming up, they would be under pressure to reflate and relax interest rates. But if they did, the dollar would certainly slide.

V. Gilts

The Governor said that the authorities had sold sufficient gilts to cover the Government's financing needs up to the end of August; but it would be important to make further substantial sales so as to bring in funds in September. A new short tap was being issued that day; it would be for decision the following week whether a new long tap should be issued.

VI. Sale of BP Shares

The Prime Minister said that she had stopped the sale of the BP shares in July. The alternative options needed to be considered more carefully, and in any case a sale later in the year might well produce larger proceeds. She had also been concerned that the Treasury were pressing to sell in New York and Frankfurt as well as in London. For political reasons, even though foreigners might buy in the secondary market, it was important to limit the sale to London. One further consideration was that the Lords' decision on Burmah might go against the Government. (The Governor commented that a final decision on Burmah could not be expected until October 1980.) One alternative to selling off BP shares was for

BNOC's assets to be sold virtually in their entirety. This was being considered. Asked whether the sale of BP shares to the institutions would be additional to their purchase of gilts, the Governor replied that there would be some substitution, but on the whole, purchases should be additional.

12..

16 July 1979

Euro. Pal.

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OD(E)

JSG

Fue



*cc: Foreign Sec.
(Chancellor/Ex)
Ld Pres.
Ld Privy Seal
MAFF
OT Trade*

10 DOWNING STREET

From the Private Secretary

12 July 1979

*Attorney-Gen.
J/Ind.
+ C.O.*

EMS

The Prime Minister read with interest the Chancellor's minute of 20 June. She agrees that we should not rush any decision as to whether and if so when the United Kingdom should join the exchange rate mechanism of EMS.

She is aware that there has been correspondence between Ministers as to how further consideration of this important issue should be handled. She recognises the eventual decision will have important implications for the Government's general economic strategy and for our position in the Community. Taking account of the special sensitivities attaching to discussion of the exchange rate, as well as the extent to which other Departments have a legitimate interest, she would like the Treasury to take the lead in producing a paper setting out the economic financial and political considerations of the options open to the Government as regards the exchange rate mechanism of EMS. The Secretary of the Cabinet will then hold a meeting of Permanent Secretaries from the Departments mainly concerned to discuss the paper before it is submitted to Ministers by the Chancellor. It should then be considered in OD under her chairmanship.

Copies of this letter go to the Private Secretaries of members of OD(E) and to Sir John Hunt.

I. P. LANKESTER

A. M. W. Battishill, Esq.,
H.M. Treasury.

JSG

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KURO POH

10 DOWNING STREET

From the Private Secretary

MR. VILE
CABINET OFFICE

EMS

The Prime Minister and the Chancellor of the Exchequer agreed this morning that the review of EMS should be handled on the lines proposed by Sir John Hunt, and I am writing to the Treasury accordingly. You should be aware of one point, which I have not referred to in the letter - namely, that the Prime Minister suggested that it would be useful for her to hold an ad hoc meeting to discuss the Chancellor's eventual paper before OD; she thought the Chancellor, Lord Carrington and the Governor should be present. The Prime Minister said that she thought the discussion in OD would go better if it was preceded by such a meeting. In this connection, she referred to last week's Cabinet decisions on regional policy which had been arrived at - in her view - much more easily because of the meeting she had had with Sir Keith Joseph on the previous Tuesday.

T. P. LANKESTER

12 July 1979

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Ref. A09953

PRIME MINISTER

EMS

Since he sent you a minute of 20th June, the Chancellor of the Exchequer and the Foreign and Commonwealth Secretary have been exchanging letters about how this issue should be handled at both official and Ministerial level. The correspondence is attached. You will see from the most recent exchange that they have both taken up unnecessarily entrenched positions from which it is difficult for either of them to retreat. I think therefore that you will need to intervene: and I believe I can offer a compromise that both are likely to be ready to accept.

2. The Chancellor of the Exchequer's position is that questions concerned with the exchange rate are essentially for him; that any discussion of EMS (other than in Cabinet) should be led by him and that preparation by officials should be under Treasury chairmanship. The Foreign and Commonwealth Secretary (and we did not prompt him to this course) says that EMS is a central issue in the EEC with implications for other Departments and feels that if the Treasury are allowed to by-pass the normal arrangements of discussion on OD(E) and with the Cabinet Office chairing interdepartmental discussion at official level as on other major Community issues this will make his task harder in keeping an oversight of other Ministers who would like to go their own way in Europe.

3. While the Foreign and Commonwealth Secretary is undoubtedly right in the general principle which he enunciates, and it is important that OD(E) should be able to look at the interaction of all aspects of our Community policy, there clearly are special considerations affecting anything to do with the exchange rate, and this may justify special handling. Perhaps more to the point I am clear that the EMS is a sufficiently important issue for you to chair any Ministerial discussion. I would therefore like to suggest the following procedure to get out of the present difficulty:-



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- (i) The Treasury should be asked to produce a paper assessing the financial, economic and political implications for the United Kingdom of all the options for the exchange rate mechanism of EMS (this would include the wider 6 per cent margin which was not mentioned in the Chancellor's minute) - this meets the Chancellor's main point.
- (ii) I would be ready to hold a meeting with the Permanent Secretaries of the Departments concerned and Mr. Franklin to go through the paper before it is submitted to Ministers - this should satisfy the FCO.
- (iii) It should then be considered in OD under your own chairmanship - on an issue of this importance it is entirely appropriate that OD should handle the matter rather than OD(E) which avoids the Foreign and Commonwealth Secretary "chairing" the Chancellor on this issue. OD is suitably small, though it would perhaps be desirable to invite the Secretary of State for Industry.
5. I attach a draft Private Secretary letter along these lines.

(John Hunt)

11th July, 1979



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G.D. M. Byrne

for my signature

DRAFT LETTER FROM THE PRIME MINISTER'S PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER'S PRIVATE SECRETARY

11

EMS

The Prime Minister read with interest the Chancellor's minute of 20th June. She agrees that we should not rush any decision as to whether and if so when the United Kingdom should join the exchange rate mechanism of EMS.

2. She is aware that there has been correspondence between Ministers as to how further consideration of this important issue should be handled. She recognises the eventual decision will have important implications for the Government's general economic strategy and for our position in the Community. Taking account of the special sensitivities attaching to discussion of the exchange rate, as well as the extent to which other Departments have a legitimate interest, she would like the Treasury to take the lead in producing a paper setting out the economic financial and political considerations of the options open to the Government as regards the exchange rate mechanism of EMS. The Secretary of the Cabinet will then hold a meeting of Permanent Secretaries from the Departments mainly concerned to discuss the paper before it is submitted to Ministers. It should then be considered in OD under her chairmanship.

by the Chancellor.

3. Copies of this letter go to the Private Secretaries of members of OD(E) and to Sir John Hunt.



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CABINET OFFICE
A2519.....
10 JUL 1979
FILING INSTRUCTIONS
FILE No.

*cc Sir A. B. ...
Mr. G. ...
Mr. ...
Mr. ...
Mr. ...*

FCS/79/25

CHANCELLOR OF THE EXCHEQUER

Sterling and European Monetary System

1. Thank you for your letter of 5 July.
2. I realise that your Department has the major interest in the question of our possible membership of the EMS exchange rate mechanism. But, as you yourself acknowledge, other departments are concerned as well; and in such cases the general practice has always been that the Chairmanship of interdepartmental discussions at official level should be assumed by the Cabinet Office. Indeed, one of the more valuable services afforded by the Cabinet Office to members of the Cabinet is surely the provision of neutral and objective Chairmanship for discussions of this kind. Most of our other colleagues seem disposed to accept this arrangement, which avoids any implication of partiality in the way the discussions are conducted. Despite the precedent set by our predecessors last year, I think it would be unfortunate to depart from this practice over the EMS. If the Cabinet Office's role is eroded in this area, it will be difficult to sustain the principle of Cabinet Office Chairmanship for interdepartmental discussions of other major Community issues such as agriculture, fish and energy.
3. I hope therefore that you can agree that the Cabinet Office should take the chair for discussions at official level, to which all the interested departments would be invited, on the question of our possible accession to the EMS exchange rate mechanism. As far as ministerial discussions are concerned, I have no doubt that in due course the issue will need to be discussed under the Prime Minister's Chairmanship in Cabinet, or in OD or perhaps E Committee. But I believe that some prior ministerial discussion in OD(E) would be valuable as well. The EMS is a central issue in our current relationship with the Community, and it surely makes sense to discuss it initially in the Sub-Committee responsible for reviewing our
/policy

CONFIDENTIAL



policy on Community issues.

4. I am copying this minute to the recipients of your letter.

C

(CARRINGTON)

Foreign and Commonwealth Office

10 July 1979



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

CABINET OFFICE July 1979
A 2381
- 6 JUL 1979
FILING INSTRUCTIONS
FILE No.

cc Sir K. Bennell
Mr Le Cheminant
Mr Franklin
Mr Mountfield
Mr Elliott

De Peter

STERLING AND THE EUROPEAN MONETARY SYSTEM

On 26th June you sent a minute to the Lord President of the Council about how to handle the question of the UK's possible participation in the exchange rate arrangements in the European Monetary System. There have since been other letters and minutes, which I have seen since my return from Tokyo.

I acknowledge that departments other than the Treasury have an interest in aspects of this issue, and I agree that it should be discussed among us. But accepting any new commitment for sterling would have such profound implications for our central and fundamental economic policies that I am quite clear that I must take the lead in Ministerial discussion, other than in the Cabinet, about the exchange rate and the EMS; and that the Treasury must be in the lead at the official level. I know that the Prime Minister agrees with me.

I will be making suggestions shortly about how we might proceed.

I am sending a copy of this letter to other ODE members and to Keith Joseph, Sir John Hunt and Clive Whitmore.

[Handwritten signature]

(GEOFFREY HOWE)

The Rt. Hon. The Lord Carrington, KCMG, MC

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG

28 June 1979

J Buckley Esq
Private Secretary to the
Lord President
Civil Service Department
Old Admiralty Building
Whitehall
LONDON
SW1

CABINET OFFICE
A 249.....
28 JUN 1979
FILING INSTRUCTIONS
FILE No.

cc G. K. Berill
M. C. Hennessey
~~M. J. Hennessey~~
M. Elliott
pw

Dear Mr Buckley

EMS

The Financial Secretary has seen your letter of yesterday to Martin Hall, and assumes that it must have crossed with his to the Lord President. He has asked me to say that he would be quite content with the Lord President's suggestion that the official handling of this issue should be for discussion after the Chancellor and Foreign Secretary have returned from Tokyo - without prejudice, of course, to what is finally decided on the handling of the matter. Perhaps therefore we can let the matter rest until Monday.

I am copying this letter to the Private Secretaries to the members of OD(E) and to Martin Vile in Sir John Hunt's office.

Yours sincerely

P Diggle

P C DIGGLE
Private Secretary



From the Secretary of State

CABINET OFFICE
A 215
28 JUN 19
FILING INSTRUCTIONS
FILE No. _____

The Rt Hon Lord Soames
Lord President of the Council
Privy Council Office
Whitehall
LONDON
SW1

Dear Christopher.

THE EUROPEAN MONETARY SYSTEM

I have just seen Nigel Lawson's letter of 27 June.

Although I attended the ODE meeting in question, I was unaware that there was a discussion on this important subject taking place outside the agenda. Naturally, had I known that this was to happen, I would have had strong departmental and personal interest in participating in it. I am not sure that an official committee can really illuminate any new points which are not already pretty familiar to all of us but if the Ministers, principally concerned feel that it would help, I certainly have no objection to it. However, I think it would be inappropriate for such a committee to take place under the auspices of the Cabinet Office. The decision must ultimately be taken on national interest grounds, particularly those concerned with our future economic strategy. For this reason I strongly support the Chancellor's view that the committee should be chaired by Sir Kenneth Couzens of the Treasury.

In any event, I would like to repeat my conviction that it would be wrong for any such discussion to take place without the Department of Trade being represented since there are few issues of greater



importance to this country's future trading prospects than this particular issue.

I am copying this letter to the recipients of Nigel Lawson's.

John Nott

John

JOHN NOTT

CONFIDENTIAL



Civil Service Department
Whitehall London SW1A 2AZ
01-273 4400

27 June 1979

514
Martin Hall Esq
Private Secretary to the
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

CABINET OFFICE
A ..2087....
27 JUN 1979
FILE INSTRUCTIONS
FILE NO. _____

cc Sir H. Berrill
Mr. Leighton
Mr. Franklin
Mr. Elliott

Dear Martin,

EMS

The Lord President has asked me to write to you about your letter of 25 June to Michael Franklin which crossed with the Foreign Secretary's of 26 June.

Both the Foreign Secretary and the Lord President, as you will have seen from his paper, are anxious that the inter-departmental Committee to discuss our future attitudes to EMS should be chaired by the Cabinet Office, as are those groups dealing with other matters which come to OD(E).

In the absence of both the Chancellor and the Foreign Secretary the Lord President asks that no machinery should start to work until the three Ministers have a chance to discuss again and decide how this should be taken forward.

I am sending copies of this minute to the Private Secretaries to other members of OD(E) and to Martin Vile in Sir John Hunt's Office.

Yours sincerely,
Jim Buckley.

J BUCKLEY
Private Secretary

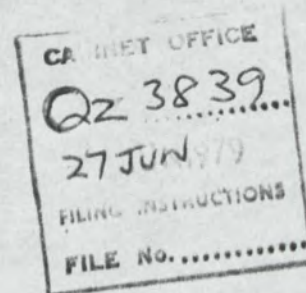
CONFIDENTIAL



Civil Service Department
Whitehall London SW1A 2AZ
01-273 4400

27 June 1979

Martin Hall Esq
Private Secretary to the
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1P 3AG



Mr Elliott
QZ 3836

Dear Martin,

EMS

The Lord President has asked me to write to you about your letter of 25 June to Michael Franklin which crossed with the Foreign Secretary's of 26 June.

Both the Foreign Secretary and the Lord President, as you will have seen from his paper, are anxious that the inter-departmental Committee to discuss our future attitudes to EMS should be chaired by the Cabinet Office, as are those groups dealing with other matters which come to OD(E).

In the absence of both the Chancellor and the Foreign Secretary the Lord President asks that no machinery should start to work until the three Ministers have a chance to discuss again and decide how this should be taken forward.

I am sending copies of this minute to the Private Secretaries to other members of OD(E) and to Martin Vile in Sir John Hunt's Office.

Yours sincerely,
Jim Buckley.

J BUCKLEY
Private Secretary



W. Franklin

I had taken to
know what to

Treasury Chambers, Parliament Street, SW1P 3AG feel about 10:00

27 June 1979

The Rt Hon Lord Soames
Lord President of the Council
Privy Council Office
Whitehall
LONDON
SW1

CABINET OFFICE
A 2079.....
27 JUN 1979
FILING INSTRUCTIONS
FILE No.

W 217

~~W. K. G. Gill
W. K. G. Gill
W. Franklin
W. G. G. Gill~~

THE EUROPEAN MONETARY SYSTEM

I have seen Geoffrey Howe's copy of the Foreign and Commonwealth Secretary's minute to you of 26 June. The Chancellor is of course in Tokyo; but I understand that he was present at the discussion of EMS in the margins of OD(E) which the Foreign Secretary reports, and that he expressed reservations about the proposal to set up a working group of officials under Cabinet Office chairmanship. As his Private Secretary's letter of 25 June to the Secretary of OD(E) implies (now copied separately to the Private Secretaries of all members of OD(E)), he regards our policy towards EMS as falling primarily within his own responsibilities. This is why he set out his considered views at length in his minute of 20 June to the Prime Minister, on which, incidentally, only John Nott has so far commented. That note was itself intended to provide a basis for discussion of this issue.

If, however, the Foreign and Commonwealth Secretary wishes to have a paper prepared interdepartmentally by officials, the Chancellor considers that this should be done under Treasury chairmanship. He has accordingly instructed Treasury officials to circulate a draft. This will be done in the course of this week, for discussion at a meeting which Mr Jordan-Moss (in the absence in Tokyo of Sir Kenneth Couzens) will be convening on Friday 30 June. I note that Lord Carrington envisages a timetable aimed at discussion in OD(E) at the end of July. I must say

I am highly sceptical (and I know the Chancellor shares this view) of the proposition that sensible decisions can be taken as early as that. Equally - though clearly it is for the Chairman to decide the agenda of OD(E) - I know he has serious reservations about the appropriateness of that Committee as a forum for taking decisions on this subject.

Finally, I entirely take John Nott's point, and am sure the Chancellor would welcome the participation of his officials whom Mr Jordan-Moss has invited to the preliminary meeting.

I am copying this letter to the recipients of the Foreign and Commonwealth Secretary's minute.

James R...
X

NIGEL LAWSON

CONFIDENTIAL

DEPARTMENT OF TRADE

1 VICTORIA STREET LONDON SW1H 0ET

Telephone 01-215 7877



From the Secretary of State

below
Please attach X

Chancellor of the Exchequer
H M Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

cc Sir K. Bevil
Mr. Clement
Mr. Franklin
Mr. Cusack

WJ

2. Requiring

26 June 1979

CABINET OFFICE
A 2057.....
27 JUN 1979
FILING INSTRUCTIONS
FILE No.

Dear Geoffrey.

THE EUROPEAN MONETARY SYSTEM (EMS)

May I say I found your long and thoughtful minute of 20 June to the Prime Minister of great interest. I strongly agree with your observation that our decision about EMS should be taken primarily on its merits for the economy.

You will appreciate the importance I attach to decisions bearing on the exchange rate and trade prospects and I trust that my officials will be fully involved in any interdepartmental work on EMS.

I am copying this to the Prime Minister, other members of OD(E), the Secretary of State for Industry, the Governor of the Bank of England and to Sir John Hunt.

Yours ever
John.

JOHN NOTT



CABINET OFFICE
A 2035
26 JUN 1979
FILING INSTRUCTIONS
FILE No.

Keep
cc Sir K. Berrill
W. Franklin
M. Lechevalier
M. Elliott

LORD PRESIDENT OF THE COUNCIL

FCS/79/121

EMS

1. We had a brief discussion after yesterday's meeting of OD(E) of one of the proposals in your paper OD(E)(79) 22 (which we shall not now be able to consider fully until our meeting on 11 July), namely that we should set in hand a study of the pros and cons of our joining the exchange rate mechanism of the European Monetary System. This is a technical and sensitive subject. I suggest therefore that the study might best be done by a small group of key officials from the Treasury, the Bank of England and the FCO. As with other aspects of work which comes to OD(E) I think it would be appropriate for this group to work under Cabinet Office chairmanship, with a view to preparing a paper for submission to OD(E) by the end of July.
2. I hope my colleagues can agree that the Cabinet Office should so proceed.
3. I am sending copies of this minute to the other members of OD(E) and to Sir John Hunt.

C

(CARRINGTON)

347
CONFIDENTIAL

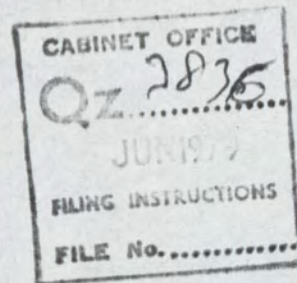


Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

25th June, 1979

*Mr Hall
with
Mr J
26c*

Dear Michael,



EMS

I understand that you discussed the future handling of official work on EMS - in the light of OD(E)(79)22 - with the Chancellor and the Foreign Secretary in the margins of the meeting of OD(E) yesterday. I am writing to let you know that the Chancellor has reconstituted the existing framework for discussion of this (EMC), with a view to producing an interdepartmentally-agreed paper for a further meeting of OD(E) on 11th July. In the absence of Sir Kenneth Couzens in Tokyo, Nick Jordan-Moss will deputise as Chairman. He will shortly be circulating a draft paper for the comment of the departments concerned.

I am copying this letter to Paul Lever.

Yours ever,

M. A. Hall

(M. A. HALL)
Private Secretary

M. Franklin, Esq.,
Cabinet Office

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

CABINET OFFICE
A .1790.....
20 JUN 1979
FILING INSTRUCTIONS
FILE NO.

cc Sir K. Berrill
 Mr. Le Chevalier
 Mr. Franklin
 Mr. Montpelier
 cc Mr. Elliott
 Mr. Walsh

PRIME MINISTER

THE EUROPEAN MONETARY SYSTEM (EMS)

Recently I had an opportunity to discuss our attitude to the EMS with the Lord President; and I have been reflecting subsequently on the matter. It is unlikely that you will be pressed on it at the European Council in Strasbourg. You may be asked about it however and rather than leaving this important issue to be dealt with only in the routine briefing arrangements, I thought it might be helpful if I let you know separately how I see the issues.

2. You made it clear after your talks with Chancellor Schmidt and President Giscard that we wished to look at all aspects of the matter and intended to do so in time to take up a position when the exchange rate mechanism is reviewed in September. I am sure that it is right not to be rushed. As you realise very well, the decision whether or not to join the exchange rate mechanism raises important issues of both international and domestic policy; this was well illustrated by what the Secretary of State for Trade said at our "Hoskyns meeting" on Monday.

EMS - Present Position

3. The EMS has now been operating for three months. During this period, some of the traditionally weak currencies (e.g. the lira) have in fact been strong. Sterling has been exceptionally strong, and if this had happened with the UK as a member of the exchange rate mechanism, sterling would have hit the upper limit of its permitted



range within three weeks of the system starting to operate. Under the rules, the UK would have had to intervene to hold sterling at that point. That would have meant selling sterling for other currencies, which tends to add to the sterling money supply. Intervention to hold the rate below its market level can also attract speculative inflows, producing further additions to the money supply.

4. A crucial phase for the EMS is probably now beginning, and we cannot be certain how smoothly the exchange rate mechanism will be working later in the year. The deutschemark, as expected, is becoming the strongest currency in the system. The Germans have been giving priority to domestic objectives in the management of their currency. They have been intervening in dollars in support of the mark. The effect has been to keep down inflation in Germany, both through a higher mark exchange rate and by reducing domestic money supply growth. In doing so they have been selling, during a period of revival of the dollar, many of the dollars they had been obliged to buy to support that currency in the last year or so. This strengthening of the mark has been putting strain on the Belgian franc, currently the weakest currency in the system, and latterly also on the Danish krone. The Belgian franc and Danish krone were devalued against the mark in the "snake" last October. The Belgian, Danes and Dutch have raised interest rates and there is now talk of further realignment. Although some of these difficulties can be ascribed to weaknesses in the Belgian and Danish economies, they illustrate the crucial importance to the EMS of what is happening to the dollar and of German reaction to it. We do not know how far movements in the dollar will apply differential pressures on EMS currencies in coming months. It seems likely however that the next few months will be a testing period for the EMS.

5. All this supports the case (which we discussed on Tuesday) for taking a cautious line at Strasbourg. The September "review" of the EMS relates under present agreements only to the operation of the "divergence indicator" mechanism, which does not in fact seem to

have played much of a role so far. It seems rather unlikely that we would want to make our decision whether to join the EMS dependent on the outcome of this somewhat narrow review, though it would be reasonable to take the results into account. The outcome of the review is likely to be reported to the Dublin European Council in November and I believe that if it suited us we could defer an announcement of our decision until then without surprising our partners unduly.

Parliament

6. The previous Government gave an undertaking that any decision to join the EMS exchange rate mechanism would be "submitted to Parliament for debate and if necessary a vote" before it were carried out. There would be pressure on us to give a similar undertaking. We should have to consider at the time how to tie in Parliamentary necessities with any announcement in Europe, whether it was in favour of joining or not.

The Principal Issues

7. The EMS is not a rigid fixed exchange rate system, so we would not lose all control over the rate if we joined. Nor, on the other hand, can we pretend that we have complete control over our exchange rate if we stay out: sterling is still an important trading currency so it is particularly liable to reflect outside influences, and the scale of our financial markets and our multinational companies provide further means by which pressures can arise.

8. But the essence of the EMS is that it constrains any member's ability to "manage" his exchange rate as he thinks best, even if such management amounts simply to letting the market decide the rate. It requires certain exchange rate objectives to be maintained at least until the members of the system collectively agree they should be changed. This in turn requires relatively high priority to be given to exchange rate policy, and some subordination of other domestic policy objectives to it.



9. This can bring economic benefits. We could get an economic benefit by choosing a starting rate in the EMS which we regarded as corresponding to our policy needs and then using the backing of the system to help us to hold it. It would be a policy decision whether we chose a relatively high starting rate to help us on inflation, or a lower one to help with competitiveness. Thus, if for example we were trying to hold a strong pound below its market level in the interests of competitiveness, membership of the EMS could be one way of doing it, though we would need our partners' agreement to such a starting rate. Possibly the rate would on average be more stable inside than outside the EMS; if so, this would be welcome to industry.

10. But there are also potential drawbacks. First, attempts to override market forces operating on the exchange rate and keep the rate within a certain margin by a combination of intervention and changes in domestic policies are notoriously difficult. We should be as likely to err on one side as on the other.

11. Second, joining the EMS would almost certainly require some modification to our approach to combating inflation through strict adherence to money supply targets.

12. If it turned out in a particular period that our EMS obligations required sustained intervention to hold up the rate, the market might conclude that sooner or later we would be forced to seek our partners' agreement to devalue. This in turn could exacerbate the outflows from sterling and lead to still greater intervention. In a situation of pressure on the rate, up or down, experience suggests that it is better to combine freedom of the rate to move with judicious and economical intervention. Getting pinned on a particular rate under heavy pressure can be expensive and, in the end, more destabilising because it encourages speculation. Then the instability which is held back in the exchange markets tends to express itself in greater instability of interest rates and the money supply. Sharp



changes in short term interest rates may be necessary to attempt - often in vain - to choke off the speculation.

13. If we found that the market wanted to carry sterling beyond our upper EMS intervention point, we should be obliged to intervene to hold the rate down. This intervention would, to some extent at least, inflate our money supply. As our predecessors found in the autumn of 1977 and, to a lesser extent in the spring of this year, such interventions could make it difficult to meet our monetary targets. Indeed, the Germans substantially exceeded their monetary target last year partly for this reason, and the Swiss had to abandon their 1978 monetary target altogether when they decided that they must give priority to holding down the franc exchange rate.

14. The ability to change central rates is an integral part of the EMS. However changes in rates have to be agreed with other members of the system and it is obviously implicit in membership that you will defend your rate seriously before seeking agreement to move. Partners will assess the impact of a particular change on them (e.g. the competitive effect) and may want changes timed so that several moves can happen together. The "ticket of entry" to an exchange rate negotiation is bound to be intervention of many hundreds of millions of dollars. A change under a fixed but adjustable exchange rate system is also a deliberate and well publicised policy act, though it can be argued that this makes it easier to link desirable policy changes (e.g. on fiscal or monetary policy) to an exchange rate devaluation or revaluation.

15. There is an important wider argument that EMS membership obliges Community partners to align their domestic economic policies over a period and is thus an instrument of economic integration. Unless very special efforts are made to the contrary, this is likely to mean alignment on the domestic economic policies of the strongest member economy, i.e. Germany. This means progress towards German rates of inflation. There is considerable and understandable reluctance to modify German economic policies (e.g. on interest rates



or the money supply) to make it easier for partners to maintain their exchange rates. The Germans see this as accepting more inflation. The recent troubles of Belgium and Denmark described above exemplify this, and I believe a good deal of the argument about the form of the EMS in 1978, baroque as it often was, revolved round the question whether German policy could be influenced or modified to ease the burden on others of holding the system together.

16. There is obviously nothing wrong with the objective of reaching German rates of inflation, allied to German ability to compete industrially. It is the objective of our policies. Similarly, the argument that the EMS would impose a discipline on domestic policy and ultimately push the French economy nearer to the strength of the German weighed heavily with President Giscard. The question is whether, if it is bound to take time to match German inflation and ability to compete, entering an exchange rate system with them like the EMS is the best way to make progress. Or whether the right course is to give priority to money supply control (and to improving the supply side of the economy) and let that be a main determinant of the exchange rate.

17. The counter-argument to the EMS is that the exchange rate route puts the cart before the horse, or the bridge before the foundations. Better to concentrate on getting your economy right without complicating and probably impairing the process by tangling with exchange market forces in what is now an unstable world monetary situation. On this argument this route to integration could prove a false one - and it certainly looked like that when Britain, Italy and France (twice) were successively driven out of the snake in 1972/76, followed later by Sweden and Norway.

18. Holland, Belgium and Denmark showed themselves particularly attached to the "snake" system during the EMS preparatory discussions. With Germany they have the longest records of living with the system, though Denmark left once. These are countries which would find it



difficult to operate an independent money supply policy and whose trade is closely linked with Germany.

Political considerations

19. From the point of view of our political stance in Europe, joining would clearly be a great advantage and a firm indication that we are breaking with the past. If we decided to join, we should want to exploit the decision so as to secure other advantages, perhaps over our net budgetary contribution. The French are clearly in no hurry to see us join. They may not wish to see another rather strong currency in the system at present because of the possible impact on the franc. But the rest of the Community, and Chancellor Schmidt in particular, would probably attach value to the completion of the EMS by adding sterling to the exchange rate mechanism. I would not myself exaggerate the value of this card, although if we do decide to join we should get as much leverage from it as we can. I certainly believe it would be a mistake to join the EMS solely in the hope of gaining concessions on the budget issue. Our decision on the EMS ought to be taken on its economic merits.

Immediate Issues

20. There are two secondary issues in this area. I know you have it in mind that it might prove possible at the time of the review of the indicator mechanism to swap some of the UK's reserves for ECUs. I had myself considered whether there was a case for announcing participation in this swap in the Budget, but decided not to pursue this. This too was discussed at Tuesday's pre-Strasbourg meeting.

21. The second question is how to secure recognition that if and when we do join the EMS, we shall be eligible for interest rate subsidies under the European Council decision of December 1978. This is not a matter which ought on merits to arise at the European Council, but briefing has, of course, been available.

Conclusion

22. Clearly we shall have to watch carefully how the exchange market develop in the coming months, how the EMS fares and how our own economy, exchange rate and money supply fare also. When the time comes for a decision, we shall have to take account of the possible value of joining as a bargaining counter, and of its political significance. But the economic implications are such that I believe the decision will have to be taken primarily on the merits for the economy. In particular the implications for our monetary targets will have to weigh heavily, because they are such an important part of our economic strategy. Meanwhile I think our approach to our Community partners should be to keep matters open, without entering into any new commitment. We should however say nothing to suggest that we will be unwilling to join the exchange rate mechanism at an appropriate time. There is, of course, a limit to the time for which we can remain in this equivocal position.

23. I shall be considering this further in the coming weeks and discussing it with the Governor and others. This period is, however, a difficult one for a decision on the EMS: the oil situation is having a different effect on our exchange rate compared with our partners, and we have to watch the impact of the Budget, the exchange control relaxations and the new policies of the Government generally. It is not a calm period in world markets, domestically or internationally. If we did decide, in the autumn, that it was not at that time possible for us to join the exchange rate mechanism, we should need to think very carefully about the way to explain our future intentions.

24. I am copying this minute to members of ODE, the Secretary of State for Industry, the Governor of the Bank of England and to Sir John Hunt.

G.H.

(G.H.)

20 June, 1979



CONFIDENTIAL

Euro-Pol

Mr. Langford
Mr. Whitmore

FCS/79/25

CHANCELLOR OF THE EXCHEQUER

MSM
SL
1977

Sterling and European Monetary System

1. Thank you for your letter of 5 July.
2. I realise that your Department has the major interest in the question of our possible membership of the EMS exchange rate mechanism. But, as you yourself acknowledge, other departments are concerned as well; and in such cases the general practice has always been that the Chairmanship of interdepartmental discussions at official level should be assumed by the Cabinet Office. Indeed, one of the more valuable services afforded by the Cabinet Office to members of the Cabinet is surely the provision of neutral and objective Chairmanship for discussions of this kind. Most of our other colleagues seem disposed to accept this arrangement, which avoids any implication of partiality in the way the discussions are conducted. Despite the precedent set by our predecessors last year, I think it would be unfortunate to depart from this practice over the EMS. If the Cabinet Office's role is eroded in this area, it will be difficult to sustain the principle of Cabinet Office Chairmanship for interdepartmental discussions of other major Community issues such as agriculture, fish and energy.
3. I hope therefore that you can agree that the Cabinet Office should take the chair for discussions at official level, to which all the interested departments would be invited, on the question of our possible accession to the EMS exchange rate mechanism. As far as ministerial discussions are concerned, I have no doubt that in due course the issue will need to be discussed under the Prime Minister's Chairmanship in Cabinet, or in OD or perhaps E Committee. But I believe that some prior ministerial discussion in OD(E) would be valuable as well. The EMS is a central issue in our current relationship with the Community, and it surely makes sense to discuss it initially in the Sub-Committee responsible for reviewing our

/policy

CONFIDENTIAL

CONFIDENTIAL



policy on Community issues.

4. I am copying this minute to the recipients of your letter.

C/

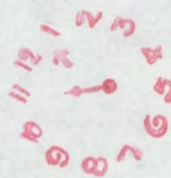
(CARRINGTON)

Foreign and Commonwealth Office

10 July 1979

CONFIDENTIAL

10 JUL 1979



6

Euro (P)



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

5 July 1979

~~Mr. C. ...~~
N ...
To ...
full
6 ...
Mr. Whitmore
NSBM ...

De P...

*glut
by*

STERLING AND THE EUROPEAN MONETARY SYSTEM

On 26th June you sent a minute to the Lord President of the Council about how to handle the question of the UK's possible participation in the exchange rate arrangements in the European Monetary System. There have since been other letters and minutes, which I have seen since my return from Tokyo.

I acknowledge that departments other than the Treasury have an interest in aspects of this issue, and I agree that it should be discussed among us. But accepting any new commitment for sterling would have such profound implications for our central and fundamental economic policies that I am quite clear that I must take the lead in Ministerial discussion, other than in the Cabinet, about the exchange rate and the EMS; and that the Treasury must be in the lead at the official level. I know that the Prime Minister agrees with me.

I will be making suggestions shortly about how we might proceed.

I am sending a copy of this letter to other ODE members, and to Keith Joseph, Sir John Hunt and Clive Whitmore.

[Handwritten signature]

(GEOFFREY HOWE)

The Rt. Hon. The Lord Carrington, KCMG, MC

26 JUL 1979





Original in G/R. DSG

a HMT Enrol
press

10 DOWNING STREET

THE PRIME MINISTER

4 July 1979

Dear Mr Jay

Thank you for your letter of 28 June about the deposit of 20 per cent of our gold and dollar reserves with the European Monetary Cooperation Fund in exchange for ECUs. This transaction will probably take place on 6 July.

You asked for an explanation of why legislative authority was not necessary for the transaction. We consider that legislative authority is contained in the Exchange Equalisation Account Act 1979. Under the arrangements for the ECU swap, the Exchange Equalisation Account will receive ECUs on a swap basis in exchange for gold and dollars. We are advised that the ECUs which will be received constitute "securities" within the meaning of that Act.

You also asked why legislation was necessary to transfer gold to the IMF in 1945 but is not thought necessary for the ECU swap. We consider that the two transactions are not comparable in that, in the IMF case no security was received into the EEA in exchange for the gold transferred; and in any event the powers available in relation to the EEA were more restricted in 1945 than they are now.

Yours sincerely
Raymond Johnston

The Rt. Hon. Douglas Jay, M.P.

6

Euro Policy



DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB

TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

3 July 1979

The Rt Hon Geoffrey Howe MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

*NGM
GSM
4/17*

Jan Geoffrey

EUROPEAN MONETARY SYSTEM

Thank you for sending me a copy of your most interesting minute of 20 June. I entirely agree with the line you propose.

You will understand that questions relating to the exchange rate are of enormous significance for industrial policy, and I attach great importance to the Department of Industry being fully involved in the interdepartmental work on EMS. I have seen Peter Carrington's minute of 26 June to the Lord President suggesting that this should be done under Cabinet Office chairmanship, and I entirely agree. I hope it will also be possible for me to attend any meetings of OD(E) at which the EMS is discussed.

I am copying this letter to the Prime Minister, other members of OD(E), the Governor of the Bank of England and Sir John Hunt.

Jan
Keith

E4 JUL 1973

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DEPARTMENT OF TRADE

1 VICTORIA STREET LONDON SW1H 0ET

Telephone 01-215 7877

European

T/L to see Policy
MAP 27/011



From the Secretary of State

R 27/11

Chancellor of the Exchequer
H M Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

26 June 1979

Dear Geoffrey,

THE EUROPEAN MONETARY SYSTEM (EMS)

May I say I found your long and thoughtful minute of 20 June to the Prime Minister of great interest. I strongly agree with your observation that our decision about EMS should be taken primarily on its merits for the economy.

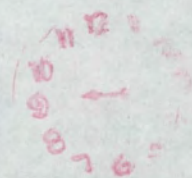
You will appreciate the importance I attach to decisions bearing on the exchange rate and trade prospects and I trust that my officials will be fully involved in any interdepartmental work on EMS.

I am copying this to the Prime Minister, other members of OD(E), the Secretary of State for Industry, the Governor of the Bank of England and to Sir John Hunt.

Yours ever
John

JOHN NOTT

26 JUN 1979





LORD PRESIDENT OF THE COUNCIL

FCS/79/121

*TK to see
MP 26/11.*

Nbom

R

27/6

EMS

1. We had a brief discussion after yesterday's meeting of OD(E) of one of the proposals in your paper OD(E)(79) 22 (which we shall not now be able to consider fully until our meeting on 11 July), namely that we should set in hand a study of the pros and cons of our joining the exchange rate mechanism of the European Monetary System. This is a technical and sensitive subject. I suggest therefore that the study might best be done by a small group of key officials from the Treasury, the Bank of England and the FCO. As with other aspects of work which comes to OD(E) I think it would be appropriate for this group to work under Cabinet Office chairmanship, with a view to preparing a paper for submission to OD(E) by the end of July.

2. I hope my colleagues can agree that the Cabinet Office should so proceed.

3. I am sending copies of this minute to the other members of OD(E) and to Sir John Hunt.

C

(CARRINGTON)

26 JUN 1979



Top copy on Euro. Policy CONFIDENTIAL

May 1979 - Strasbourg

Euro. Council



Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

20th June, 1979

Dear Brian,

ECU SWAP

At the Prime Minister's briefing meeting yesterday on the European Council in Strasbourg, I understand there was some discussion of the possibility that the Prime Minister would announce in Strasbourg the UK's decision to participate in the ECU Swap. If the Prime Minister decides to announce this decision in Strasbourg, the Chancellor suggests that the Prime Minister should use the following form of words, which has been agreed with the Bank and telephoned to the Cabinet Office:

"I can tell my colleagues that the UK Government have it in mind to participate in the deposit of reserves on a swap basis with the European Monetary Co-operation Fund in exchange for ECUs. This will make it clear that, whatever our decision in due course on participation in the exchange rate arrangements, we desire to be closely involved in the evolution of the European Currency Unit and of European monetary institutions."

As you will see, this form of words will make it clear that the decision to participate in the ECU Swap should not be taken to mean that the Government have already decided to join the EMS exchange rate arrangements.

I also enclose a technical note on the ECU Swap. You may like to draw the Prime Minister's attention in particular to paragraph 6 which explains that, in the last Parliament, there was considerable Parliamentary interest in the Government's decision on this point. On past form some Labour members are

/likely to

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likely to react adversely to the Government's decision and their hostility could be increased if the announcement were made outside Parliament. For this reason the form of words in paragraph 2 above stops short of announcing a firm decision, which could more wisely be left for the House of Commons, when the Prime Minister reports upon the Council meeting. In any case the Prime Minister will no doubt wish to have the Parliamentary background in mind, which could lead to pressure for a debate.

I am copying this letter to the Private Secretaries to the Foreign and Commonwealth Secretary, the Lord Privy Seal, the Lord President of the Council, the Minister of Agriculture, the Attorney General, the Governor of the Bank of England and Sir John Hunt.

Yours sincerely,

A.M.W. Battishill

(A.M.W. BATTISHILL)

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- i. Mr Caskledge
2. Prime Minister

Further briefing for
Strasbourg.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

R
20/6

PRIME MINISTER

THE EUROPEAN MONETARY SYSTEM (EMS)

Recently I had an opportunity to discuss our attitude to the EMS with the Lord President; and I have been reflecting subsequently on the matter. It is unlikely that you will be pressed on it at the European Council in Strasbourg. You may be asked about it however and rather than leaving this important issue to be dealt with only in the routine briefing arrangements, I thought it might be helpful if I let you know separately how I see the issues.

2. You made it clear after your talks with Chancellor Schmidt and President Giscard that we wished to look at all aspects of the matter and intended to do so in time to take up a position when the exchange rate mechanism is reviewed in September. I am sure that it is right not to be rushed. As you realise very well, the decision whether or not to join the exchange rate mechanism raises important issues of both international and domestic policy; this was well illustrated by what the Secretary of State for Trade said at our "Hoskyns meeting" on Monday.

EMS - Present Position

3. The EMS has now been operating for three months. During this period, some of the traditionally weak currencies (e.g. the lira) have in fact been strong. Sterling has been exceptionally strong, and if this had happened with the UK as a member of the exchange rate mechanism, sterling would have hit the upper limit of its permitted



range within three weeks of the system starting to operate. Under the rules, the UK would have had to intervene to hold sterling at that point. That would have meant selling sterling for other currencies, which tends to add to the sterling money supply. Intervention to hold the rate below its market level can also attract speculative inflows, producing further additions to the money supply.

4. A crucial phase for the EMS is probably now beginning, and we cannot be certain how smoothly the exchange rate mechanism will be working later in the year. The deutschemark, as expected, is becoming the strongest currency in the system. The Germans have been giving priority to domestic objectives in the management of their currency. They have been intervening in dollars in support of the mark. The effect has been to keep down inflation in Germany, both through a higher mark exchange rate and by reducing domestic money supply growth. In doing so they have been selling, during a period of revival of the dollar, many of the dollars they had been obliged to buy to support that currency in the last year or so. This strengthening of the mark has been putting strain on the Belgian franc, currently the weakest currency in the system, and latterly also on the Danish krone. The Belgian franc and Danish krone were devalued against the mark in the "snake" last October. The Belgian, Danes and Dutch have raised interest rates and there is now talk of further realignment. Although some of these difficulties can be ascribed to weaknesses in the Belgian and Danish economies, they illustrate the crucial importance to the EMS of what is happening to the dollar and of German reaction to it. We do not know how far movements in the dollar will apply differential pressures on EMS currencies in coming months. It seems likely however that the next few months will be a testing period for the EMS.

5. All this supports the case (which we discussed on Tuesday) for taking a cautious line at Strasbourg. The September "review" of the EMS relates under present agreements only to the operation of the "divergence indicator" mechanism, which does not in fact seem to



have played much of a role so far. It seems rather unlikely that we would want to make our decision whether to join the EMS dependent on the outcome of this somewhat narrow review, though it would be reasonable to take the results into account. The outcome of the review is likely to be reported to the Dublin European Council in November and I believe that if it suited us we could defer an announcement of our decision until then without surprising our partners unduly.

Parliament

6. The previous Government gave an undertaking that any decision to join the EMS exchange rate mechanism would be "submitted to Parliament for debate and if necessary a vote" before it were carried out. There would be pressure on us to give a similar undertaking. We should have to consider at the time how to tie in Parliamentary necessities with any announcement in Europe, whether it was in favour of joining or not.

The Principal Issues

7. The EMS is not a rigid fixed exchange rate system, so we would not lose all control over the rate if we joined. Nor, on the other hand, can we pretend that we have complete control over our exchange rate if we stay out: sterling is still an important trading currency so it is particularly liable to reflect outside influences, and the scale of our financial markets and our multi-national companies provide further means by which pressures can arise.

8. But the essence of the EMS is that it constrains any member's ability to "manage" his exchange rate as he thinks best, even if such management amounts simply to letting the market decide the rate. It requires certain exchange rate objectives to be maintained at least until the members of the system collectively agree they should be changed. This in turn requires relatively high priority to be given to exchange rate policy, and some subordination of other domestic policy objectives to it.



9. This can bring economic benefits. We could get an economic benefit by choosing a starting rate in the EMS which we regarded as corresponding to our policy needs and then using the backing of the system to help us to hold it. It would be a policy decision whether we chose a relatively high starting rate to help us on inflation, or a lower one to help with competitiveness. Thus, if for example we were trying to hold a strong pound below its market level in the interests of competitiveness, membership of the EMS could be one way of doing it, though we would need our partners' agreement to such a starting rate. Possibly the rate would on average be more stable inside than outside the EMS; if so, this would be welcome to industry.

10. But there are also potential drawbacks. First, attempts to override market forces operating on the exchange rate and keep the rate within a certain margin by a combination of intervention and changes in domestic policies are notoriously difficult. We should be as likely to err on one side as on the other.

11. Second, joining the EMS would almost certainly require some modification to our approach to combating inflation through strict adherence to money supply targets.

12. If it turned out in a particular period that our EMS obligations required sustained intervention to hold up the rate, the market might conclude that sooner or later we would be forced to seek our partners' agreement to devalue. This in turn could exacerbate the outflows from sterling and lead to still greater intervention. In a situation of pressure on the rate, up or down, experience suggests that it is better to combine freedom of the rate to move with judicious and economical intervention. Getting pinned on a particular rate under heavy pressure can be expensive and, in the end, more destabilising because it encourages speculation. Then the instability which is held back in the exchange markets tends to express itself in greater instability of interest rates and the money supply. Sharp



changes in short term interest rates may be necessary to attempt - often in vain - to choke off the speculation.

13. If we found that the market wanted to carry sterling beyond our upper EMS intervention point, we should be obliged to intervene to hold the rate down. This intervention would, to some extent at least, inflate our money supply. As our predecessors found in the autumn of 1977 and, to a lesser extent in the spring of this year, such interventions could make it difficult to meet our monetary targets. Indeed, the Germans substantially exceeded their monetary target last year partly for this reason, and the Swiss had to abandon their 1978 monetary target altogether when they decided that they must give priority to holding down the franc exchange rate.

14. The ability to change central rates is an integral part of the EMS. However changes in rates have to be agreed with other members of the system and it is obviously implicit in membership that you will defend your rate seriously before seeking agreement to move. Partners will assess the impact of a particular change on them (e.g. the competitive effect) and may want changes timed so that several moves can happen together. The "ticket of entry" to an exchange rate negotiation is bound to be intervention of many hundreds of millions of dollars. A change under a fixed but adjustable exchange rate system is also a deliberate and well publicised policy act, though it can be argued that this makes it easier to link desirable policy changes (e.g. on fiscal or monetary policy) to an exchange rate devaluation or revaluation.

15. There is an important wider argument that EMS membership obliges Community partners to align their domestic economic policies over a period and is thus an instrument of economic integration. Unless very special efforts are made to the contrary, this is likely to mean alignment on the domestic economic policies of the strongest member economy, i.e. Germany. This means progress towards German rates of inflation. There is considerable and understandable reluctance to modify German economic policies (e.g. on interest rates



or the money supply) to make it easier for partners to maintain their exchange rates. The Germans see this as accepting more inflation. The recent troubles of Belgium and Denmark described above exemplify this, and I believe a good deal of the argument about the form of the EMS in 1978, baroque as it often was, revolved round the question whether German policy could be influenced or modified to ease the burden on others of holding the system together.

16. There is obviously nothing wrong with the objective of reaching German rates of inflation, allied to German ability to compete industrially. It is the objective of our policies. Similarly, the argument that the EMS would impose a discipline on domestic policy and ultimately push the French economy nearer to the strength of the German weighed heavily with President Giscard. The question is whether, if it is bound to take time to match German inflation and ability to compete, entering an exchange rate system with them like the EMS is the best way to make progress. Or whether the right course is to give priority to money supply control (and to improving the supply side of the economy) and let that be a main determinant of the exchange rate.

17. The counter-argument to the EMS is that the exchange rate route puts the cart before the horse, or the bridge before the foundations. Better to concentrate on getting your economy right without complicating and probably impairing the process by tangling with exchange market forces in what is now an unstable world monetary situation. On this argument this route to integration could prove a false one - and it certainly looked like that when Britain, Italy and France (twice) were successively driven out of the snake in 1972/76, followed later by Sweden and Norway.

18. Holland, Belgium and Denmark showed themselves particularly attached to the "snake" system during the EMS preparatory discussions. With Germany they have the longest records of living with the system, though Denmark left once. These are countries which would find it



difficult to operate an independent money supply policy and whose trade is closely linked with Germany.

Political considerations

19. From the point of view of our political stance in Europe, joining would clearly be a great advantage and a firm indication that we are breaking with the past. If we decided to join, we should want to exploit the decision so as to secure other advantages, perhaps over our net budgetary contribution. The French are clearly in no hurry to see us join. They may not wish to see another rather strong currency in the system at present because of the possible impact on the franc. But the rest of the Community, and Chancellor Schmidt in particular, would probably attach value to the completion of the EMS by adding sterling to the exchange rate mechanism. I would not myself exaggerate the value of this card, although if we do decide to join we should get as much leverage from it as we can. I certainly believe it would be a mistake to join the EMS solely in the hope of gaining concessions on the budget issue. Our decision on the EMS ought to be taken on its economic merits.

Immediate Issues

20. There are two secondary issues in this area. I know you have it in mind that it might prove possible at the time of the review of the indicator mechanism to swap some of the UK's reserves for ECUs. I had myself considered whether there was a case for announcing participation in this swap in the Budget, but decided not to pursue this. This too was discussed at Tuesday's pre-Strasbourg meeting.

21. The second question is how to secure recognition that if and when we do join the EMS, we shall be eligible for interest rate subsidies under the European Council decision of December 1978. This is not a matter which ought on merits to arise at the European Council, but briefing has, of course, been available.

Conclusion

22. Clearly we shall have to watch carefully how the exchange markets develop in the coming months, how the EMS fares and how our own economy, exchange rate and money supply fare also. When the time comes for a decision, we shall have to take account of the possible value of joining as a bargaining counter, and of its political significance. But the economic implications are such that I believe the decision will have to be taken primarily on the merits for the economy. In particular the implications for our monetary targets will have to weigh heavily, because they are such an important part of our economic strategy. Meanwhile I think our approach to our Community partners should be to keep matters open, without entering into any new commitment. We should however say nothing to suggest that we will be unwilling to join the exchange rate mechanism at an appropriate time. There is, of course, a limit to the time for which we can remain in this equivocal position.

23. I shall be considering this further in the coming weeks and discussing it with the Governor and others. This period is, however, a difficult one for a decision on the EMS: the oil situation is having a different effect on our exchange rate compared with our partners, and we have to watch the impact of the Budget, the exchange control relaxations and the new policies of the Government generally. It is not a calm period in world markets, domestically or internationally. If we did decide, in the autumn, that it was not at that time possible for us to join the exchange rate mechanism, we should need to think very carefully about the way to explain our future intentions.

24. I am copying this minute to members of ODE, the Secretary of State for Industry, the Governor of the Bank of England and to Sir John Hunt.

G.H.

(G.H.)

20 June, 1979

Extract from: **CONFIDENTIAL** Original: Italy June 79
PM/Andreotti talks. - 10 - 15 June 79
Euro Pol.

preparation and that the European Commission should be instructed in such a way as to pave the way for decisions at the following meeting of the Council. It was also necessary to work round the flanks, in other words to engage in systematic bilateral discussion. European Council meetings were not always the best occasions for actual decisions.

EMS

Signor Andreotti recalled that the Italian Government had decided in December to join the EMS and had nearly been brought down as a result. His Government had, nevertheless, thought it right to join in order to demonstrate its European will and also because membership of the system had obliged the Government to adopt more rigid internal and monetary policies. The results so far had been favourable. Signor Andreotti asked what the British Government's attitude now was towards the EMS. The Prime Minister said that the Government was reviewing the question of the UK's relationship with the EMS and would be prepared to announce the results of their preliminary review before September. The Government would probably wish to allocate some of the UK's reserves to the EMS. At present, however, sterling was at a level well above the EMS ceiling, partly because North Sea oil was keeping the exchange rate above what would be justified by the UK's economic performance, and also because of the recent increase in the MLR to 14 per cent. The deposit of some UK reserves in the EMS would, however, serve as a declaration of faith in the UK's intention to join the system. The Prime Minister asked Signor Andreotti whether membership of the EMS had obliged the Italian Government to adopt tougher policies on money supply and inflation than they would otherwise have done. Signor Andreotti said that his Government had already planned an austerity programme before joining: but membership of the EMS made it easier to put this programme into effect since everybody knew that such measures had to be taken as a result of Italy's participation in the scheme.

/ The Prime Minister

CONFIDENTIAL

The Prime Minister said that the British Government, too, was prepared to be very tough on inflation. Some exchange controls were being relaxed, in order to release UK investment to Europe. This was one way of gradually bringing the exchange rate down: money would be able to enter and leave the UK on more equal terms than before.

Signor Andreotti said that, when his Government had taken over, Italy's rate of inflation had stood at 23 per cent. The Government had got it down to 13.4 per cent and was determined to keep it there.

Energy

Signor Andreotti said that energy would be high on the Agenda at Strasbourg. Each member country of the Community had a different situation so far as energy was concerned: the UK had oil, the FRG coal, while Italy had nothing. It was essential to try to produce some concrete decisions at Strasbourg. It was no use simply declaring that energy consumption should be reduced by 5 per cent, and then leave it to member countries, with all their differences in resources, to carry out this prescription. It would be much better if the European Council could agree, for example, that all petrol stations in the EEC should be closed on Saturdays and Sundays. If all members were to subscribe to such a decision, it would be easier for each country to accept it. The problems of nuclear energy, as well, could be more easily tackled on a Community basis.

The Prime Minister said that she was not in favour of the weekend closing of petrol stations since this would discriminate against those who were obliged to work on Saturdays and Sundays. Each country would develop a different means of achieving the common objective. The Prime Minister said that she was more concerned by the nuclear energy issue: Europe would have to replace its coal and oil by nuclear power but there had been insufficient preparation of the public case

CONFIDENTIAL
PM/Giscard Meeting Note : 5 June 79

Original on: Euro Pol.
France: PM's visit: May 79

The Prime Minister pointed out that the UK was quite capable of engaging in fair competition but could not be expected to compete against subsidised produce.. She expected heavy competition from France and Germany in manufactures, an area in which the UK was herself less efficient, but the UK's efficiency in agriculture did not bring a fair reward. President Giscard commented that the UK would encounter problems in endeavouring to change the situation - not from France, but from countries such as the Netherlands, Denmark and Ireland. If the UK were to concentrate her efforts at reform on the problem of agricultural surpluses, she would encounter no adverse reaction from France; there would, however, be a French reaction if the concept of the single market for agriculture were to come under attack. The organisation of the CAP and the method of financing it were different questions.

EMS

Turning to the EMS, the Prime Minister noted that the review of the exchange rate system would be taking place in three months' time. The UK had, at present, a high exchange rate for sterling, not because of the UK's economic performance but because of North Sea oil. The Government needed to keep the rate high for the time being and this would make it difficult to enter the EMS straight away. It might, however, prove possible at the time of the exchange rate review to swap some of the UK's reserves for ECUs. In the longer term, the UK was keen to join the European Monetary System if this was feasible. President Giscard commented that it was not necessary for the UK to reach a final decision on joining the EMS quickly. It would, however, be significant if the UK were to create the conditions for joining; he recommended a progressive approach to entry, which would be better than to attempt to move too fast.

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/At 1215

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BG Cartridge, No 10



We spoke.

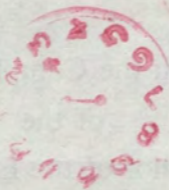
With the Compliments
of the
Chancellor of the Exchequer's
Private Secretary

[Handwritten signature]

14/11

Treasury Chambers,
Parliament Street,
S.W.1.

174 MAY 1979



7 May 1979

THE EUROPEAN MONETARY SYSTEM

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The European Monetary System has now been in operation for two months. This period has not been wholly free of technical difficulties - attributable at least in part to the non membership of the £ sterling - but the signs are so far that these are teething problems that will be overcome. Certainly the strength of the determination of the Member States, especially France and Germany, to keep a system in being and to develop it towards the goal in two years of a European Monetary Fund should not be underestimated. Too much political capital has been invested for the enterprise to be lightly given up and, prestige apart, the EMS is seen by the Eight as a development of genuine economic importance both within and outside the Community.

2. From the point of view of international trade and development, it is clear that the US economy is no longer capable of adequately supporting the extensive role the US \$ still plays. This underlines the importance from the international point of view of the linking together, albeit in a limited way, of Community currencies in a monetary system which contributes to increased monetary stability. Internally, within the Community, the EMS is regarded as the indispensable starting point for economic stabilisation leading over a period of time to greater convergence of performance on the part of the economies of Member States. For the purposes of policy planning it must be assumed therefore that the EMS has come to stay and that those Member States involved in it will endeavour to make a central (if not indeed the central) instrument of further economic progress in the Community. Indeed, whether inside or outside the EMS, the United Kingdom has no interest in the failure of a scheme which seeks stability in monetary movements.

THE RELATIONSHIP BETWEEN THE EMS AND PROGRESS TOWARDS CONVERGENCE

3. The previous British Government took the position that there had to be greater progress towards economic convergence before the UK would be prepared to take on the full disciplines of the exchange rate mechanism. It is generally agreed that such convergence if it is to be sustained and self generating must be based primarily on the exercise of economic discipline at the national level. Led by Germany, the Eight accorded monetary policy a central role as one of the starting points for economic stabilisation. As long as the UK remains outside the EMS she cannot hope to be treated as an equal partner in moves towards

/convergence

convergence, or benefit from interest subsidies. There has on occasion been a tendency to argue that this does not matter since the UK is not short of the sort of loan finance being given to Italy and Ireland. It is indeed true that the resources of the UK economy should be such that it should be able to generate a very high proportion of the investment finance it needs. It is however the case that over the last couple of years the UK has been the second biggest (after Italy) absolute borrower from Community sources (EIB, ECSC and Euratom) and stands to gain sizeable benefit from the new so called "Ortoli facility" for industrial and energy investment. Against the background of this record it makes little sense for the UK to deny itself the reduced interest rates on certain of these loans which it could expect to obtain if it were to become a member of the EMS.

THE UK POSITION

4. The United Kingdom should clearly join the EMS. Both economically and politically it is central to the future development of the Community. As there were for Italy and Ireland, there are undoubtedly important considerations which weigh against membership - the UK is not unique in this. If it were thought that the £ could not necessarily sustain its present strength it should be remembered that currencies in difficulty can expect support as part of the bargain of enforcing monetary discipline. Nevertheless it will be important to ensure that the £ enters the system at a level which can be maintained. In this context the question of the lowering of exchange control barriers needs examination. The arguments in favour of joining however outweigh the disadvantages. And it is only from inside that the EMS will be successfully moulded to meet UK needs.

Certainly for the rest of the Community the attitude adopted to the EMS by the new government will be a touchstone of the genuineness of its European professions. Even if therefore, for technical reasons, HMG do not immediately join the system, they should make clear to their partners at an early stage their intention of becoming a member. It is important not to make membership formally conditional upon receiving a given level of interest subsidies though it would be right for the UK to make it clear privately that this was a matter about which it wished to come to early agreement while other aspects were being sorted out.

7 May 1979

THE BRITISH CONTRIBUTION TO THE COMMUNITY BUDGET

During the last few months there has been a very considerable increase in general awareness within the Community institutions and the Member States of the existence of a problem concerning the net UK contribution to the Community budget and of its extent. There is also a growing realisation that, left unattended, the problem will get worse and that the UK cannot be expected to tolerate this indefinitely. There is however no consensus on how the problem should be solved. Indeed, while a few people inside Community institutions and Member State governments have begun to think about the problem there has as yet been no overt discussion of the subject. This said, the problem is increasingly cutting across and preventing a rational discussion of other issues of interest to the Community as a whole, such as economic convergence and the future size and shape of the Community budget, which is one reason why the attention of the UK's partners can more readily be focussed on this problem than in the past.

2. The juncture is thus an especially delicate one. There is everything to play for and much to lose. If handled carefully, the UK's partners can be persuaded to start moving towards a solution, something which they will wish to do in relation to a new British government which exhibits goodwill towards the Community. Conversely, a bad start will make the problem much more difficult and could prejudice the extent of the improvement attainable. The rest of the note deals with the context in which HMG must work and the tactics appropriate to this.

3. Ways of improving the UK situation

There are four broad ways of improving the UK's position in relation to the Community budget :

- (a) on the expenditure side, holding it down in those areas of least benefit to the UK - notably the CAP;
- (b) also on the expenditure side, increasing expenditure in those areas of greatest potential benefit to the UK (certain forms of regional expenditure, the social fund);
- (c) on the receipts side of the Community budget, effect a relative reduction in the UK's share of Community financing by the introduction of the principle of capacity to pay e.g. by introducing progressivity into the VAT tranche of Community own resources;

/ (d)

- (d) act on the net UK contribution to the budget by some financial mechanism designed to reduce the gap between what the UK puts in and what it gets out.

4. There is general recognition, the UK problem apart, that progress must be made on bringing the CAP in bounds. Among the Eight, Finance Ministers have a hard fight ahead with Agriculture Ministers and the farming lobby to bring costs under control and this will take time - too long for the UK's purposes in the context of the budget. It will in any case be wise to keep the two questions of control over CAP policies and spending and the British budget contribution, though obviously related in substance, largely separate when it comes to tactics. Progress on the CAP is much more likely to be achieved if it is allowed to develop as a policy objective desirable in its own right and not merely as a concession to British axe grinding which ought to be resisted. Any possible developments on the CAP, while of real benefit to the UK will not solve the budget problem, and will take time.

As for increasing other forms of expenditure, there is also general agreement that increases in social and regional expenditure are right in themselves and are an appropriate manner of reducing the disproportionate predominance of agriculture in the budget. The development of such expenditure will however be slow and other, poorer, Member States must be expected to gain considerably more than the UK - especially after enlargement. Moreover HMG will not wish to espouse increased public expenditure, even at Community level, unless they are satisfied as to its real value.

As regards introducing the principle of capacity to pay into the receipts side of the Community budget, there is no general acceptance as yet of the validity of this principle and it is clear that it will be difficult to bring it about. Moreover, even if introduced, such a principle would not come into effect until the 1982-1983 financial year and would be likely to apply to only part of the budget contributions. The element of progressivity involved would have to be very steep - probably unacceptably so to other Member States to bring significant financial relief to the UK. This is not to say the principle is not worth establishing. It is, but it is likely to bring limited benefit to the UK.

5. As for the possibility of negotiating a revised financial mechanism, it has to be recognised that this would be regarded by the UK's partners as "non-communautaire" especially if (as would almost certainly have to be the case if the mechanism were to be effective) it was made to apply to the net rather than, as at present, the gross UK contribution. (This is despite the fact that Member States do of course think in net terms.) Such a solution would also be the quickest and surest solution from the UK point of view. It could be constructed in a manner which in practice helped the UK alone, thus limiting the burden on the richer Member States who would be called upon to pay more. Germany in particular has little interest in underwriting an unnecessarily rapid expansion of the Community budget overall in an effort to find a solution to a

/problem

problem which essentially affects one Member State (the reasons for the current Italian deficit are different from those of the UK and are likely to be temporary).

HMG'S tactics

6. The UK should pursue all the objectives listed in paragraph 4 above since they are both right for the Community and will bring benefit in varying degrees to the UK. The solution to the budget problem must however lie in a financial mechanism and this will need to be sold to the UK's partners with the minimum of doctrine as the best practical answer available to solve a real problem. The precise formula adopted is of less importance than that it achieves the right objectives: a range of possible options will need to be thoroughly explored. And the technical work on the form the mechanism finally takes must be done sufficiently thoroughly to ensure that it will do its job permanently since the Community is already allergic to renegotiation and could not be expected to tackle this question a third time.

7. This is the issue above all which the new government needs to discuss with its Community partners bilaterally and privately before taking up a firm position either vis a vis them collectively or publicly. This is not a subject susceptible of solution in the normal framework of the Council of Ministers. Contacts at ministerial level (which should not neglect the smaller countries which possess the capacity to block routes forward even if they cannot carry solutions) should be adequately prepared and followed up at official level. In the time available before the next European Council (22 June) it will almost certainly not be possible to accomplish all the lobbying necessary to produce even the outline of a solution acceptable to all. It should however be possible with adequate preparation to obtain a commitment to a detailed study of the scale of the problem of net budget flows and perhaps of possible solutions between then and the next European Council, in December, thus paving the way for a final decision perhaps by the summer of 1981.

