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PREM 19/2162

European Monetary System (EMS)

EUROPEAN POLICY

PART 2

Pt 1: June 1979
Pt 2: March 1982

PREM 19/2162

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~3.3.82~~		~~12.11.85~~					
~~25.3.82~~		~~21.11.85~~					
~~30.3.82~~		~~22.11.85~~					
~~22.7.82~~		~~29.11.85~~					
~~26.10.82~~		~~20.12.85~~					
~~18.3.83~~		~~5.9.86~~					
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NB Seminar Papers on 'Joining the ERM' are to be found in the folder attached to this file. — now inserted in file

PART 2 ends:-

Bonn Tel No 009 7.1.87

PART 3 begins:-

DN to PM 10.6.87

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(83) 11th Conclusions, Minute 3	24.03.83
CC (85) 33rd Conclusions, Minute 4.	21. 11. 85

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed R Wayland Date 7 October 2015

PREM Records Team

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FRAME ECONOMIC

EUROPEAN MONETARY SYSTEM (EMS)

SUMMARY

1. GERMAN ATTEMPTS TO PLAY DOWN REPORTED FRANCO-GERMAN DIFFERENCES OVER EMS EXCHANGE RATES. EXPRESSIONS OF SYMPATHY WITH THE FRENCH POSITION MIXED WITH A FIRM RESOLVE TO STAVE OFF ANY REALIGNMENT UNTIL AFTER THE FEDERAL ELECTIONS. EVENTS MIGHT MAKE THIS IMPOSSIBLE BUT EVEN SO THERE IS UNLIKELY TO BE ANY DAMAGE TO THE GOVERNMENT'S ELECTORAL POSITION.

DETAIL

2. THE GERMANS ARE ATTEMPTING TO PLAY DOWN THE APPARENT TENSION WITH FRANCE OVER EMS EXCHANGE RATES WHICH WAS GIVEN PROMINENT COVERAGE BY THE BRITISH MEDIA TODAY. CONTACTS IN BONN AND FRANKFURT AT ALL LEVELS HAVE EMPHASISED THAT RECENT PRESSURES ON THE FOREIGN EXCHANGES HAVE RESULTED FROM THE MARKET PERCEPTION OF DOMESTIC POLITICAL DEVELOPMENTS IN FRANCE AND THAT, BEYOND FULFILLING NORMAL OBLIGATIONS UNDER EMS ARRANGEMENTS, NO FURTHER ACTION IS CONTEMPLATED TO BRING THE DMARK IN LINE WITH OTHER CURRENCIES. IN WORDING WHICH HAD OBVIOUSLY BEEN CAREFULLY PREPARED, THE CHANCELLERY TOLD US THAT THEY THOUGHT CHIRAC HAD YESTERDAY SPOKEN RATHER HASTILY AND WITHOUT CONSIDERATION FOR THE EFFECT WHICH HIS STATEMENTS WOULD HAVE ON THE FINANCIAL MARKETS. THEIR TONE WAS, HOWEVER, ONE OF UNDERSTANDING RATHER THAN ANGER AT THE FRENCH POSITION. THE FEDERAL ECONOMICS MINISTER, BANGEMANN HAS SINCE REPEATED MUCH THE SAME THING TO JOURNALISTS. HE RULED OUT ANY REVALUATION, CLAIMING THAT ''THE DM HAS AN APPROPRIATE VALUE WITHIN THE EMS AT THE MOMENT''.

3. WE UNDERSTAND FROM THE FEDERAL FINANCE MINISTRY THAT A SIMILAR LINE WAS TAKEN AT A MEETING OF THE INNER CABINET THIS AFTERNOON, AT WHICH STOLTENBERG WAS PRESENT. TURBULENCE CAUSED BY A FRENCH POLITICAL CRISIS DID NOT JUSTIFY AN EMS REALIGNMENT. IF IT CONTINUED, ''OTHER MEASURES'' MIGHT BE NECESSARY, IN WHICH FRANCE WOULD BE REQUIRED TO PLAY A PART, BUT THE POLITICAL CONSEQUENCES OF A REALIGNMENT BEFORE THE FEDERAL ELECTIONS - ALIENATED FARMERS, DISSATISFIED INDUSTRY- RULED THAT OPTION OUT.

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4. ONE IMPORTANT REASON BEHIND GERMAN RELUCTANCE IS A GENUINE WORRY OVER A LOSS OF COMPETITIVE EDGE FOR THEIR EXPORTS. THEY CAN CITE MANY ARGUMENTS TO SUPPORT THEIR CASE: FIGURES ISSUED RECENTLY FOR THE THIRD QUARTER SHOW EXPORTS 1.5 PER CENT DOWN ON A YEAR EARLIER: SOME IMPORTANT SECTORS OF INDUSTRY, EG CHEMICALS AND MACHINE TOOLS, HAVE WARNED OF A MARKED DECLINE IN EXPORT PERFORMANCE: THE STOCK MARKET HAS INDICATED A LACK OF CONFIDENCE: AND MANY OF THE RECENT INDEPENDENT ECONOMIC FORECASTS HAVE EMPHASISED THE RISKS FOR THE ECONOMY THIS YEAR FROM FALLING EXPORTS.

5. THERE IS, HOWEVER, A GROWING BELIEF, PARTICULARLY AMONG THOSE IN FRANKFURT CONCERNED WITH THE FOREIGN EXCHANGES, THAT THE GOVERNMENT CANNOT HOLD THIS LINE MUCH LONGER. SCHLESINGER (BUNDESBANK) COMMENTED TO ME THIS EVENING THAT ALTHOUGH THE F.R.G. WAS FULFILLING ITS OBLIGATIONS UNDER THE EMS, BUYING DANISH KRONER TODAY AS WELL AS FRENCH FRANCS, THEY COULD NOT INDEFINITELY CONTINUE TO PAY OUT SUCH SUMS. THE QUESTION THEREFORE AROSE WHETHER THERE WOULD BE A REALIGNMENT, OR WHETHER THE PROBLEM WOULD SOLVE ITSELF BY OTHER MEANS. AS OF NOW THIS QUESTION WAS STILL OPEN. ASKED WHETHER A REALIGNMENT WOULD BE FEASIBLE IN THE LAST FORTNIGHT OF THE FRG ELECTION CAMPAIGN, SCHLESINGER SAID IT WAS NOT EXCLUDED, BUT POLITICIANS HERE AND IN FRANCE HAD RATHER TIED THEIR OWN HANDS BY THEIR PUBLIC STATEMENTS: MAKING A DRAMA OUT OF WHAT OUGHT TO BE TREATED AS A TECHNICALITY.

COMMENT

6. I FEEL SURE THAT THE AUTHORITIES HERE WILL DO ALL THEY CAN TO STAVE OFF ANY REALIGNMENT INVOLVING UPWARD REVALUATION OF THE DEUTSCHMARK UNTIL AFTER THE ELECTION ON 25 JANUARY. BUT IF EVENTS MADE THIS UNAVOIDABLE BEFORE THEN, I DO NOT BELIEVE THAT THE COALITION'S PROSPECTS IN THE ELECTION WOULD BE SERIOUSLY DAMAGED.

BULLARD

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PRIVATE AND CONFIDENTIAL

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

22 October 1986

I showed your letter to the Prime Minister. She has read it closely and - judging by the amount of underlining - with interest. She has not commented on the substance, which will not particularly surprise you. I am sure that she would like a talk at some point, but I fear that there is no immediate prospect of this. Let us be in touch nearer the end of the year.

CHARLES POWELL

Sir Michael Butler, G.C.M.G.

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PRIVATE & CONFIDENTIAL

21st October, 1986

The Rt. Hon. Margaret Thatcher,M.P.,
10, Downing Street,
Whitehall,
London, S.W.1.

Prime Minister
Michael Butler asked me to give you this on a personal basis. He does not expect a reply. CDP 24/X.

Dear Prime Minister,

I would like, if you permit, to put a few thoughts to you about the E.M.S. I do so because I believe that, for the first time since 1979, the moment is not far off when it would be both good economics and good politics to join the exchange rate mechanism. You have obviously been giving the question a lot of thought already. So please forgive me if I say nothing new to you. I write now in order to suggest that you avoid saying anything which would close off the option before the election.

You were, of course, right not to join at DM 3.70 or 3.40 to the pound. We could not have held the parity and we needed to get down to at least DM 3.00 from the point of view of export-led growth and import substitution. The risk, however, now is that the pound will overshoot downwards and threaten your achievements on inflation unless our interest rates are absurdly high. Stability at something like the present parity for the last year of your present Government and the first one or two years of your next ought on the other hand to produce a major increase in exports, a decline in imports of consumer goods and, therefore, still bigger growth in C.D.P.

Over the last year I have spent a lot of time trying to persuade people in the City and elsewhere that you were also right to see an election trap in joining the E.R.M. You clearly still need to be careful not to join at a time or a parity which would make it impossible to avoid a realignment conference of Finance Minsters before the election. But the lower the pound sinks and the nearer the election gets, the less the risk seems to be. At a

/certain

certain level and only a few months before an election the markets would not believe that we could be knocked off a recently established central rate which was low objectively in relation to import and export prices. At the very worst, much less action would be required to defend it.

My colleagues at Hambros, who have a good record at judging the money and gilts markets, take the view quite strongly that joining the E.R.M. at around or below the present parity would be accepted by the foreign exchange markets in general and the speculators in particular, as a signal to leave the pound alone. Stability at DM 2.75 or 2.80 might be credible up to the election even if we joined quite soon. They also consider that gilts would strengthen considerably. Money supply considerations permitting, interest rates could be 1% or even 2% lower, perhaps even more as confidence in our holding the rate grew.

If you were to decide to join, it would be very desirable that it should appear to the markets as a decision taken because you judged the time ripe and not because of speculative pressures. This would not only make the operation politically easier at home but would strengthen its credibility abroad. It would also be essential that the markets should get no prior warning or the pound would shoot up before the parity could be fixed. So the operation would admittedly be a bit tricky. But I do believe it would be a sound move to make during the next few months. My guess is that it would have the incidental advantage of opening up the divisions in the Labour Party on the subject of Europe which they are trying so hard at present to hide.

If you were to find the thesis in this letter persuasive, the timing would depend both on your private thoughts about when the election will be and on developments in the markets. Nobody but you could have a feel for when the time might be ripe.

If there were any points in this letter which you wanted to discuss, I should, of course, be at your disposal. And I should like to repeat what I said when I came to say good-bye on leaving Brussels - that I am very much on your side and would like to help in any way I can.

Yours ever

Michael Butler

MDB/MML

The politics of the French franc/DM rate

Brendan Brown

So far, the Federal Republic of Germany's huge trade surplus — near DM80bn this year and rising, probably to DM90bn, next year — has created remarkably little strain in intra-EEC relations. The contrast with the years 1955-80 is striking. Then, large German trade surpluses led to a chorus of calls for the Federal Republic to revalue the DM and take other corrective measures. Why is history not repeating itself? Largely because of an unprecedented divergence of fiscal policy within the EEC — in particular, between France and the Federal Republic.

Why tolerate the strong DM?

The countries with the weaker trade performances and suffering most from German competition — for example, France, Italy and Belgium — are also those which are running large budget deficits (measured on the OECD basis of general government balances). Yet these deficits have not created substantial inflationary pressure, owing, in large part, to the readiness of investors in the fiscally-tight countries to put funds into the high coupon bond markets of the fiscally-easy countries and the willingness of borrowers in the latter countries to raise finance in the fiscally-tight currencies. Whilst this international cycling of funds has proved effective in suppressing the normal inflationary symptoms of budget laxity, it has produced an unwelcome side-effect. Manufacturing industry in the fiscally-easy countries has been losing competitiveness as their national currencies have been buoyed up, at least in real terms, by capital inflows.

Unfortunately, it is not possible to suppress the side-effect without attacking the basic malaise of large budget deficits. Any measures to discourage the inflow of capital into the fiscally-easy countries would unleash the forces of inflation. Bond markets would slump under the weight of the full supply of government paper. In turn, the authorities would most probably resort to a partial monetisation of their budget deficits rather than accept a crisis rise in interest rates.

The phenomenon of capital being cycled from the fiscally-tight to the fiscally-easy countries within Europe is part of a wider pattern. At the world level, Japan, the Federal Republic and Switzerland are the source of capital to the easy fiscal policy countries — the USA, France, the UK, Italy, Australia and New Zealand, for example.

Table 1: General government financial balances

% of GDP	*1979*	*1981*	*1983*	*1985**	*1986**
USA	+0.6	−0.9	−4.1	−3.7	−3.8
Japan	−4.8	−4.0	−3.5	−1.4	−1.0
Germany	−2.7	−3.8	−2.8	−1.5	−1.5
France	−0.7	−1.8	−3.1	−3.2	−3.4
Italy	−9.5	−11.9	−12.4	−13.1	−13.1
UK	−3.2	−3.2	−3.5	−3.6	−4.1

Source: OECD and P&D estimates. *Forecasts.

International flow of funds

The force behind the flow of funds between the fiscally-tight and easy countries is differential interest rates. Bond yields and interest rates in the fiscally-easy countries (both in nominal and real terms) tend to be substantially higher than those in the fiscally-tight countries, not surprisingly, given that large public deficits must compete with other possible uses of private savings.

Yet there are many potential sources of disturbance to the flow. For example, some of the fiscally-easy countries may eventually opt for inflation and currency depreciation, particularly as foreign creditors would bear part of the cost. Maybe investors in the fiscally-tight countries will have growing doubts about the wisdom of soft currency investment, belatedly recalling the cautionary tales of the 1970s, when investment in the low coupon and low interest currencies proved to be the winner.

Both within Europe and at a world level, there has been a dramatic increase in fiscal divergence between countries in recent years (see Tables 1 and 2). In the period 1981-85, budget deficits (defined as general government balances according to OECD practice) of the Federal Republic and Japan, measured relative to net private savings, have halved, whilst the same ratio for the USA has almost quadrupled and for France doubled. The Federal Republic and Japan may be ranked as fiscally-tight countries (budget deficits less than 20 per cent of private savings), whilst the UK, France and the USA are ranked as fiscally-easy countries (the same ratio

Table 2: Budget deficit as % of private savings

	1979	1981	1983	1985*
USA	−9.3	14.9	69.0	52
Japan	29.8	26.5	28.2	12
Germany	27.8	47.6	33.6	18
France	6.7	23.5	45.5	50
Italy	51.4	74.4	85.4	87
UK	34.7	43.2	41.9	42

Source: OECD and P&D estimates. *Forecasts.
Note: Included in net private savings are households' and business gross savings less capital consumption.

more than 40 per cent of private savings).

Within Europe, the most striking increase in fiscal divergence has been between the Federal Republic and France. The years in which this divergence grew, 1981-85, can usefully be divided into two sub-periods, 1981 to spring 1983 and spring 1983 to the present.

In the first sub-period, the fiscal boost given to the French economy by the incoming Mitterrand Administration was the main force behind the diverging trend. Despite record high interest rates and bond yields in France, foreign capital was not attracted, principally because markets were concerned that government policies would produce even larger current account and budget deficits and an eventual inflation storm. In addition, there was the phenomenon of domestic capital flight.

In the second sub-period, from spring 1983, growing Franco-German fiscal divergence has been due principally to a tightening of budgetary policy in the Federal Republic, undertaken by the CSU/CDU/FDP Government. Meanwhile, following the March 1983 EMS realignment, the French Government committed itself to financial orthodoxy, and investors' fears about runaway deficits and inflation in France subsided.

French franc strength, 1983-85

The French franc has been remarkably firm against the DM during this second sub-period, sustained by the high real interest rates which are the product of relatively easy fiscal policy and by the conversion of the Mitterrand Administration to austerity. At end-September 1985, the French franc was 4 per cent higher in real terms (using CPI indices as deflators) against the DM than on average during 1978-82 and 9 per cent higher than in 1973-77. If the franc had been outside the EMS, it would have floated up against the DM over the past two years. Instead, there has been persistent intervention by the Banque de France to hold the French franc down against the DM.

The strength of the French franc has persisted despite the big deterioration of France's trade performance, relative to the Federal Republic's, over the past two years. Whereas the German trade surplus has increased from DM50bn in 1984 to an estimated DM80bn in 1985, France's trade is at best expected to be in deficit by Ffr20bn, down from Ffr28bn in 1984. German export volume growth of 8 per cent and 9 per cent in 1985 and 1986 respectively, contrasts with French growth of 2.6 per cent and 3.2 per cent.

At the same time as France has been underperforming the Federal Republic by an increasingly wide margin in trade, French interest rates and bond yields, underpinned by easy fiscal policy, have increased in attractiveness. For example, Euro-French franc bond yields (for 5-7 year maturities) still average above 10.5 per cent pa, compared with just over 6.5 per cent for equivalent DM paper. The nominal yield differential of 4.0 points compares with a forecast inflation differential between France and the Federal Republic in 1986 of 2.5 points.

Might fiscal divergence increase?

There is little chance of fiscal policy in France being tightened ahead of the Presidential elections — expected to be held two years beyond the legislative elections of March 1986. At best (from the viewpoint of a fiscal conservative), the Government that emerges in spring 1986 will continue the present policy of holding the budget deficit at around 3.3 per cent of GDP, albeit allowing for some slippage into off-budget accounts.

One scenario in which the budget deficit may increase significantly further in 1986-87 is that of landslide gains for the RPR (Gaullists). A coalition government of the RPR-UDF, having an absolute majority in the Assembly, and in which the RPR was the dominant party, would probably then be formed. Such a government might well embark on a programme of substantial tax cuts, in principle balanced by expenditure cuts and the sale proceeds

of denationalisation (see article on pages 19-21). But asset sales only produce quasi-revenue, and expenditure cuts may not reach the planned level. Thus, the budget deficit, on OECD definitions, could expand substantially.

An easing of fiscal policy, provided it is accompanied by a credibly firm monetary policy (to which end the Banque de France has recently reformed its operating procedures, moving, for example, to an M3R from an M2R target) has political attractions in the run-up to the Presidential elections. It is the method of reflation least likely to bring immediate downward pressure on the franc. Moreover, by sustaining high yields in the French capital market, it facilitates the abolition of exchange restrictions, an important part of the RPR programme. Once lifted, French investors might still not show a great interest in foreign bond markets, where yields are lower than in the high-yielding domestic bond markets.

Just as there is little prospect of a tightening of fiscal policy in France in the next two years, so the chances are slim of an easing of fiscal policy in the Federal Republic. The members of the Bonn coalition are presently discussing details of a common programme for cutting taxes by DM40bn over the next legislative period (1987-91). Their intention, however, is to balance these by cuts in industrial subsidies and by keeping a tight rein on state spending. In short, there is little prospect of fiscal convergence between France and the Federal Republic before the French Presidential elections.

French resistance to cheap DM

A scenario of no fiscal convergence between France and the Federal Republic would not be encouraging for French manufacturing industry, as the franc would most likely remain firm against the DM over the medium term. Already, the strong franc (in real terms) is taking its toll. According to recent INSEE estimates, France is suffering a serious erosion of market share. France's exports have grown this year at a rate 2 per cent below the expansion of its customers' total imports. In turn, the disappointing export performance has had a bearing on manufacturing investment. The growth of spending by manufacturing industry (in the competitive sector) on machinery and equipment has slowed to 6 per cent this year from 8 per cent in 1984. By contrast, in the Federal Republic, the same item is growing by 14 per cent this year, up from 2 per cent in 1984.

Such statistics suggest that the combination of easy fiscal and tight monetary policy is threatening French manufacturing industry in the same way as Reaganomics eventually threatened US industry. In the USA, Japanese imports became the scapegoat for policy failure. In France, the scapegoat may turn out to be imports from the 'cheap' currency countries, in particular, the Federal Republic. But France cannot feasibly follow the US-Japan precedent and threaten its largest trading partner, the Federal Republic, with protection unless it adopts a more expansionary fiscal policy. Alternatively, France might (behind the scenes) push for a big revaluation of the DM within the EMS (say, by 8 to 10 per cent), perhaps offering, in return, concessions on the EEC agricultural policy. But the scope for bargaining exchange rates against agricultural subsidies is now much less than at the start of the EMS. The Kohl Government would hardly welcome a French offer of co-operation towards reforming the agricultural policy with the January 1987 elections looming, in which the farmers' vote might be crucial.

A large unilateral revaluation of the DM could seriously damage German economic prospects. On the assumption of an unchanged degree of fiscal divergence and of France continuing to adhere to a conservative monetary policy, the revaluation would bring in its wake a large increase of capital outflows from the Federal Republic. Investors would realise that the next currency realignment would be far into the future and see even greater attraction in the high yielding bond markets of the fiscally-easy countries. In turn, the German economy would be hit by the double blow of higher interest rates and a stronger mark.

Gaullist nostalgia

Perhaps an RPR Government would decide to bring new life to French industry by a Gaullist-type devaluation, moving the French franc down 10 per cent, say, against the other EMS currencies and so liquidating five years of socialism. Again, it is difficult to see that the other EMS countries would acquiesce in such a competitive devaluation. In 1981 and early 1983, France's suggested devaluation had

to be reduced considerably in the face of strong opposition. In effect, a Gaullist-type devaluation would require France, at least temporarily, to withdraw from the exchange rate mechanism of the EMS.

In effect, given the probable decision to make no change in fiscal policy, the French Government has little scope for independent action in currency policy. At most, there will be a small change of emphasis. Probably, through 1986, monetary policy will become slightly more expansionary, with short-term rates coming down to 7.5 per cent whilst a 4-5 per cent realignment of the French franc against the DM is agreed within EMS. The French trade balance in manufactures would worsen further but there would be relief in the fall in energy prices, so, overall, the current account might be in small surplus. The economy would grow at around 1.5 per cent, up from 1 per cent, led by stronger consumer spending, reflecting the rise in real disposable incomes, helped, in turn, by the firm franc policy.

The SPD, Greens and M Barre

On this 'central case', investment in franc deposits and bonds would prove rewarding through 1986. The outlook beyond turns crucially on the outcome of the German elections in January 1987 and the French presidential elections of spring 1988.

In the event of the present coalition Government in Bonn losing its absolute majority in the January 1987 elections, a new fillip would be given to capital outflows from the Federal Republic. The prospect of a minority SPD Government, dependent on the toleration of the Greens, would undermine confidence in the DM, not least because of fears about a neutralist drift in the Federal Republic's foreign policy. The French franc would gain new strength vis-à-vis the DM, thus postponing the onset of the difficult mature stage that eventually follows in the wake of a move to an easy fiscal policy.

How would France react to further weakness of the DM, due this time to political causes in the Federal Republic rather than to divergence of fiscal policy? If fiscal policy were left unchanged, there would be a further erosion of competitiveness for French export industry. The dilemma could only be resolved by an early cut in French interest rates, matched by a tightening on the fiscal front.

For fiscal consolidationists, in particular for M Barre, the above circumstance would be ideal (from an economic, not security, viewpoint) for achieving the long-term reduction in budget deficits. Otherwise, fiscal consolidation would have to be accompanied by real depreciation of the franc which might have unwelcome inflationary side-effects. If M Barre were elected President he would probably embark on a programme gradually reducing the budget deficit through time. In order to prevent economic recovery being threatened by this fiscal retrenchment, there would have to be offsetting falls in interest rates. Normally, these would go along with some tendency of the franc to weaken — unless there were, meanwhile, an offsetting 'autonomous' rise in the demand for French investments — as in the case of the Kohl Government being defeated.

The combination of M Barre as President of France and an SPD minority government coming to power in Bonn would provide the jackpot to holders of French franc bonds. For French industry, however, the combination of a gradual depreciation of the franc alongside a fiscal tightening, would be kinder. Even then, the present holder of franc bonds could keep significant gains.

The next EMS realignment

In sum, a major change in French fiscal policy is improbable ahead of the 1988 presidential elections. In the interim, a modest realignment of the Ffr/DM rate is expected to be agreed during the next year, probably involving a 5 per cent reduction of the French franc's bands against the DM within the EMS. The actual move down of the French franc would be less during 1986 than the lowering of its bands, as the franc would start trading at its new ceiling after the realignment. A 3-4 per cent devaluation of the franc during 1986 is already more than discounted in present interest rate differentials between Euro-Ffr and Euro-DM deposits. The most likely date for the formal realignment is in spring or summer 1986 — in the wake of a shift towards lower interest rates in France after the elections. Alternatively — albeit of lower probability — the Federal Republic may unilaterally (together with the Netherlands) revalue the DM by, say, 5 per cent against the other currencies, as soon as the Christmas holidays, hoping thereby to avoid an inflow of 'hot' money ahead of the French elections which would complicate domestic monetary management.

CHANCELLOR OF THE EXCHEQUER

pa £M-S

David

You may like to see the attached, to draw on as you see fit. Relevant to the hallers/Civil Aviation thesis that joining EMS would mean a return to exclusive contracts.

Salient points:-

4 out of the 13 have no exclusive contracts

2 have ineffective "exclusive contracts" ie. 2 their mandate only 4 have effective contracts.

The new airways existing members

Let Sean - you any thing - to liberalisation

RL 20/12

ANNEX A

EXCHANGE CONTROLS IN ERM MEMBER COUNTRIES

1. The current exchange control position of members of the ERM is:

Belgium and Luxembourg

No restrictions on capital movements apart from a two-tier foreign exchange market, dating back to 1954-55. This is technically an exchange control in our view, though it appears to have little effect at present.

Denmark

As a result of a series of liberalisations, there have since 1984 been only minor restrictions on capital movements.

France

Full set of exchange controls since 1939 apart from two periods between 1966 and 1968. Two periods of minor relaxation since the ERM began, in 1980-81 and from the end of 1983 to date, interrupted by restrictions in 1981-3.

Germany

No controls.

Ireland

Wide-ranging controls. Some relaxation in 1979 partly linked to Irish participation in the EMS, and some tightening in 1983. An incidental consequence of Irish participation was that parity between the Irish pound and the pound sterling was broken and UK residents became subject to the same controls as other non-residents.

Italy

Considerable restrictions on both portfolio and some direct investment - these were reinforced temporarily in 1981 and 1982 by an import deposit scheme. Since then, changes have mostly been in the direction of liberalisation, although some were forced on the Italians by European Court cases. A bill to introduce major reforms is before Parliament. (liberalisation).

Netherlands

No controls.

23. XII
AM 65

PRIME MINISTER

JOINING THE EMS

You asked about the letter, attached, in yesterday's FT, drawing attention particularly to the statement that the EEC accounts for only 39% of our manufactures compared to over 50% of larger imports.

The figures are correct. ("Larger" I take here to mean that our imports are larger than our exports!) Our deficit with the Community is of course reduced by a surplus on oil and invisibles. Our overall current account deficit with the Community in 1984 was £1.3 billion.

I am not entirely sure what the author is driving at, but taken with the final paragraph, he perhaps means that joining the EMS at the present exchange rate would lock in the present imbalance in manufactures.

If this is the argument, it fails both because there is no necessary reason why we should have a balance with the EC in our trade in manufactures (bearing in mind oil, invisibles etc.) and also no reason why we should be in balance with any particular area of the world. Bilateral trade positions, at least between us and the EC, in any case probably only have a small influence on bilateral exchange rates: confidence, investment flows etc. are much more important.

There is perhaps one point in favour of the letter writer, though rather low in importance. If a benefit of joining the EMS is exchange stability, importers of manufactures from the EC will gain more than exporters of manufactures to the EC in a crude sense, simply because there are more of them.

DN

(David Norgrove)

29 November 1985
(DCAAWO)

Joining the EMS

From the Treasurer,
Labour Economic Policy Group

Sir,—Why does Sir Terence Beckett rejoice (November 22) because Mr Samuel Brittan has now joined those who want us to charge over the cliff by joining the European Monetary System now or in the foreseeable future?

The evidence which the Confederation of British Industry gave to the Treasury Committee on this question was astonishing for its lack of perception. It did not realise that British industry was bound to suffer under a fixed exchange rate limited to the Ecu because importers would gain far more than exporters. The EEC accounts for only 39 per cent of our exports of manufactures compared to over 50 per cent of our larger imports. It then proceeded to blame its members for the mess we are in by attributing much of this to "non-price-competitiveness," not realising that there is no such thing as a free lunch in business and that as an explanation of what has happened since 1979 it could only stand up if the situation had actually got worse under the Government!

The truth it ignores is that all factors of production have to be paid for and that firms which are fighting for survival as a result of an increase in the real exchange rate cannot match the competition in every respect.

The reality the CBI must face is that in the absence of tariff protection against imports from the EEC the real exchange rate against the D-Mark has got to fall by 30 to 35 per cent to enable us to get back to full employment. The policies which the CBI favours were tried and failed in the 1920s. The policies we need are those of the 1930s—a competitive exchange rate backed by an accommodating money supply. We became the most instead of the least successful industrial country in the world. We could do the same again, particularly if we followed the advice of Lester Thurow in again putting an end to free trade with the Continent.

Shaun Stewart,
72 Albert Street, NW1.

pa.

MR NORGROVE

21 November 1985

PATRICK MINFORD'S VIEWS ON THE EMS

Patrick Minford argued strongly against joining the EMS at a seminar on Tuesday. His objections were:

i. The risk of capital and trade controls to help sustain exchange rate parity.

ii. Speculators could bet against the currency without any risk of losing, but with considerable potential gains. This encouraged speculative pressures on currencies.

iii. These speculative pressures caused dramatic changes in interest rates unwarranted by domestic monetary conditions. Financial volatility was therefore increased.

I attach a press notice summarising his lecture.

David Willetts

DAVID WILLETTS

Centre for Economic Policy Research

For release Tuesday, 19 November at 1:30 pm

EMS MEMBERSHIP DISASTROUS FOR BRITAIN
MINFORD ARGUES

It would be a disaster for Britain to join the European Monetary System (EMS), argued economist Professor **Patrick Minford** today. There were few clear benefits and important disadvantages to membership. In the past the EMS has encouraged the growth of distortionary barriers to capital mobility and of restrictions on free trade. It has also led to increased monetary volatility in member countries. Minford argued that present UK monetary policy is performing reasonably well. Why then embark upon an unknown sea of troubles?

Patrick Minford is Professor of Economics at the University of Liverpool and a Research Fellow in the International Macroeconomics programme of the Centre for Economic Policy Research (CEPR) in London. He spoke at a lunchtime meeting organised by the Centre, one of a regular series of meetings at which Research Fellows discuss policy-relevant research. They may also advance specific views on policy, but these views are their own and not those of CEPR, which takes no institutional policy positions.

Minford observed that the EMS is a system of "fixed-but-adjustable" parities between a number of European countries, each pursuing independent monetary policies. The key currency in the EMS is the Deutschmark (DM), and the monetary policy of the Bundesbank plays a key role in the behaviour of the EMS. There have inevitably been shifts of member currency parities against the DM, notably the Belgian and the French francs and the Italian lira. These parity shifts are generally foreseen well in advance, even if their timing is uncertain. They create a "one-way option" in the devaluing currency, of the kind familiar in the later years of the Bretton Woods agreement. The exchange market becomes unstable, and during these crises capital flows must be stemmed by means of exchange controls and abrupt shifts in monetary policy. A period of quiescence usually follows the devaluation, but in the absence of monetary policy alignment with the Bundesbank, the initial instability recurs. Hence, Minford argued, exchange controls become institutionalized, either through two-tier markets or physical controls. Controls on trade in services such as tourism and insurance also become necessary, because these are a potential route for avoiding capital controls; even barriers to trade in goods may be encouraged for the same reason. Monetary policy also becomes more volatile.

It is often claimed in defence of the EMS that it has reduced fluctuations in intra-European price competitiveness, but evidence for this is weak and

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informal, Minford argued. The earlier pattern of random fluctuations has been replaced under the EMS by occasional sharp swings, resulting in possibly less volatility (lower variance) but a more skewed distribution. It was not clear that this was preferable, Minford observed.

Minford drew attention to **the disadvantages of EMS.** One cost is the tendency of the EMS to encourage **barriers to capital mobility and to free trade.** The distortions caused by these barriers are well-known and likely to be important, driving a wedge between investment returns in the world and in the protected markets.

A second cost of the EMS is **the increased monetary volatility it causes in member countries.** Such volatility leads markets to add a risk premium to bond yields. Interest rates increase, thus creating another market distortion. Monetary volatility also contributes to greater volatility in the real economy, Minford added.

These problems are compounded for Britain, because she is an oil exporter and one of the major world financial centres. One object of the government's Medium Term Financial Strategy (MTFS) was to create monetary stability. Minford argued that Sterling M3 had been rightly abandoned (informally) as a major indicator some four and a half years ago, because it yielded a distorted picture in the more competitive financial environment which has arisen since 1979. Since 1981 M0 has assumed an informal role as an indicator of monetary conditions and has performed relatively well. **The correct policy for the UK, according to Minford, involves continued emphasis on M0, preferably in a slow evolution towards Monetary Base Control. Policy should respond to the exchange rate only if it displays sharp and sustained movements, which threaten to destabilise monetary conditions. Such a policy has worked well hitherto, and Minford viewed this as perhaps the most decisive argument against the EMS. Why embark upon a sea of troubles when present policies serve us reasonably well?**

For further information contact:

Stephen Yeo 01 930 7154
CEPR

The Centre for Economic Policy Research is a private educational charity which promotes independent analysis of open economies and the relations between them. The research work which it disseminates may lead to or may include views on policy, but CEPR itself takes no institutional policy positions. Patrick Minford is a Research Fellow of the Centre's research programme in International Macroeconomics. The opinions he expresses are his own and not those of the Centre. Financial support for this meeting has been provided by a grant from the German Marshall Fund of the United States, which does not necessarily endorse the views expressed by Professor Minford.

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FRAME ECONOMIC

ECOFIN: 18 NOVEMBER 1985: AMENDMENT TO MONETARY PROVISIONS OF THE TREATY

SUMMARY

1. COUNCIL DIVIDED DOWN MIDDLE. STOLTENBERGER AND CHANCELLOR SAID TREATY AMENDMENT BOTH UNNECESSARY AND RAISED CONSTITUTIONAL ISSUES. ATTENTION SHOULD CONCENTRATE ON IMPLEMENTATION OF EXISTING PROVISIONS ON CAPITAL CONTROLS. BEREGOVOY SAID TREATY AMENDMENT UNTHINKABLE WITHOUT REFERENCE TO MONETARY ISSUES. DELORS CIRCULATED AMENDED PROPOSAL DROPPING EARLIER INVIDIOUS VOTING PROPOSALS BUT INTRODUCED A REFERENCE TO EMU. DUTCH CONSIDERING ALTERNATIVE AMENDMENTS: BELGIAN DRAFT CIRCULATED.

DETAIL

2. TIETMEYER (CHAIRMAN OF MONETARY COMMITTEE) REPORTED ON THE COMMITTEE'S EXAMINATION OF THE COMMISSION'S DRAFT AMENDMENT TO ARTICLE 107. OPINION IN THE COMMITTEE HAD BEEN DIVIDED ON THE QUESTION WHETHER THE PROGRESS MADE IN MONETARY COOPERATION IN RECENT YEARS SHOULD BE REFLECTED IN A TREATY AMENDMENT. THE COMMISSION'S AMENDMENT HAD BEEN CRITICISED FOR MAKING NO REFERENCE TO ECONOMIC AND MONETARY UNION (EMU): BECAUSE IT THREATENED THE CHECKS AND BALANCES BETWEEN GOVERNMENTS AND CENTRAL BANKS AND IMPLIED THAT THE COMMISSION WOULD PROPOSE COMMUNITY ACTION IN THIS AREA UNDER ARTICLE 235: BECAUSE OF THE DISTINCTION IT DREW BETWEEN PARTICIPANTS AND NON-PARTICIPANTS IN THE EXCHANGE RATE MECHANISM (ERM): AND BECAUSE IT WAS TOO DESCRIPTIVE AND RAISED TOO MANY DIFFICULT DETAILS. EVEN THOSE MEMBERS OF THE COMMITTEE WHO SUPPORTED MONETARY AMENDMENT IN PRINCIPLE THOUGHT THE TEXT UNSATISFACTORY. THE COMMITTEE WAS UNABLE TO GIVE ANY CLEAR CUT CONCLUSIONS AS TO THE NEXT STEP: BUT STOOD READY TO ASSIST ECOFIN IF MINISTERS WISHED WORK TAKEN FORWARD IN THIS AREA.

3. DUISENBERG (CHAIRMAN OF COMMITTEE OF CENTRAL BANK GOVERNORS) SUMMARISED HIS COMMITTEE'S REACTION TO DELORS' PROPOSAL ON THE LINES OF 10387/85. THE TREATY CHANGE ENVISAGED MIGHT AFFECT THE FUNCTIONING OF THE EUROPEAN MONETARY SYSTEM (EMS). ECOFIN HAD AGREED ON 11 JUNE THAT FURTHER DEVELOPMENT OF EMS SHOULD REMAIN A MATTER FOR FINANCE MINISTERS AND FOR THE COMPETENT COMMITTEES. ANY TREATY CHANGE SHOULD PROVIDE FOR EQUILIBRIUM BETWEEN PROGRESS IN THE MONETARY AND NON-MONETARY SPHERES: SHOULD NOT AFFECT THE DECISION MAKING PROCESS: AND SHOULD BE PLACED IN THE CONTEXT OF THE ULTIMATE OBJECTIVE OF EMU, TAKING ACCOUNT OF EXPERIENCE IN EMS.

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4. DELORS (COMMISSION) SAID THAT THE COMMISSION'S PROPOSAL REFLECTED 4 PRINCIPLES.

(I) POLITICAL: FAILURE TO AMEND ARTICLE 107 WOULD SUGGEST THAT THE COMMUNITY DID NOT BELIEVE IN MONETARY COOPERATION. THERE MIGHT NOT BE ANOTHER IGC FOR 30 YEARS.

(II) THERE SHOULD BE NO TRANSFER OF MONETARY POWERS AT PRESENT FROM NATIONAL CENTRAL BANKS TO COMMUNITY INSTITUTIONS.

(III) THERE WAS ROOM FOR IMPROVEMENT IN THE PRESENT SYSTEM.

(IV) NO INSTITUTIONAL CHANGE UNLESS IT WAS RATIFIED BY NATIONAL PARLIAMENTS: THE COMMISSION'S DRAFT MADE CLEAR THAT THIS WAS A NECESSARY CONDITION FOR TRANSFORMING THE EMCF INTO AND EMF.

THE COMMISSION'S PROPOSALS SHOULD ALSO BE SEEN AGAINST THE BACKGROUND OF THE 1978 DECISION TO SET UP THE EMS AND OF THE DISCUSSION AT THE 1984 INFORMAL ECOFIN AT RAMBOUILLET.

5. IN THE LIGHT OF THE MONETARY COMMITTEE'S AND CENTRAL BANK GOVERNORS' COMMENTS HE NOW WISHED TO PROPOSE A REVISED AMENDMENT TO ARTICLE 2 (TO COVER EMU) AND ARTICLE 107. (TEXT MUFAXED TO MORTIMER (TREASURY) AND WALL (FCO)). THIS REFERRED TO THE NEED TO COOPERATE IN ECONOMIC AS WELL AS MONETARY POLICIES. IT ALSO OMITTED ANY REFERENCE TO VOTING ARRANGEMENTS WITHIN THE EMCF, EVEN THOUGH HE DISAGREED WITH THE OBJECTIONS WHICH HAD BEEN RAISED TO THIS FEATURE OF THE COMMISSION'S ORIGINAL PROPOSAL. DIFFERENTIATION WAS A PROBLEM IN A NUMBER OF AREAS OF COMMUNITY POLICY.

6. WATNIEL (BELGIUM) SUPPORTED THE PRINCIPLE OF TREATY AMENDMENT AND CIRCULATED ALTERNATIVE PROPOSALS (MUFAXED TO MORTIMER AND WALL). THE TREATY SHOULD REFER TO EMU, THOUGH TREATY AMENDMENTS SHOULD BE KEPT TO A MINIMUM AND SHOULD BE COUCHED IN BROAD TERMS TO ASSIST FUTURE DEVELOPMENT OF MONETARY COOPERATION. AMENDMENTS TO ARTICLE 104 SHOULD BE CONSIDERED AS WELL. THE MONETARY COMMITTEE SHOULD DO FURTHER PREPARATORY WORK.

7. THE CHANCELLOR RECALLED THE DISCUSSION AT RAMBOUILLET TO WHICH DELORS HAD REFERRED. MINISTERS HAD AGREED THAT THE EMS HAD DEVELOPED SUCCESSFULLY. BUT THIS DID NOT JUSTIFY TREATY AMENDMENTS, WHICH WERE TECHNICALLY UNNECESSARY AND RISKY. TECHNICALLY, THE EMS HAD WORKED SATISFACTORILY AND FLEXIBLY. TREATY AMENDMENT MIGHT MAKE PROGRESS IN THE EMS MORE DIFFICULT. THERE WOULD BE PROBLEMS BECAUSE OF THE LIKELIHOOD OF COMMISSION PROPOSALS UNDER ARTICLE 235 AND BECAUSE OF THE INVOLVEMENT OF THE EP. WE SHOULD CONCENTRATE ON PRACTICAL DECISIONS: REMOVAL OF EXCHANGE CONTROLS AND BARRIERS TO THE PRIVATE USE OF THE ECU. THE COMMISSION'S NEW DRAFT REMAINED AMBIGUOUS. HE WAS GLAD THAT THE REFERENCE TO EMCF VOTING RIGHTS HAD BEEN DELETED: BUT THE REFERENCE TO EMU MADE MATTERS WORSE. EMU INVOLVED A COMMUNITY CURRENCY, A COMMUNITY CENTRAL BANK AND FISCAL UNION WHICH WOULD IN TURN INVOLVE POLITICAL UNION. THE COMMUNITY SHOULD AVOID MAKING ITSELF A LAUGHING STOCK BY AGAIN ADOPTING, AS IN 1972, VAGUE COMMITMENTS TO EMU WHICH WOULD NOT BE FULFILLED.

8. STOLTENBERG (GERMANY) ECHOED THE CHANCELLOR'S OPPOSITION AND SCEPTICISM. THE COMMISSION'S PROPOSALS WOULD JEOPARDISE THE /BUNDESBANK'S

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CONDUCT OF EXTERNAL AND INTERNAL POLICY. THEY DID NOT MERELY ENSHRINE EXISTING PRACTICE IN THE TREATY. THE CHANCELLOR HAD BEEN RIGHT TO POINT TO THE RISK OF AN INCREASING ROLE FOR THE COMMISSION. ARTICLE 107 SHOULD NOT REFER TO A TWO-SPEED EUROPE. THE GERMAN CABINET HAD DISCUSSED MONETARY AMENDMENT: THEY HAD AGREED THAT THEY COULD NOT ACCEPT A MONETARY AMENDMENT NOW. THE EUROPEAN COUNCIL WOULD HAVE SUFFICIENT SUBJECTS WITHOUT AMENDMENT TO THE MONETARY ARTICLES. TOO MANY PROBLEMS COULD NOT BE TACKLED AT ONCE.

9. DUKES (IRELAND) AGREED WITH STOLTENBERG THAT FAILURE TO AGREE MONETARY AMENDMENTS WOULD NOT MAKE THE IGC AND THE DECEMBER EUROPEAN COUNCIL A FAILURE. THE EUROPEAN COUNCIL HAD IN THE PAST ASKED ECOFIN TO GET ON WITH THE JOB OF IMPROVING MONETARY COOPERATION AND CONVERGENCE OF ECONOMIC POLICY AND PERFORMANCE. THERE WAS NO SHORTAGE OF POLICY INSTRUMENTS. THE PROCESS WOULD NOT BE HELPED BY HASTY AMENDMENTS TO THE TREATY. HE SHARED THE CHANCELLOR'S DOUBTS ABOUT THE WISDOM OF REFERRING TO EMU.

10. BEREGOVOY (FRANCE) ARGUED THAT MONETARY AMENDMENT WAS A NECESSARY PART OF TREATY AMENDMENT. A MONETARY DIMENSION WAS AN ESSENTIAL INGREDIENT IN THE CHANGES TO THE COMMUNITY WHICH IS NOW UNDER DISCUSSION. NOT TO AMEND ARTICLE 107 WOULD BE TO TAKE A STEP BACKWARDS WHEN AN OPPORTUNITY OF TREATY AMENDMENT WAS THERE. ANY AMENDMENT SHOULD INCLUDE A REFERENCE TO EMU, EMS AND THE ECU. DETAILED REFERENCES TO THE EMCF WERE PERHAPS PREMATURE AND OBJECTIONABLE.

11. ANDERSSEN (DENMARK) SAID THAT THE EMS HAD OPERATED SUCCESSFULLY SO FAR. THE DANISH GOVERNMENT'S POSITION ON TREATY AMENDMENT WAS RESERVED: BUT CHANGING ARTICLE 107 MIGHT HAVE AWKWARD LEGAL CONSEQUENCES WHILE A REFERENCE TO EMU COULD JEOPARDISE DANISH COOPERATION ON TREATY AMENDMENT.

12. POOS (LUXEMBOURG) SUPPORTED THE PRINCIPLE OF TREATY AMENDMENTS. THE IGC SHOULD CONSIDER THE COMMISSION TEXT AND THE BELGIAN PROPOSALS.

13. CALAMIA (ITALY) SAID THAT PROGRESS MUST BE MADE IN THIS AREA. THE TREATY SHOULD REFER TO EMU AND CONSOLIDATE THE PROGRESS BROUGHT ABOUT ON THE EMS.

14. RUDING (NETHERLANDS) OBSERVED THAT OPINIONS WERE DEEPLY DIVIDED. THE NETHERLANDS WOULD NOT WISH TO BLOCK MONETARY AMENDMENT BUT AMENDING ARTICLE 107 WAS NOT A HIGH PRIORITY FOR THE IGC. ANY AMENDMENT WOULD NEED TO BE EXAMINED VERY CAREFULLY IN A VERY SHORT PERIOD OF TIME. SUBSTANTIVE NEGOTIATION ON ANY TEXT MUST REMAIN WITHIN ECOFIN AND ITS ATTENDANT COMMITTEES. THE COMMISSION'S REVISED PROPOSAL WAS AN IMPROVEMENT ON THE FIRST DRAFT: IT INCLUDED THE FINAL OBJECTIVE OF EMU AND EXCLUDED THE NOTION OF A TWO-SPEED EUROPE. IN A LATER INTERVENTION HE SUGGESTED THAT HE MIGHT BE ABLE TO OFFER A REFERENCE TO THE 1978 COUNCIL DECISIONS ON THE EMS TAKING THE FORM OF A PREAMBLE TO THE REVISED TREATY. THIS MIGHT GET OVER THE JURIDICAL PROBLEM OF A REFERENCE IN THE BODY OF THE TREATY. (SUBSEQUENTLY WE OBTAINED

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OBTAINED COPIES OF THE DRAFTS ON WHICH THE DUTCH ARE WORKING - MUFAXED TO MORTIMER AND WALL. THE AMENDMENT TO THE PREAMBLE REPRESENTS ONLY A SMALL PART OF THE DUTCH PROPOSALS).

15. IN A FURTHER ROUND OF INTERVENTIONS, DELORS EXPRESSED SURPRISE AT THE REJECTION BY SOME OF A FAIRLY MODEST TEXT. IT ALTERED NOTHING. THE EMU WAS ALREADY IMPLICITLY IN THE TREATY. IN THE EMS CONTEXT THE COMMISSION HAD NEITHER MADE NOR INTENDED INITIATIVES. STOLTENBERG DENIED THAT HE HAD GIVEN ANY ULTIMATUM. HE HAD EXPLAINED THE PROBLEMS WITH THE COMMISSION TEXT. GIVEN THE SHORTAGE OF TIME, THE EUROPEAN COUNCIL SHOULD CONCENTRATE ON WHAT COULD BE ACHIEVED: THE GERMAN VIEW WAS THAT THE MONETARY DIMENSION WAS NOT ESSENTIAL. IF NECESSARY THE MATTER COULD BE REMITTED AGAIN TO ECOFIN. THE CHANCELLOR SAID THAT HE HAD NOTED THE SUGGESTION THAT AN AMENDMENT MIGHT JUST RECORD EXISTING PROGRESS. BUT THERE WAS A PHILOSOPHIC PARADOX. SUCH A COURSE WAS JURIDICALLY IMPOSSIBLE. SIMILARLY IT HAD BEEN SUGGESTED THAT EMU WAS IMPLICITLY PRESENT IN THE TREATY. BUT EXPLICIT REFERENCE WOULD BE POLITICALLY UNACCEPTABLE. THIS WAS A HIGHLY COMPLEX AREA. THE MILAN COUNCIL HAD BEEN RIGHT TO REMIT IT TO ECOFIN. DISCUSSION THERE AND ITS ATTENDANT COMMITTEES WAS THE ONLY WAY FORWARD EVEN IF IT COULD TECHNICALLY BE DISCUSSED IN THE EUROPEAN COUNCIL. THE LATTER COULD BRING THE WHOLE EXERCISE INTO DISARRAY.

16. SANTER (PRESIDENCY) SUMMED UP. THERE WERE CLEARLY CONSIDERABLE DIVISIONS OF OPINION. BUT IT WOULD NOT BE POSSIBLE TO AVOID HAVING A PROPOSAL FOR MONETARY AMENDMENTS IN SOME FORM BEFORE THE DECEMBER EUROPEAN COUNCIL: THE AGREEMENT AT MILAN HAD REQUIRED A QUALITATIVE LEAP FORWARD IN COMMUNITY AFFAIRS. HE HAD NOT GIVEN UP HOPE THAT A MIDDLE WAY COULD BE FOUND WHICH WOULD COMMAND GENERAL ASSENT. THE MONETARY COMMITTEE SHOULD CONSIDER ON 28 NOVEMBER DELORS'S REVISED DRAFT AND THE BELGIAN PROPOSALS. ITS DISCUSSION COULD BE REPORTED TO THE EUROPEAN COUNCIL.

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CAB - WILLIAMSON, JAY
TSY - PS/CHANCELLOR, LITTLER, LAVELLE, FITCHEW, EDWARDS, MS BARBER
BANK - KIRBY, LOEHNIS

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NOTE FOR THE RECORD

MEMBERSHIP OF THE EXCHANGE RATE MECHANISM OF THE E M S

The Prime Minister yesterday held a meeting to discuss whether the UK should become a member of the E R M. Present were the Chancellor, the Foreign Secretary, the Governor of the Bank of England, the Lord President, the Lord Privy Seal, the Chancellor of the Duchy, the Chief Whip, the Secretary of State for Trade and Industry, Sir Peter Middleton, Sir Terence Burns, Mr Eddie George and Professor Brian Griffiths.

Introducing the discussion, the Chancellor said he had given considerable thought to the proposal that the UK should now join. The belief that outside the E R M the UK would have greater freedom than inside, was, to a large extent, illusory: the Government never had complete freedom of action in the real world. Its economic policy depended critically on confidence in the markets and that confidence could be greater if the Government had made the commitment to the E R M. The Chancellor recognised that, if the UK joined and there were substantial pressure on sterling during the run up to an election, the UK would have to take leave of absence from the system. But it could well be easier to manage pressure on sterling in those circumstances if the UK had shown its commitment by joining the E R M.

In a discussion of the possible political problems of persuading Government supporters on the merits of joining, the Chancellor of the Duchy gave his view that, if the Government decided to go in, any political problems could be overcome. The likely support from some back-benchers who were otherwise critical of the Government's economic policy might prove to be very helpful. The Lord Privy Seal was more doubtful and also argued that it would be wrong for the Government to tie its hands by making a commitment of this kind to its European partners.

The Secretary of State for Trade and Industry said he had in the past always been opposed to joining, in the belief that

that membership would be de-stabilising. He had now concluded that it would be right to join, both because the fragility of present monetary policies had been displayed and because there was now a much weaker connection between movements in oil prices and the exchange rate.

The Prime Minister argued strongly against joining for two reasons. First, the UK had very low reserves by comparison with other members of the system and it also had more open capital markets than any other except Germany. Pressure on sterling would feed straight through to interest rate decisions in a mechanical way, leaving the Government no discretion. Secondly, for the UK to pull out of a system in advance of an election would, whatever the Government said, be taken as an indication that it lacked faith in its own economic policies. The important factors for maintaining confidence in Government policies were firm control of public expenditure and public borrowing. The Government must maintain some freedom of manoeuvre and should not tie itself to exchange rates within a rigid grid.

The Foreign Secretary acknowledged the political hazards. However, the M T F S had been crucial in creating confidence and giving long-term credibility to the Government's policies. However, everyone had now lost confidence in sterling M3 as a monetary indicator. The Chancellor's and Governor's Mansion House speeches had been masterly in making bricks without straw. The hazards to interest rates were now greater outside the E R M than inside it. He also took note that the Government's main economic advisers had now changed their minds and were in favour of joining.

The Governor pointed to the difficulties of explaining policies in the present circumstances. The Government had to say that it looked at the exchange rate in judging economic policy but this was inevitably followed by the question, what level for the exchange rate the Government had in mind as being acceptable. There was no answer to that. The Prime

Minister suggested that this was an inadequate formulation of the question. The speed of movement of the exchange rate as well as its level had to be a factor.

The Lord President expressed confidence in the judgement of the Chancellor and the Governor. If they felt the time was right to join, their views needed to be given full weight.

The Chief Whip was surprised that there had been so little call for the UK to join the E R M since the Mansion House speeches had been made. It seemed likely that the calls for the UK to join would increase with the passage of time.

The Chancellor saw a distinct possibility that the UK might be forced to take a decision to join at some later date in much more difficult circumstances. The Lord President also saw difficulties in a situation in which the Government decided not to go in despite a growing belief that it should have decided in favour.

The Prime Minister, bringing the discussion to a close, said she had not been convinced by the arguments in favour of joining. She agreed, however, that it would be right to maintain rigidly the line which had been taken so far, that the UK would join when the time was right. As for the conduct of economic policy, it was all the more important now to maintain strict adherence to the public expenditure totals.

DAVID NORGROVE

14 November 1985

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PRIME MINISTER

ERM

You are holding a meeting tomorrow morning at 0900 for 1½ hours to discuss whether the UK should join the ERM.

The cast list is the Chancellor, Governor, Foreign Secretary, Lord Whitelaw, Mr Tebbit, Mr Brittan, Mr Wakeham, Mr Biffen, and, in the back row, Sir Peter Middleton, Terry Burns, Eddie George and Brian Griffiths.

The papers are:-

(a) Note by Brian Griffiths

(b) Paper by the Treasury

(c) Answers to our questionnaire

(d) The main paper prepared for the seminar in February.

You will remember that this last paper includes the arguments the Treasury were prepared to include at a time when they were sceptical about the case for joining.

I am told privately that the Chancellor has seen separately all of the Ministers who are coming to this subject for the first time. The Treasury tell me their reaction has been that of course this is a subject where they are prepared to trust the judgment of the Chancellor and Governor.

This suggests to me that the Chancellor has blinded them with science, bringing out the advantages in terms of economic policy, narrowly defined, without exposing for them the political disadvantages you see particularly in the weeks before an election.

I suggest you begin by asking the Chancellor and Governor to

set out the case in favour. You should probably then explain your strong doubts before inviting the wider group of Ministers to comment.

It could actually be rather awkward if (as seems most unlikely) the meeting tomorrow morning were to decide in favour of joining: the Governor is off to South America from next weekend until early December!

Duty Clerk

PP David Norgrove
12 November 1985

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PRIME MINISTER

THE EXCHANGE RATE MECHANISM

The Chancellor argues that the presentation of our financial policy is now so unclear that we are paying the price in higher interest rates. We look at so many indicators that the markets believe that we can always find a justification for whatever we want to do. The original objective of the MTFS - creating a clear framework of intermediate rules such as monetary targets - has been lost. Interest rates are higher than they need be because they include a risk premium to allow for the possibility that policy will be relaxed. So we need to re-establish a clear financial rule by joining the ERM.

You might want to ask the following questions about this analysis:

Do we need to re-present the MTFS?

The Chancellor is trying to return to a golden age when the MTFS was clearly defined and rigorously followed. But:

- the most important component of the MTFS concerns fiscal policy. Joining the ERM does nothing to buttress our commitment to controlling public expenditure or ensuring the PSBR continues to decline as a percentage of GDP.

- like all such golden ages it never existed. We first adopted the MTFS in March 1980 and by July 1980 the removal of the corset led to the first 'distortion' of £M3. We have used £M3, M1, PSL2, and MO in subsequent formulations of the strategy.

- this Government has painfully earned credibility for its commitment to reduce inflation. That is the ultimate objective. Do we need to nail new colours to the mast when the markets already know where you are trying to steer the ship. How great are the market's fears of your

commitment to a tight policy being undermined by the attractions of a pre-election spending spree?

This Government's financial policy boils down to cutting back on borrowing together with a willingness to raise interest rates when the pound looks weak or financial conditions look loose. It is the element of discretion in all this which makes the markets suspicious. But if we have managed so far why can't we continue to do so?

Will we not export this problem to Germany?

The Chancellor argues that the pace of financial innovation and deregulation in London is more rapid than in Germany and it is this which makes it difficult to read the financial indicators here.

But if we try sticking to the DM, we also bring together the British and German banking and capital markets. Competition between these markets will ensure that the pace of financial innovation and deregulation is similar in both countries. Hence we cannot avoid the innate uncertainties of reading money supply figures created by innovation and deregulation by moving this problem to Germany.

Will it Work?

The sterling Deutschmark rate has fluctuated between $3.50 and 4.00 in the past four years. If we joined the EMS we would presumably need to hold in the DM 3.60 to DM 3.80 range at the most. But the financial world may continue to be as volatile in the future as it has been over the past few years:

- the oil price is still unstable and pulls sterling and the Deutschmark in different directions.

- if there is a flight from the dollar funds may not go equally into Britain and Germany.

What about the run-up to the next Election?

Can we actually stick to the exchange rate rule if there is a risk of Labour winning the next Election? There could be a run on the pound, in which case the Chancellor accept that we would have to withdraw from the ERM. He thinks this could be turned against Labour. This is the crucial political question. There is a risk that any such crisis would rebound against the Government. After all, the Government remains responsible for financial policy. And if the exchange rate is the only financial rule we have, and we are driven off that, then we really are in uncharted waters.

Do you wish to reduce your control over changes in interest rates?

At the moment, our changes in interest rates have an important discretionary element, though often provoked by crises in the exchange markets and driven by the clearing banks. You will now lose what political control over interest rate changes you have, as they will be determined by fluctuations in the sterling rate against the Deutschmark. The Chancellor sees this as positively desirable. He believes it will enable us to achieve lower interest rates on average. But from a political point of view it reduces your room for manoeuvre.

Duty Clerk

pp Brian Griffiths

David Willetts

David Willetts

12 November 1985

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b/u.

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

11 November 1985

David Norgrove Esq
10 Downing Street
LONDON SW1

Dear David

ERM

I attach a copy of the Chancellor's paper on the ERM for the Prime Minister's seminar on Wednesday 13 November. For the benefit of others attending the meeting, I am also now circulating the answers to the questions posed in your letter to me of 15 October. (They were prepared jointly by the Treasury and the Bank).

I am copying this to Joan MacNaughton (Lord President), Len Appleyard (FCO), John Mogg (DTI), David Morris (Lord Privy Seal), Andrew Lansley (Chancellor of the Duchy), Murdo Maclean (Chief Whip) and John Bartlett (Bank of England).

Yours ever
Rachael

RACHEL LOMAX
Principal Private Secretary

THE EUROPEAN MONETARY SYSTEM

Paper by the Chancellor of the Exchequer

On any objective test the British economy is doing well. For over four years now it has grown at a steady 3 per cent a year and we have the prospect of this continuing in the period ahead. We are achieving the steady growth which governments have sought in vain for many years.

But we cannot take this for granted. The only way we can keep growth going (and with it any prospect of a fall in unemployment) in the world in which we live is to keep inflation coming down - and convince people that it will continue to come down and stay down. The main threat to steady growth is the fear that inflation will re-emerge and that measures which the Government would then take to combat it will thrust the economy into recession and a further rise in unemployment.

Given our record since 1979 it is fair to ask why these fears about inflation persist. The answer is history. Low inflation is a relatively recent phenomenon. In the eyes of the world's financial markets, and this includes our own, British governments remain suspect. There is still a nagging fear that sooner or later we will succumb to the temptation of going for an easy inflationary option. The only means of countering this fear has been explicitly to constrain our own freedom of action by setting targets for monetary growth and supporting this by a tight fiscal policy. This was the thinking that lay behind the publication of the MTFS. The conduct of economic policy must always be guided by a mixture of rules and discretion. Since the collapse of Bretton Woods in 1971, policy in the UK seemed to rely wholly on discretion, and not at all on rules - and we were simply not trusted to use our discretion in a

consistently non-inflationary way. So we had to make a fresh commitment to a new set of anti-inflationary rules - the MTFS.

This commitment has served us well. But it is running out of steam. First, as a matter of substance, the measures of money (including in particular £M3) are going through a prolonged period of instability. They are doing so for the best of reasons: the liberalisation of the economy which is an essential element in our overall strategy includes financial liberalisation, which is progressing apace. But the fact remains that the money numbers cannot be taken at their face value when the institutional structure is in a state of flux. The rules based on them have inevitably lost much of their original clarity. And, to carry conviction in the markets, we have needed to buttress them by adopting a visibly cautious approach to setting interest rates - certainly since last January.

Second, it is most unusual for a British Government to maintain the same policy for as long as we have done. This carries with it great advantages. But it does give us a growing problem of presentation. After a period of some years, there is a need for a shot in the arm - a touch of imagination and freshness to help the explanation and to ensure that our policies continue to carry conviction.

After grappling with these problems as Chancellor over two years now, I have come firmly to the conclusion that joining the exchange rate mechanism of the EMS would deal with both the issue of substance and the issue of presentation, and is the only practicable means of doing so. The exchange rate is more readily comprehensible than monetary targets, and we are already relying on it to a major extent as an indicator. To join the EMS would reinforce the discipline and commitment inherent in the MTFS - and be seen to do so. The interested public seem ready for it.

Industry certainly is. We should respond to a general yearning for a greater degree of exchange rate stability. And we could give policy the new impetus we need to carry us up to the election and beyond.

The public stance of the Government has consistently been that sterling would join the Exchange Rate Mechanism (ERM) when the time was right. Answering Dr Owen on 31 January this year in the House of Commons, the Prime Minister said:

> "We have always said that we shall join the exchange rate mechanism of the EMS when we believe that the time is appropriate. It is kept under review from time to time, but I must make one thing clear. Joining the EMS would not obviate increases in interest rates, it would not obviate the need for financial discipline and, indeed, it might increase it."

I am convinced that the time is now right. The economy is strong, inflation is coming down and the exchange rate is not under threat. Over the past three years now (see Chart 1) the sterling/deutschemark exchange rate has bobbed about within a range of broadly DM3.60 to DM4.00 to the £: we are now in the lower half of that range at a little over DM3.70, and we should take the opportunity to join at around this rate. On the other hand, if we defer a decision much longer we will simply run out of time: we clearly could not join too close to the election and I have in any case to recast the presentation of policy fundamentally between now and the Budget following the patching up job I did at the Mansion House. I believe we should seize the initiative and join now.

Of course, there are risks. But the balance of argument is now very different from what it was two or three years ago. We are not now in a state of general crisis with Europe over our Budgetary contribution. We do not have an inflation rate that is out of line with the EMS countries in general. The petrocurrency problem - the

tendency of sterling, alone among European currencies to move in line with the price of oil - is a shadow if its former self (see Chart II). And the main currency concern - the dollar, and to some extent the yen - is one that we share with the other EMS currencies.

The main risk that remains is one that will be with us indefinitely: that sterling will be subject to excessive fluctuations because of the openness of our markets and the fact that ours is such a widely-held currency: the plain fact is that if a bout of exchange rate pressure were to arise on this account we should be bound in practice to adjust our interest rates accordingly, whether or not we were in the EMS - as the experience of this January clearly showed.

We must recognise this reality. If interest rates are going to change anyway in response to the exchange rate we should be foolhardy to forego the advantages of an explicit exchange rate policy which, through its effect on expectations, will have a beneficial long term influence on interest rates. And the only possible explicit policy we could have is to join the ERM.

The state of affairs I have just decribed is, indeed, likely to become progressively more pronounced. Now that we are disabled from steering by £M3 (although of course we continue to watch it closely) and are obliged to place greater weight on the exchange rate, markets will increasingly come to wonder why it is that we are <u>not</u> joining the EMS. And the only conclusion they can reach - aided and abetted by periodic moans from industry - is that we may wish to see the exchange rate lower, if not now, then before too long. Thus the gap between the level of interest rates needed to maintain the sterling parity within the EMS, and the higher level of interest rates needed to maintain roughly the same parity outside the EMS, already evident today, will steadily widen.

The reference to industry deserves some elaboration. We all know that our most intractable economic problem apart from unemployment itself (and with which indeed it is closely linked) is the persistent tendency of British industry to allow its labour costs per unit of output to rise faster than its competitors' do. This can be resolved only in one of two ways: a falling exchange rate to accommodate inordinately rising costs, or industry controlling its costs better. Industry is far more likely to buckle down to the latter, which is the infinitely preferable course, if it knows that the former has been rendered unlikely by virtue of our joining the exchange rate mechanism of the EMS - a step, incidentally, which (for reasons of exchange rate stability) they themselves have called for.

There is, however, one further risk, which cannot be left out. Whether or not we are in the EMS, it must be quite likely that the outcome of the next General Election will not seem a foregone conclusion in advance, and thus that there will, before polling day, be a precautionary flight from sterling which could well be of considerable dimensions. In or out of the EMS, we will wish to turn this to our political advantage, by pointing out that if the mere prospect of a Labour Government causes such alarm, it is not difficult to imagine how much worse the reality would be. But in or out of the EMS, this would still leave us with a nasty financial crisis to handle.

In my judgement it would be marginally easier to handle if we were inside, rather than outside, the EMS. This is because inside the EMS, the flight would be likely to arise at a much later stage (and thus last much less long) and could be pinned much more convincingly on the political threat rather than being seen as a lack of confidence in our own economic management. Indeed, if we <u>were</u> in the EMS at the time, we would almost certainly wish to take temporary leave of absence to deal with what would clearly be a temporary <u>political</u> phenomenon.

But well before then we would, if we were to join the EMS now, have established our fundamental credibility as a member of the system. Indeed, for the reasons set out in the earlier parts of the paper, I am forced to the conclusion that not to join now would be a historic missed opportunity in the conduct of economic policy which we would before very long come bitterly to regret.

One last point. My judgement that the advantages of joining now outweigh the risks is shared not only by the Governor of the Bank of England, but also by senior officials in both the Treasury and the Bank. They all believe that it makes operational sense to join and that they can now deliver our policy objectives more effectively in the EMS than if we remain outside it.

N.L.
11 November 1985

ANNEX

History and Mechanics of the EMS

The European Monetary System (EMS) was set up following a Franco-German initiative at the European Council in April 1978, the detail being finally approved at the European Council in December. The objective of the system was the establishment of a "zone of monetary stability in Europe". The agreement included the creation of a new currency unit, the European Currency Unit (ECU). The importance of convergence of economic policies for the success of such a system was emphasised.

2. All the then nine members of the Community were members of the system, but the United Kingdom decided not to participate in the Exchange Rate Mechanism (ERM). However, Britain participates in all aspects of the EMS other than the exchange rate mechanism: 20 per cent of our gold and dollar reserves are deposited with the European Monetary Co-operatin Fund (EMCF) for which we in exchange are credited with ECUs; there is a sterling component in the ECU and the UK plays a full part in all Community discussions about the development of the system.

3. The ERM is the heart of the system. Countries participating in it agree to fix a set of central cross rates between each pair of currencies (known as the "parity grid"). Members are then committed to maintain their market exchange rates against other ERM currencies within a band 2¼ per cent either side of the agreed central rates (except for the Lira which for the time being is kept within a ± 6 per cent margin). It is assumed that the UK would enter the system with the 2¼ per cent margin.

4. Action to maintain ERM currencies within the agreed bands usually takes the form of:-

- Intervention in the exchange markets. (This is compulsory at the outer limits of the band, but discretionary when "intra-marginal")

- Changes in domestic interest rates

- Some combination of the two.

Members may also seek a currency realignment - usually only done if intervention and interest rate changes are judged unlikely to suffice to maintain the parity. Intervention may either be in dollars or in the participating currencies (subject to certain limits for intra-marginal intervention). There are substantial short-term credit facilities available for financing intervention, but these have been used relatively sparingly.

5. The system has enjoyed greater stability than many expected at the outset. There were several significant realignments notably in the period October 1981 to March 1983; including three devaluations of the French franc. But there has been no general realignment since March 1983 - this July's change was confined to the Italian lira.

6. Following the March 1983 realignment the ERM withstood a see-saw movement in the deutschemark-dollar rate in 1984 from DM2.5 to DM3.2 without unmanageable difficulties, though the French, Italians and Belgians each had to intervene to the tune of over $1 billion in February 1984. During 1985 the deutschemark has strengthened against the dollar by about 25 per cent, from a low of 3.47 to 2.60, without any significant strain on the mechanism. This includes the period since the G5 agreement of 22 September in which the DM has risen by 7½ per cent against the dollar.

7. The stability of the ERM since March 1983 reflects greater convergence between ERM countries following the strong French measures of March 1983 to tighten fiscal and monetary policies and the sharp (and continuing) fall in both French and Italian inflation rates.

HM TREASURY
11 November 1985

CHART I: MOVEMENTS IN STERLING AGAINST DM

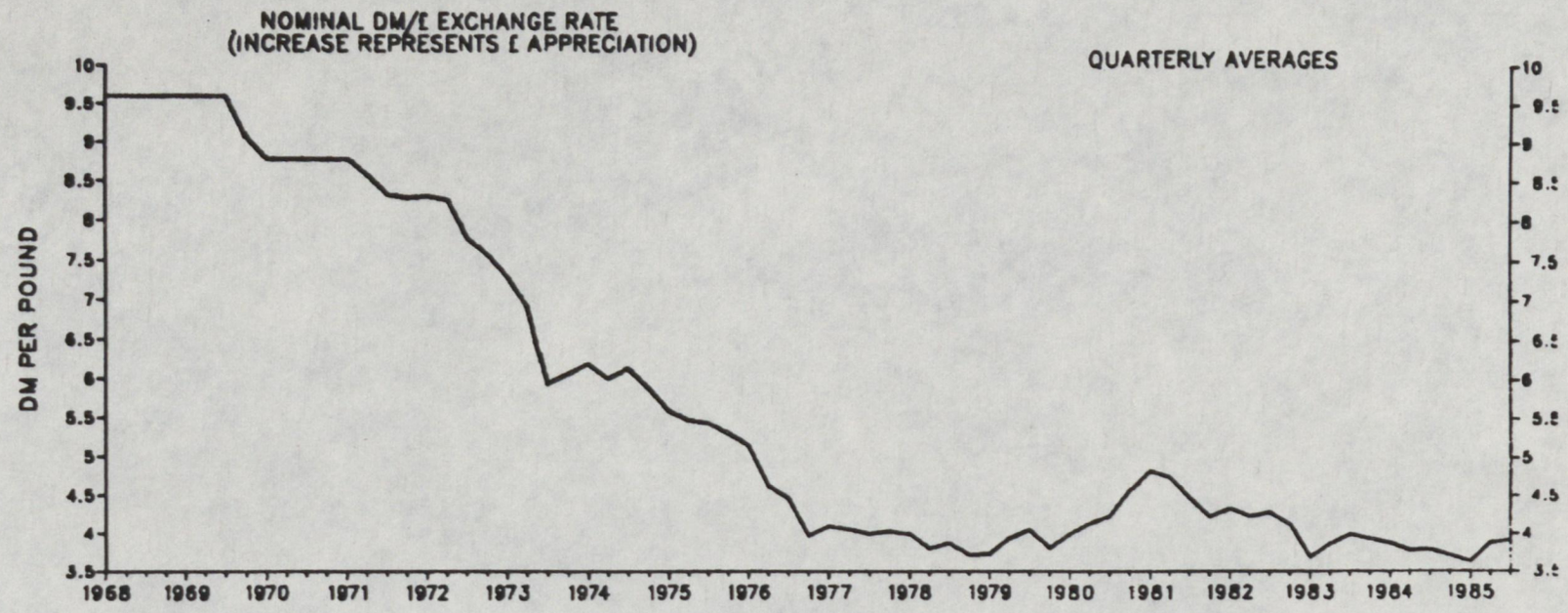
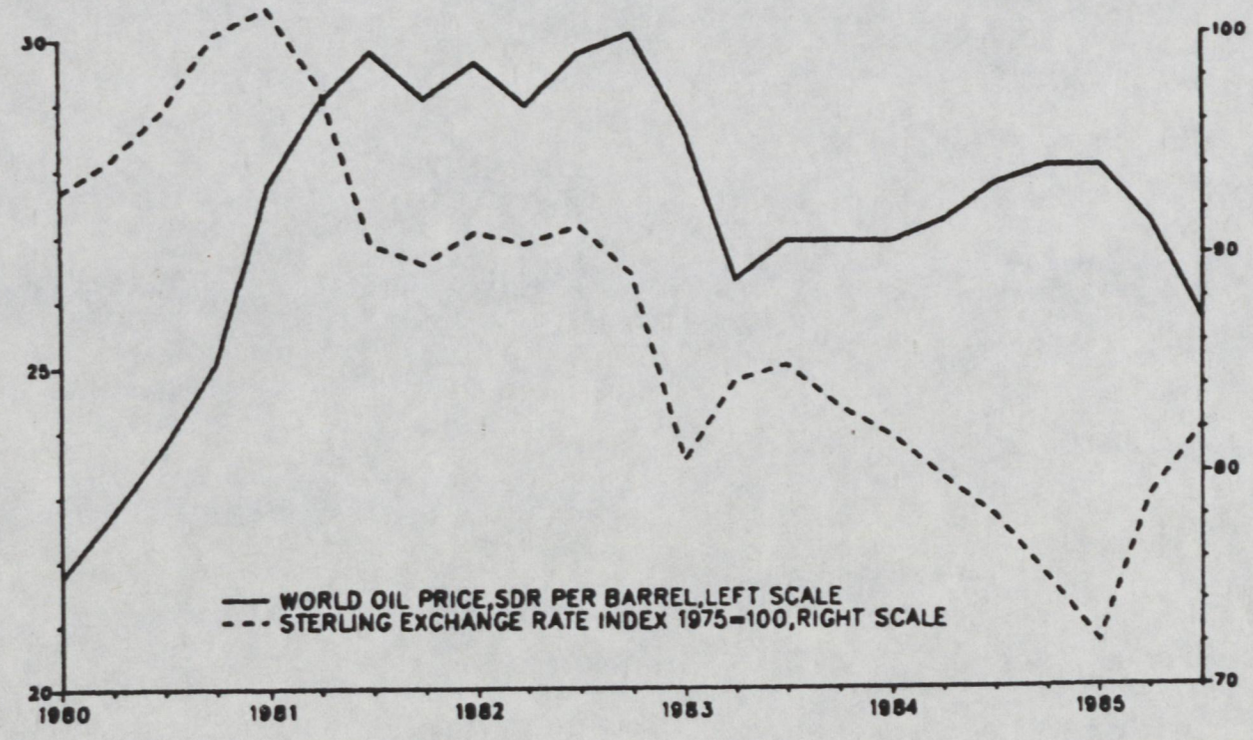


CHART II: OIL PRICES AND THE EXCHANGE RATE



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SECRET

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

8 November 1985

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David

ERM

... Please substitute the attached chart for chart 3 attached to the questions and answers for the Prime Minister's seminar on 13 November.

I am copying this to John Bartlett (Bank of England).

Yours ever
Rachel

MRS R LOMAX
Principal Private Secretary

SECRET

RR3.27

SECRET

28 : CC AW JDW CC DN. CC B.Y.P

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

6 November 1985

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David

ERM

As requested the Treasury and the Bank have prepared full written answers to the questions attached to your letter of 15 October, in preparation for the Prime Minister's seminar on sterling and the ERM on 13 November. These are attached.

I am copying this to John Bartlett (Bank of England).

Yours ever
Rachel.

RACHEL LOMAX
Principal Private Secretary

The questions are not answered strictly in the order in which they were listed; some reordering has been done where this might help by bringing related answers together.

Q21. What are the implications for the way we conduct and present policy, of sticking to the present arrangements?

(a) The conduct of policy would lack a visible discipline, and its presentation would lack clarity.

(b) The MTFS framework of monetary targets has, successfully, provided an objective guide to the conduct of policy. But, as discussed at the PM's July seminar, financial innovation has made it increasingly difficult to interpret the monetary aggregates (especially at present £M3), and so to rely on them as a policy discipline as heavily as we have in the past. We have to be guided by a wide range of factors, and have in practice - especially since January - placed much greater emphasis on the exchange rate, without of course any explicit target. The discretionary element in policy decisions has correspondingly increased.

(c) Without a more clearly-defined intermediate objective, policy is also harder to explain, and a high premium attaches to maintaining the markets' trust in the skill and judgement with which policy is operated. The Mansion House speeches were well received in this respect but have only provided a breathing space in which to rethink the presentation of policy. More precise policy guidelines will be looked for when the MTFS is updated at the time of the Budget.

(d) Unless we can find more robust guidelines our handling of interest rates in particular will remain under exceptionally close scrutiny. To maintain confidence, we will need to be very cautious indeed - more cautious probably than if we had successfully established a clear external discipline.

This seems to me the main argument in favour of joining, to be weighed against the risks.

(e) Moreover while sterling remains outside the ERM it is a particularly tempting target for speculation on the foreign exchange markets.

Q2. Would joining the ERM amount solely to an evolution of the policy framework or would it also imply a change in the policy stance?

(a) Joining the ERM would not imply any change in the policy stance. Rather it would reinforce the framework and give policy new impetus.

(b) It would be an evolution. As explained above, we have already been obliged to modify the operation of monetary targets and forced to pay more attention to exchange rate changes in making decisions about interest rates. This started in Autumn 1980 and Spring 1981 when interest rates were reduced in the face of sterling's strength despite rapid growth of £M3. Chart 1 shows that the sharp interest rate hikes of Autumn 1981, January 1983, July 1984 and January 1985 were all triggered by exchange rate weaknesses. Interest rate reductions have generally been accompanied by exchange rate strength or, at least, stability.

(c) Joining the ERM would be a logical further step in this direction. Within the ERM we could continue to operate policy to keep sterling strong and maintain pressure to bring inflation down.

Q1. What are the reasons for wanting to take a decision now - one way or the other?

(a) The balance of argument has now shifted towards joining (see Question 19) and we could now go in from a position of strength. This is widely recognised not least by the Government's own supporters. And membership of the ERM is increasingly seen as the missing piece of jigsaw as far as monetary policy is concerned.

(b) As a result there is recurring speculation that we are going to join. This is unsettling to markets and industry. It would be better to resolve this uncertainty now, well before the run-up to the next election.

(c) Moreover if we do not join markets will start to ask why not. They are likely to conclude that we want to keep our options open. In practice this means the option to devalue - as persistently argued by the CBI. The price we will pay for these suspicions is the need to maintain conspicuously high interest rates.

Q16. What flexibility would be lost by sterling joining the ERM, in terms of (i) the policy stance (ii) timing of decisions (iii) presentation?

(a) As explained above the policy stance is directed towards putting downward pressure on inflation and ERM membership would not involve any change in this.

(b) Reinforcing our disinflationary strategy inevitably entails some sacrifice of discretion over the operation of policy, but imposing constraints on discretionary action in such a visible way would improve credibility and confidence. It would reassert the principle of self-discipline inherent in the original MTFS.

(c) As a result there would be some loss of flexibility in the timing of decisions. In particular, it would create pressures for changes in interest rates to take place earlier than they have tended to do in the present system. This would be helpful if it reduced the "bias in delay" which is a potential problem in any discretionary system. It would only be a problem if the market's view of the need for action were different from our own - a situation that can arise whether or not we are in the ERM.

(d) There would be little change in the presentation of policy. As explained above interest rate increases have almost invariably been associated with exchange rate movements. But the underlying explanation can usually be presented in terms of the ultimate counter-inflationary objective of policy and this would continue to be so.

Q19. Are the objections to joining of a fundamental nature or are they questions of timing?

(a) Objections to joining are no longer a matter of timing. Those that remain are more fundamental.

(b) The exceptionally good cost performance of Germany. Our relative performance has improved. In terms of consumer prices from 15% compared with 8% average for EMS countries in the final quarter of 1979 to 3¾% compared with 3% average for EMS contries prospectively by the middle of next year. In this respect the greater freedom of action outside ERM is illusory; we should not wish to avail ourselves of the freedom to depreciate. One purpose of joining would be to put pressure on our costs to develop more in line with those in Germany.

(c) The oil factor. This makes us potentially vulnerable to any weakening in the oil price and, in the long term, to the decline in North Sea output. But the real oil price has already declined from its peak and oil price movements no longer exercise as great an influence on sterling as in the past (see chart 2). In 1980-81 the market took an exaggerated view of the importance of changes in oil prices for sterling. More recently, with the prospect of gradually declining oil production, the markets' perception has changed, and the impact of oil price movements on sterling has become less pronounced. But it cannot be denied that this factor will continue to distinguish us from other members of the EMS (see question 18).

(d) The dollar problem. Sharp changes in the dollar can affect the relationship between the DM and sterling. This partly reflects the size, openness and dollar orientation of our financial markets. But major swings in the dollar can produce strains within the existing ERM too. While the dollar has already had a sizeable adjustment, there may be more to come.

(e) The oil and dollar problems will pose difficulties whether or not we are in the ERM. Both have become somewhat less acute recently. But there is no reason to expect them to ease significantly in the short term. So the arguments in terms of

'unripe time' are no longer convincing. It is a matter of judgement if the longer term difficulties are so fundamental that they offset the clear advantages of joining.

Q3. Are present monetary and fiscal policies tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy? For how long?

(a) We judge present policies to be tight enough to bring down inflation. Over the past two years or so - despite some short term volatility, not shared by ERM members - there has been no downward trend in the DM/£ exchange rate (see chart 3). Relative to the German inflation rate we expect to be at least as well placed as other major ERM countries over the period ahead.

(b) The biggest risk to stability within the existing EMS is a sharp fall in the dollar which might cause the Deutschemark to appreciate against all other EMS currencies. In such an event there would probably be some realignment within ERM. If we were within the ERM we would consider the position of sterling in the light of our performance against domestic monetary targets and other indicators. The overriding consideration would be the need to maintain downward pressure on inflation.

Q4. Would a decision on when to join be affected by the rate of sterling against the DM at that particular time? What do you see as the appropriate rate for sterling against the DM?

(a) There is no uniquely 'right' rate; a balance has to be struck between the need to maintain downward pressure on inflation and the need to avoid impairing industry's international competitiveness. The DM/£ rate of 3.50 reached last February was clearly too low and threatened anti-inflationary policy; the rate of 4.00 reached in July was probably too high and threatened to put too much pressure on industry's competitiveness.

(b) The current rate of 3.74 is close to the average over the past 2½ years of 3.84 and has been consistent with anti-inflationary pressure and steady 3 per cent output growth. And over this period

employment growth in the UK has been clearly better than in ERM countries.

(c) These considerations together probably point to a central rate somewhere between DM3.65 and DM3.75. But if we decide to join we would have to be prepared to join at something close to the current rate. The ERM margins would give us some room for manouevre, however.

Q5. How would the role of the monetary targets change if sterling were to join the ERM?

Q6. How much weight would in practice be given to them?

(a) The role of monetary targets has already changed. We interpret their behaviour in the light of other information - particularly exchange rate movements which have taken a more decisive role.

(b) Inside the ERM short term interest rates would be operationally determined, particularly at times of exchange market pressure, by the need to stay within the band. But monetary developments would remain just as important as before in influencing the course of inflation in the medium term, and monetary targets would play the same role as now.

(c) Other EMS members have monetary targets and there is no reason to expect any fundamental conflict between pursuing those targets and operating within the ERM.

(d) If a conflict did arise, however - eg if we persistently found that the level of interest rates required to keep sterling within the ERM was not high enough to deliver monetary conditions sufficiently tight - then we would need to consider whether to seek a realignment.

Q7. In what ways would joining the ERM have a helpful effect on expectations?

(a) By demonstrating our determination to pursue a firm anti-inflationary policy.

(b) By enabling policy to be presented more clearly and convincingly.

(c) The exchange rate commitment would make it plain to companies that excessive pay increases would not be bailed out by a depreciating exchange rate.

(d) Greater exchange rate stability would provide a firmer basis for industrial decision-making which could ultimately be helpful to employment.

Q8. Would a tightening of policy (if that proved necessary) be more easily accepted within Government and by the Government's supporters if sterling were in the ERM rather than outside it? Why?

(a) A tightening of policy would normally, as now, be presented as necessary to the counter-inflationary strategy.

(b) The exchange rate is a more widely understood form of financial discipline than the monetary aggregates.

(c) In current circumstances of uncertainty about the interpretation of the monetary aggregates, the monetary "rules" implied by the present approach are far from clear even to those who find it easy to think in such terms.

Q9. How would the decision to join the ERM be presented both to the markets and more widely?

(a) As a logical extension of our present financial policies (reflecting the increased weight placed on the exchange rate).

(b) The formal exchange rate commitment involved in membership of the ERM would be seen by the markets as reinforcing the intended discipline of monetary targets.

(c) More widely, it would be presented as underlining the Government's determination to reduce inflation.

Q10. How would the admission of sterling change the ERM?

It would introduce a second internationally traded currency and one that would tend to be affected by oil price changes in the opposite way to other ERM currencies. In order to minimise any potential instability arising from this change very close collaboration between the German and UK monetary authorities would be needed, but there is every reason to believe that the Germans would recognise this as clearly as ourselves.

Q11. What turbulence would you expect if we were to join?

Joining the ERM would probably not in itself generate turbulence. However, speculators would no doubt take an early opportunity (eg if there were a weakening in the oil price or further instability in the dollar) to test the £/DM rate. We would obviously need to be ready to react to such turbulence - should it arise (see question 17).

Q12. To what extent would the present level of reserves provide a cushion against temporary downward pressure on the exchange rate, on the basis of past experience here and in other countries? Would you expect a net cost to the reserves over time?

(a) Our available reserves are relatively small, as the table shows. And they may in any event need to be strengthened, by further borrowing if necessary, in due course. In the ERM they would need to be buttressed by close co-operation with Germany.

(b) Our reserves could provide a cushion against modest downward pressure. But if the pressures on sterling were severe there would be no alternative to raising interest rates.

(c) There is no reason why, over time, the pressures should be one way. Hence there should be no net reserve loss.

INTERNATIONAL COMPARISON OF RESERVES*
(Convertible currencies)

	$ billion	% of 1984 exports
UK	10.4 (1)	8.6
Germany	36.9	17.5
France	21.5	18.4
Italy	19.2	22.6
Netherlands	8.4	10.9
Belgium	3.8	7.1
Ireland	3.4	32.1

(1) Including the $2.5 billion FRN borrowing.

* The UK figure is for end-October: other countries are for July or August.

Q13. In periods of upward pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?

(a) If intervention led to a large increase in the reserves there would be a presumption that interest rates could be reduced.

(b) If we felt that intervention and/or interest rate reductions were inconsistent with our anti-inflationary objective we would consider seeking a realignment. This situation might arise, for example, if the Germans were not to stick to their traditional disciplined policies in the future eg in the aftermath of an SPD victory in the German elections in (March) next year. In practice, however, even if the SPD were to win the next German election this is most unlikely, given the SPD's track record when in office before, to signal any departure from financial orthodoxy.

Q14. Is it envisaged that interest rates would change more often than they do now?

(a) If we are successful in establishing credibility, membership of the ERM should promote more stable monetary conditions than we could enjoy outside it. The general level of interest rates could then be lower, and change less frequently if we joined. The present level of UK interest rates currently includes a premium for uncertainty about the Government's monetary policy and the future course of the exchange rate.

(b) But at some - possibly quite early - stage the market may well test our resolve and commitment to the ERM. We would need to react promptly and effectively by raising interest rates. It could well be only after weathering that test that the benefits outlined in (a) above would emerge.

(c) In the face of exchange rate shocks - a fact of life whether we are in the ERM or not - there would be even less scope inside for the exchange rate to take any of the strain. The shock would be quickly transmitted to the money markets and its impact on interest rates might be more immediate. But in practice the difference is unlikely to be very great, as the events of this January demonstrated.

Q15. Is there a risk that the decision to abolish exchange controls would be seriously called in question?

(a) No. There is no influential body of opinion nowadays that argues that exchange controls allow a country to prop up the exchange rate and so avoid higher interest rates for long if confidence weakens. Currently the pressure is on those EEC members that have exchange controls to dismantle them.

(b) This pressure would be reinforced by Britain's membership because the continuation of controls, rather than the absence of British membership, would then be more obviously the most important obstacle to the proper working of the EMS.

Q17. What are the downside risks?

(a) The main downside risk of giving greater emphasis to the exchange rate is that sterling will come under strong pressure in the foreign exchange markets confronting us with a difficult choice between devaluing and a sharp tightening of policy. That risk exists now. But in the ERM it would have a higher political profile. Devaluation would be seen as a defeat for the Government.

(b) Devaluation could also seriously undermine the credibility of policy that membership of the ERM is intended to bring. On the other hand, avoiding this by a sharp rise in money market rates, which would almost certainly be quickly followed by an increase in mortgage rates, would itself be very unattractive, particularly at a time when unemployment was high. But this dilemma also exists now, outside the ERM. The real difference would be the heightened profile.

Q18. Does the UK's position as a major oil producer and exporter **exporter mean that it is too risky to join?**

(a) Obviously these characteristics of the UK's position do make it harder to Britain to be a member of the ERM. It is partly for this reason that Britain has not so far joined.

(b) The importance of the oil factor is less than early years of EMS when UK oil production rose at a very rapid rate and oil prices rose by large amounts.

(c) With gradually declining oil production, fluctuations in oil prices are likely to have a diminishing impact on sterling; and there are clear signs - see the attached chart 2 - that this has been occurring over the past two years.

(d) Over the longer period some fall in the real exchange rate will probably be necessary as the economy adjusts to gradually lower oil output (even though we may be self sufficient at the end of the century). In any case, this would best come about through a deceleration of domestic wage costs. Membership of EMS should improve the chances of this happening.

Q20. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?

(a) No.

(b) Working to an unpublished band would be very close to continuing present policy and give us none of the benefits that membership would.

(c) Working to a published band would give us the effective obligations of membership - and all the downside risks mentioned in answer to question 17 - without the benefits of the institutional backing and credibility tht formal membership would give.

(d) It would also make it very difficult indeed to explain why we had decided not to join the ERM.

Q22. Given that financial innovation is proceeding fast in the US and Germany why is it more difficult to interpret financial conditions in the UK?

(a) The US is also going through a period of rapid financial change and has for some time experienced similar difficulties to our own in interpreting their monetary aggregates. They have, for example, already raised their M1 targets once this year, but remain well above the new, higher, target range. And, like us, they have had to give more emphasis in policy decisions to their exchange rate.

(b) In Germany, on the other hand, financial innovation is much less pronounced. German banks have traditionally provided the wide

range of services now being introduced by banks in the UK; and the pressure for change is also less because decades of comparative stability mean there is less demand for new instruments and techniques as protection against interest rate volatility. As a result the German authorities have been more easily able to deter innovation by informal controls. Where such pressure is felt it can be deflected to the banks' activities outside Germany (eg in Luxembourg) without apparent effect on domestic conditions, though even this has so far been on a relatively modest scale.

Q23. What can the Bank/Treasury do within the existing system to improve the reliability and usefulness of the financial indicators?

(a) Very little that has not been done already.

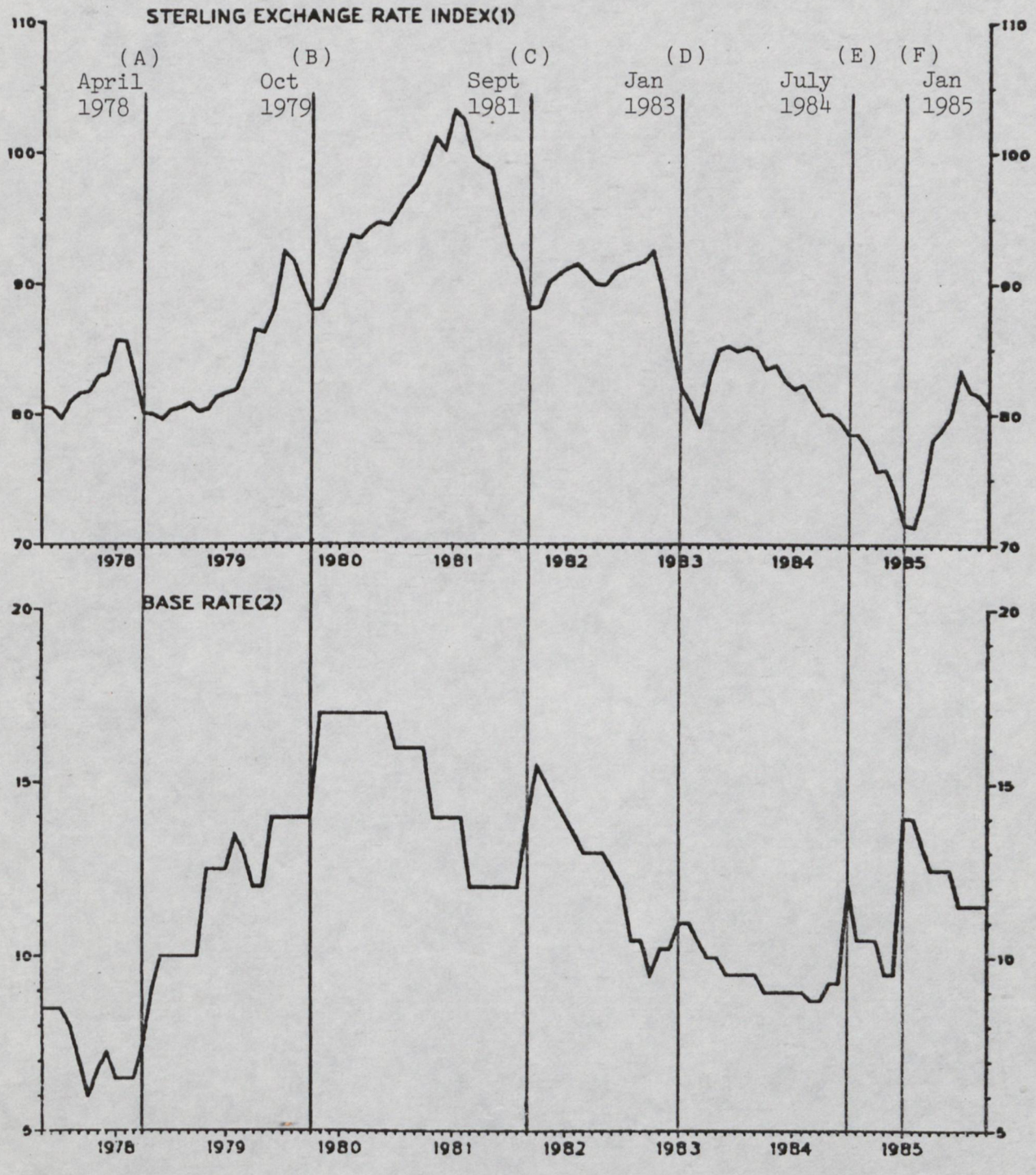
(b) Following the abolition of controls in 1979/80 there are further big structural changes in the financial system in train - including liberalisation of the building societies and "Big Bang" in the securities industry. Given this, the monetary aggregates are likely to continue to be very difficult to interpret for some years ahead.

(c) In the Mansion House Speeches we probably went as far as we could in justifying an intepretative approach to monetary targetry. We have only bought time and, as noted earlier, will need to provide more robust policy guidelines in March. Any additional emphasis on the exchange rate will pose the question: 'why not join the ERM', with consequent problems in the markets/see Question 1.

This of course is intended to answer Alan Walters on MBC.

(d) To move to a monetary base control system would be a bigger, riskier, step than joining the ERM - and one which would be much worse received by the markets, who remain unconvinced about MO. It would involve a major shift in the demand for monetary base, which would be difficult to identify for several years. During that time the money numbers would be impossible to interpret, interest rates would be highly volatile and it would be extremely difficult to establish credibility for policy.

CHART 1: **BASE RATES AND EXCHANGE RATES**

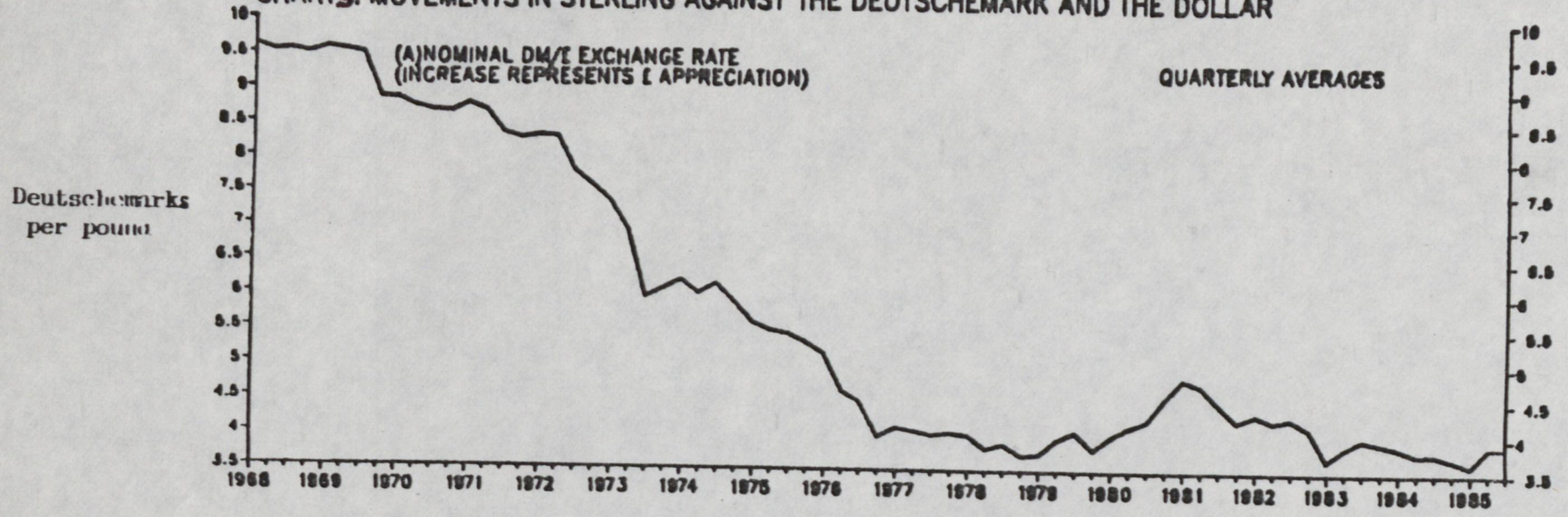


(1) MONTHLY AVERAGE
(2) END OF MONTH

BASE RATE RISES:

(A) from 6½% to 7½% (21 April), 9%(10 May) and 10%(12 June)
(B) from 14% to 17% (16 November)
(C) from 12% to 14% (16 September) and 16%(1 October)
(D) from 10¼ to 11% (12 January)
(E) from 9¼% to 10% (9 July) and 12%(11-12 July)
(F) from 9½% to 10½%(11 January), 12%(14 January-MLR reintroduced) and 14%(28 January).

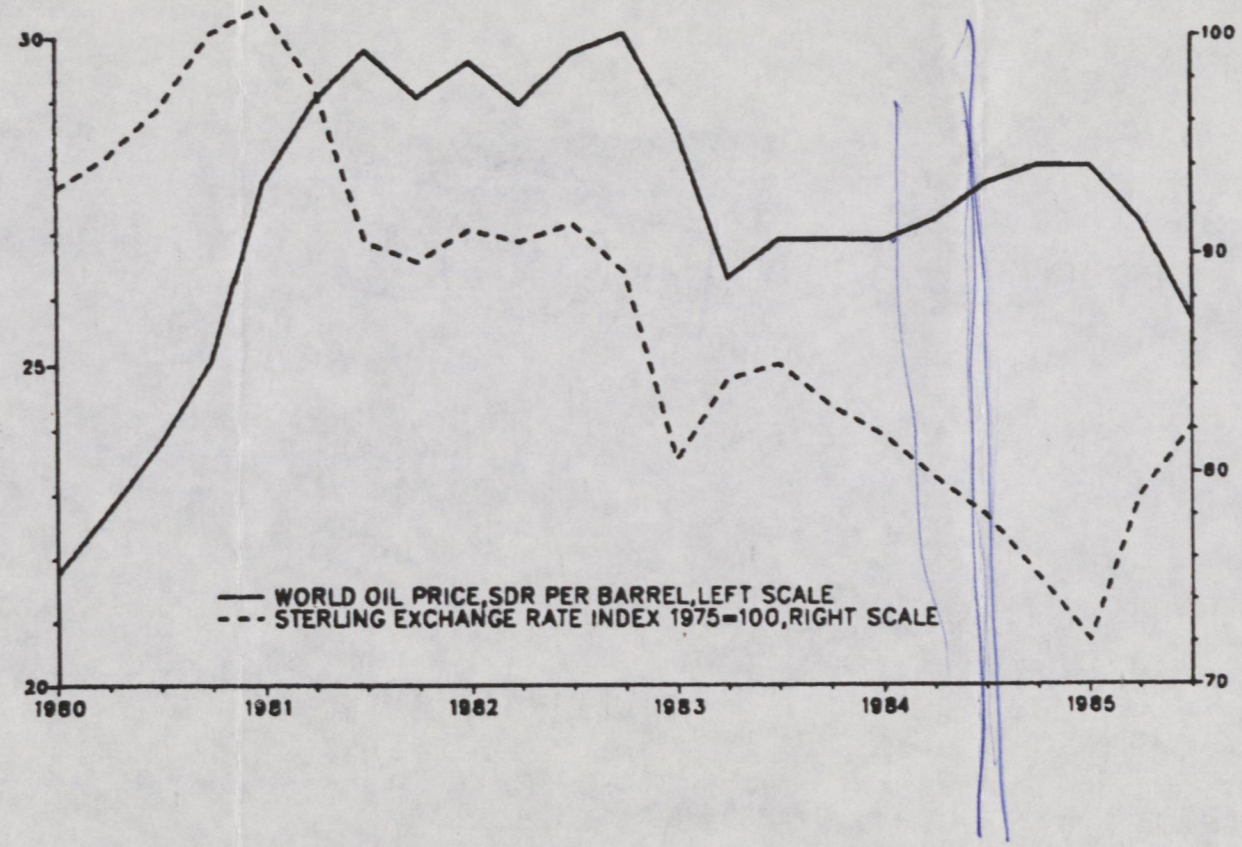
CHART 3: MOVEMENTS IN STERLING AGAINST THE DEUTSCHEMARK AND THE DOLLAR

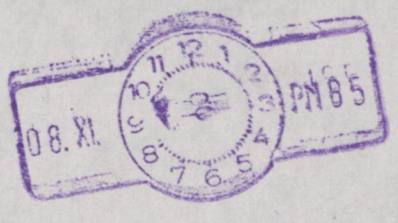


EUROPOL

EMS PTZ

CHART 3: OIL PRICES AND THE EXCHANGE RATE

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PM 6 5

SECRET

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10 DOWNING STREET

From the Private Secretary

18 October 1985

ERM

Could you please send a copy of the reply to the questionnaire and the paper for the 13 November meeting to Sir Alan Walters (personal and confidential) c/o Julian Exeter at the British Embassy, Washington? They ought to catch the confidential bag on either Monday 4 or Tuesday 5 November if he is to have an opportunity to consider them and to comment.

(David Norgrove)

Mrs. Rachel Lomax,
H.M. Treasury.

SECRET

SECRET

10 DOWNING STREET

From the Private Secretary

15 October 1985

Dear Rachel,

ERM

The Prime Minister has asked that the Treasury and Bank should give full written answers to the questions attached in preparation for the next meeting on sterling and the ERM. The meeting is scheduled for 13 November, and I should be grateful if the replies could reach me by 7 November.

The Prime Minister, as you know, wishes to invite a wider circle of Ministers to the meeting on 13 November. They will need a suitable paper to give them an overview of the issues. I shall be in touch separately about the circulation of this and about the circulation of the questionnaire answers to the wider group.

I am copying this to Len Appleyard (Foreign and Commonwealth Office) and John Bartlett (Bank of England).

Yours ever

David

David Norgrove

Mrs Rachel Lomax
HM Treasury

SECRET

ERM QUESTIONS

Why decide now?

1. What are the reasons for wanting to take a decision now - one way or the other?

The policy framework and stance

2. Would joining the ERM amount solely to an evolution of the policy framework or would it also imply a change in the policy stance?

3. Are present monetary and fiscal policies tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy? For how long?

4. Would a decision on when to join be affected by the rate of sterling against the DM at that particular time? What do you see as the appropriate rate for sterling against the DM.?

5. How would the role of the monetary targets change if sterling were to join the ERM?

6. How much weight would in practice be given to them?

Expectations and presentation

7. In what ways would joining the ERM have a helpful effect on expectations?

8. Would a tightening of policy (if that proved necessary) be more easily accepted within Government and by the Government's supporters if sterling were in the ERM rather than outside it? Why?

9. How would the decision to join the ERM be presented both to the markets and more widely?

Effects on the ERM and the markets

10. How would the admission of sterling change the ERM?

11. What turbulence would you expect if we were to join?

Managing Sterling within the ERM

12. To what extent would the present level of reserves provide a cushion against temporary downward pressure on the exchange rate, on the basis of past experience here and in other countries? Would you expect a net cost to the reserves over time?

13. In periods of upward pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?

14. Is it envisaged that interest rates would change more often than they do now?

15. Is there a risk that the decision to abolish exchange controls would be seriously called in question?

16. What flexibility would be lost by sterling joining the ERM, in terms of (i) the policy stance
(ii) timing of decisions
(iii) presentation

Risks

17. What are the downside risks?

18. Does the UK's position as a major oil producer and exporter mean that it is too risky to join?

19. Are the objections to joining of a fundamental nature or are they questions of timing?

Alternative options

20. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?

21. What are the implications, for the way we conduct and present policy, of sticking to the present arrangements?

22. Given that financial innovation is proceeding fast in the US and Germany why is it more difficult to interpret financial conditions in UK?

23. What can the Bank/Treasury do within the existing system to improve the reliability and usefulness of the financial indicators?

14 October 1985

MJ2BFD

SECRET

25

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 .....

Sir Peter Middleton KCB
Permanent Secretary

10 October 1985

D Norgrove Esq
Private Secretary
10 Downing Street

Dear Mr Norgrove

The ERM

file with DRN (EMS)

Thank you for showing me your proposed list of questions. I think they are a good lot - though we might not wish to answer them in their present order. I have only three suggestions:

a. Questions 14 and 15 could be reframed to make a single question: what are the implications, for the way we conduct and present policy, of sticking to the present arrangements.

b. I think we should have a question to cover the Prime Minister's concern about the petro currency status of sterling. I suggest:

"Does effect on £ resulting from the UK's position as a major oil producer and exporter mean that it is too risky to join the EMS "

c. I suggest you add a couple of questions on timing:

"Are the objections to joining of a fundamental nature or are they questions of timing."

"What are the reasons for wanting to take a decision now - one way or the other."

Yours ever,

Peter

P E MIDDLETON

SECRET

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pa

PD

PRIME MINISTER

EUROPEAN EXCHANGE RATE MECHANISM

At the end of your last meeting on whether sterling should join the exchange rate mechanism you said that a further meeting would be needed, but that first the Treasury and Bank should be invited to prepare answers to a number of questions.

I attach a list of questions, which take on board comments from the Policy Unit. Content with the questions?

I suggest asking the Treasury and Bank to complete the examination paper in writing by the end of the month.

The meeting itself is scheduled for 13 November. You said that this should now include a wider group of Ministers than has so far been involved. Please tick Ministers from the list below whom you would like to attend.

- ✓ Mr Tebbit
- ✓ Lord Whitelaw
- ✓ Mr Brittan
- ✓ Mr Wakeham (for backbench reactions)
- Mr Younger (for commonsense comments, though no obvious departmental role)
- ✓ Mr Biffen (bring in later?)
- Lord Young

Any others?

Plus of course the Chancellor ✓, Governor ✓, and Foreign ✓ Secretary. Do you want officials? No

Middleton
Burns
Littler
McMahon
George
Loehnis

A conspectus paper will be needed to help ministers coming fresh to the subject.

Content to proceed in this way?

DRN

David Norgrove
9 October 1985

Please retype.

ERM QUESTIONS

1. What are the reasons for wanting to take a decision now - one way or the other?

2. Would joining the ERM amount solely to an evolution of the policy framework or would it also imply a change in the policy stance?

3. Are present monetary and fiscal policies tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy? For how long?

4. How would the role of the monetary targets change if sterling were to join the ERM?

5. How much weight would in practice be given to them?

6. In what ways would joining the ERM have a helpful effect on expectations?

7. To what extent would the present level of reserves provide a cushion against temporary downward pressure on the exchange rate, on the basis of past experience here and in other countries?

8. In periods of upward pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?

9. Is it envisaged that interest rates would change more often than they do now?

10. Is there a risk that the decision to abolish exchange controls would be seriously called in question?

11. What flexibility would be lost by sterling joining the ERM, in terms of (i) the policy stance
(ii) timing of decisions
(iii) presentation

12. Would a tightening of policy (if that proved necessary) be more easily accepted within Government and by the Government's supporters if sterling were in the ERM rather than outside it? Why?

13. What are the downside risks?

14. Does the UK's position as a major oil producer and exporter mean that it is too risky to join?

15. Are the objections to joining of a fundamental nature or are they questions of timing?

16. How would the decision to join the ERM be presented both to the markets and more widely?

17. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?

18. What are the implications, for the way we conduct and present policy, of sticking to the present arrangements?

2
15. How would the admission of sterling change the EMS ERM?

3
20. What reactions would you expect if we were to join?

4
21. What rate do you see as the appropriate rate for sterling against the DM? What rate against the $? (No use to say whatever is the market rate on the day - that begs the question.

Would a decision when to join be affected by rate of sterling against DM at [illegible] time?

MJ2BFD

SECRET

MJDBFE

cc DW DN

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10 DOWNING STREET

From the Private Secretary

7 October 1985

ERM QUESTIONS

I understand that Nigel Wicks agreed to send you informally a list of questions about the ERM which we are putting together here. I now attach a first attempt at them. I intend to put them to the Prime Minister this weekend and would be grateful for any comments before then.

(no BF cleared)

If she agrees, I would aim to circulate them thereafter, asking for written replies by the end of the month.

A more comprehensive piece of work will also no doubt be needed as the basis for the meeting now scheduled for 13 November to put in the picture, among other things, those Ministers who have not been involved before.

David Norgrove

Sir Peter Middleton KCB
HM Treasury

SECRET

cc DW
DN

ERM QUESTIONS

1. Would joining the ERM amount solely to an evolution of the policy framework or would it also imply a change in the policy stance?

2. Are present monetary and fiscal policies tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy? For how long?

3. To what extent would the present level of reserves provide a cushion against temporary downward pressure on the exchange rate, on the basis of past experience here and in other countries?

4. Is it envisaged that interest rates would change more often than they do now?

5. In periods of upward pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?

6. How would the role of the monetary targets change if sterling were to join the ERM?

7. How much weight would in practice be given to them?

8. In what ways would joining the ERM have a helpful effect on expectations?

9. Would a tightening of policy (if that proved necessary) be more easily accepted within Government and by the Government's supporters if sterling were in the ERM rather than outside it? Why?

10. What policy flexibility would be lost by sterling joining the ERM?

11. Would are the downside risks?

12. How would the decision to join the ERM be presented both to the markets and more widely?

13. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?

14. How might macro-economic policy change if sterling does not join the ERM?

15. How would its presentation change?

SECRET

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MR. WICKS

PROFESSOR BRIAN GRIFFITHS

MR. WILLETTS

ERM QUESTIONS

Here is a draft exam paper for the Treasury and Bank to answer in writing before the next meeting on this subject, which very likely will be in the middle of November.

Grateful for comments.

DAVID NORGROVE

4 October 1985

SECRET

SECRET

ERM QUESTIONS

1. What assurance is there that present monetary and fiscal policies are tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy?

2. How far would the present level of reserves provide a cushion against periods of pressure on the exchange rate, on the basis of past experience here and in other countries?

3. In periods of upward pressure on the exchange rate what considerations would determine the extent of acceptable intervention before a decision to seek a realignment?

4. How much weight would in practice be given to the monetary targets if sterling were to join the ERM?

5. In what ways would joining the ERM have a helpful effect on expectations? (Is there a risk that it would be seen as an attempt to set an external constraint on growth, based on the general perception of the effect of over-valuation of sterling in the 1960s?)

6. Would joining the ERM make the Government's own decisions easier to take and more easily accepted by the country? Why?

7. How would a decision to join the ERM be presented?

8. If sterling does not join the ERM, will the presentation of macro-economic policy need to change? How?

SECRET

SECRET

FM SUBJECT cc Master

VC 4 A C B 21

cc: FCO
Bank of England

blind copies:
Sir A Walters
Brian Griffiths
(Policy Unit)

10 DOWNING STREET

1 October 1985

From the Private Secretary

Dear Rachel,

EUROPEAN EXCHANGE RATE MECHANISM

The Prime Minister yesterday held a meeting to discuss whether the UK should join the Exchange Rate Mechanism of the EMS. Present were the Chancellor of the Exchequer, the Economic Secretary, Sir Peter Middleton, Sir Terence Burns, Mr. Cassell, the Foreign Secretary, the Governor of the Bank of England, the Deputy Governor, Mr. George, Mr. Loehnis and Professor Brian Griffiths.

Opening the discussion, the Chancellor noted that the balance of argument as seen in February had been against joining the ERM, for two main reasons: first, sterling had fallen and to join might have been misinterpreted; secondly the reserves were then rather low. However sterling was at present not weak, and the reserves had been strengthened, though swap arrangements would have to be negotiated if sterling joined the ERM.

The case now for joining was the need to reinforce existing anti-inflationary policy. This policy was continuing to be successful. But the monetary indicators were proving increasingly difficult to interpret. To join the ERM would be a natural development in view of the increasing weight that had been placed on the exchange rate and it would strengthen the strategy in the eyes of the markets. It would make clear to industry that they could not look to depreciation of the exchange rate to solve difficulties which were of their own creating, and it would set the right financial context for the government's own decisions on expenditure. Policy itself was adequately tight; the task was one of presentation and market psychology.

The Governor of the Bank of England agreed. There was a need to reinforce the strategy. With the divergence of the targetted monetary aggregates it was proving an increasingly difficult challenge to present monetary policy in a credible and operable way. In discussing their approach to monetary policy the authorities were compelled to point to their subjective assessments of monetary conditions and to the behaviour of the exchange rate as an indicator. Yet there was then no answer to the question what range for the exchange rate the authorities had in

CST

mind. If sterling joined the ERM all the presentational difficulties would be met. The Governor said the UK would be joining the ERM from a position of strength and would contribute strength to the system.

The Foreign and Commonwealth Secretary noted that the Treasury and Bank had changed their view from a position of great scepticism to a belief that it would now be right to join. This change had been a product of experience. The Foreign Secretary further drew attention to the increasing convergence of the economies of the EMS countries and to the unwritten framework for realignments which now existed. It was also important to bear in mind that economic decision making in the UK was already in practice dominated by the behaviour of the exchange rate. The MTFS had served the Government well. It now needed strengthening.

The following were the main points made in discussion.

(i) To join the ERM would reduce the Government's room for manoeuvre. With large and open capital markets and relatively small reserves, interest rates might well need to move more sharply than otherwise and there would be greater automaticity about the changes. The result might be a faster speed of adjustment towards German economic performance, and higher unemployment. It was not clear that an external discipline would enable decisions to be made or accepted more easily than they were with an economic policy based on self-discipline. Against this it was argued that the events of January in particular, with sharp increases in interest rates as the exchange rate fell, had already fundamentally changed market perceptions of the basis of policy, putting the exchange rate in the forefront. There were risks, but membership of the ERM would of itself help towards greater stability in the exchange rate through the effect on expectations, and if interest rates rose earlier when the exchange rate was weak the increases might be smaller. The greater stability and confidence given by membership would help towards lower levels of interest rates.

(ii) Monetary targets would need to be maintained, but the emphasis given to each of the indicators would change. Joining the ERM would improve the credibility of monetary policy, particularly if the target range for £M3 had to be increased, and against the background of the end of overfunding.

(iii) Sterling was a very different currency from those of the other members. The behaviour of the ERM with sterling in it could not be predicted on the basis of past experience.

(iv) Sterling was increasingly the chosen vehicle for speculators. To join the ERM would help reduce speculative activity. Speculation would however tend to be encouraged if sterling approached the limits of its band and the parity was called in question. There had been wide fluctuations

but no trend in sterling against the other European currencies as a group.

(v) The markets and commentators now had a more balanced understanding of the importance of oil to the UK economy. There were however major uncertainties about the prospects for oil prices, which could cause wide fluctuations in the sterling exchange rate.

(vi) Particular problems might arise from capital movements out of sterling as the end of the Parliament approached, though, it was noted, these might be eased to the extent that the UK had by that time established a good track record as a member. The German elections in 1987 were also a factor to be taken into account.

Bringing the discussion to a close, the Prime Minister said she was not convinced that the balance of the arguments had shifted in favour of joining. A further discussion would be needed, to which other colleagues should be invited. A list of questions would be circulated as a basis for discussion.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and John Bartlett (Bank of England).

Yours,

David.

DAVID NORGROVE

Mrs Rachel Lomax
HM Treasury

THE TIMES 1/10/85

FINANCE AND INDUSTRY

Executive Editor Kenneth Fleet

Markets' timing is all wrong on EMS entry

The rumour that sterling was finally to join the exchange rate mechanism of the European Monetary System the very weekend before the Opec meeting in Vienna had an engaging dottiness about it. That is about the last moment the Bank of England would advise to the Treasury, it being a week when those who monitor the market are always on their toes. If the markets had their timing wrong, however, there seems little doubt that their thinking was on the right track. Entry into full membership of the EMS is under more active consideration today than at any time since the Callaghan Government opted out at the start and there is a distinct air of immediacy about the issue.

Whatever Dr David Owen, or Sir Terence Beckett at the CBI might wishfully think, it is a contradiction in terms to suppose that we could mesh into the exchange rate mechanism immediately, yet freely choose the (lower) parity at which we enter. The whole point of the mechanism is to stabilize parities at a level the market will accept and industry can live with.

Since mischievous dealers would undoubtedly want to test a new bi-polar EMS if sterling were to join the mark as a central reference currency of world stature, it would be asking for trouble to fix an entry parity markedly out of line with market forces. As last week's exercise on the dollar showed, the markets are prepared to accept determined leadership from central banks if it is offered, but this must go with the grain of the market.

In that sense, the reaction to Friday's rumour was most instructive. The sharp fall in sterling, particularly against the mark, surely reflected a view that the short-term level of sterling as a consistent recent beneficiary of bouts of dollar weakness was not sustainable in the medium term in a European context. Industrialists, for once, would have agreed wholeheartedly with the market's judgement.

Yesterday, the pound dropped again in the morning below $1.40 before recovering most of the ground in the afternoon. The pattern was repeated against the mark, which is more important in terms of the EMS argument. The closing value of DM3.76 is now in line with the central levels shown over the past 18 months of fluctuations. Much the same applies to sterling's rate against the European Currency Unit (ECU), not surprisingly perhaps since sterling and the mark form a hefty proportion of the basket.

Manufacturers who compete with German goods would undoubtedly prefer a parity around DM3.5 or an ECU at £0.63 but these levels were only reached during sterling's winter disgrace. By contrast, sterling's latest central parity for fixing the value of the ECU is £0.55, which looks too high a level for the pound in Europe and compares with yesterday's rate of £0.59.

Pending what happens at Vienna and its market spin-off, the current market rates, as adjusted for the rumour and perhaps with another minor downward adjustment, look the most practical near the time of a British entry into the exchange rate mechanism. If the Treasury wanted a much lower rate, it would have to wait for quite different circumstances since dollar weaknesses should sustain the pound.

The authorities may reckon that they can use the leverage of desired sterling entry into the EMS to persuade the Italians, French and others to make their currency controls more liberal in line with the spirit of the EMS. If so, they may think that a slightly higher entry parity for sterling than some would like is a price worth paying for stability.

SECRET

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PRIME MINISTER

STERLING AND THE EUROPEAN EXCHANGE RATE MECHANISM

Joining the ERM could turn out to be the most important economic decision of this Parliament and quite possibly of your administration.

2. The meeting to discuss this is on Monday at 1600 for two hours. The proposed cast is

Chancellor	Governor	Nigel Wicks
Economic Secretary	Kit McMahon	Brian Griffiths
Sir Peter Middleton	Eddie George	John Redwood
Sir Terence Burns	Anthony Loehnis	Myself
Frank Cassell		

And the Foreign and Commonwealth Secretary.

3. The papers are:

Annotated Agenda	(Flag A)
Treasury/Bank paper	(Flag B)
Record of February's meeting	(Flag C)
Note by John Redwood	(Flag D)
Note by David Willetts	(Flag E)
Telegram from Sir Alan Walters	(Flag F)
Note on presentation by Nigel Wicks	(Flag G)
Hansard extract of your comments to the House	(Flag H)

— the other participants do not have this.

The main paper from February's meeting is also enclosed.

4. You might like to invite the Chancellor to introduce the discussion, and then to ask the Foreign and Commonwealth Secretary and Governor for their views.

/Approach

Approach

5. Your discussions with the Chancellor have moved this question to the point where it may look to the Treasury that it is a foregone conclusion that we shall join.

6. I would urge you to make the proponents argue their case, even if you privately agree with them. David Willetts' note (Flag E) sets out some of the difficult questions.

7. The Treasury/Bank paper seems to start from a view that economic decision takers do not recognise the force of the Government's economic policies. The problem is to show them that the Government's policies will produce a fully competitive economy, where costs have to be properly controlled. Joining the ERM would be designed to give them a signal which they can understand.

8. On that basis, the proposal to join the ERM should be seen as an evolution of the policy framework, a more convincing explanation of it, not a tightening of the policy stance.

9. But the Chancellor's reference at your meeting to "raising the stakes" is an admission that the policy stance may not be tight enough. Under the existing regime if markets think the policy stance is too lax, the exchange rate takes the strain (i.e. falls). In the medium term this is a delusion because it simply takes the pressure off management and unions to get their costs right. But in the short term it does give some room for manoeuvre - room for manoeuvre which will be lost if we join the ERM. In the ERM loss of market confidence feeds back very quickly through the exchange rate into interest rates (unless we devalue).

10. In the ERM we tie ourselves to Germany. The figures show the pressures that may be placed on the exchange rate.

/ Germany

	Germany	UK
Inflation	2	6 (though falling)
Manufacturing earnings	2½	9
Manufacturing unit wage costs	-2	5

11. Sir Alan Walters and, to a lesser extent, the Chancellor tend to see joining the ERM as a question of the framework. John Redwood sees it more as a question of the stance, risking tighter policies, higher unemployment and damage to the Government's electoral prospects.

12. One further point. The past behaviour of the ERM is no guide to how it would behave with sterling in it. Among other things, the other members may find the ERM even more difficult to manage with us than it was without us. The kudos from joining the ERM could be short-lived. (This is implied in one of David Willetts' questions and mentioned in the Annex to the Treasury/Bank paper).

Next steps and procedure

13. As the Chancellor has asked, you will want to avoid taking a final decision even if the clear outcome is in favour of joining. You could point to the need to consult other colleagues.

14. Nigel Wicks' minute (Flag G) discusses the important question of presentation.

15. If that is the way the decision goes, you might further discuss dates for joining with the Chancellor at your bilateral on Wednesday. You will also want to discuss the presentation with the colleagues most closely concerned.

/16.

16. You may also want to talk further about Parliamentary aspects in view of Mr. Healey's statement (last page of the Treasury/Bank paper) and your remarks to the House (Flag C). Neither seems to tie the Government to consult in advance.

DRN

DAVID NORGROVE

27 September 1985

L03A2Q

26th June 1979

Mr. Eldon Griffiths: Will my right hon. Friend undertake to keep the House informed of the progress in the Government's thinking on EMS before a final decision is taken by the Cabinet? Is my right hon. Friend satisfied that there is now a common European policy for the production as well as the conservation of energy? Will Europe be able to speak with one voice not only in Tokyo but to OPEC? Is the Prime Minister aware that there is a wide welcome in Europe, as there is in Britain, for the refreshing change in style and manner in which she has approached the European Community?

The Prime Minister: I shall endeavour to meet my hon. Friend's point about the EMS. The next meeting is in September when, unless anything unusual occurs, the House will not be sitting.

Mr. Shore: The Prime Minister spoke earlier about the timing of the possible main EMS decision in September. Will she think about this again, because it really would be intolerable, given the importance of the issue, if such a decision were made at a Council of Ministers meeting at a time when the House had no opportunity to debate it and was, in fact, in recess.

The Prime Minister: What I said about September was that we would be in a position then to make our first assessment. I did not say that we would be in a position then to decide whether we would join. We shall be in a position then to make our first assessment. I am determined that we shall not hurry this matter, and I shall take full account of what the right hon. Gentleman and my hon. Friend the Member for Bury St. Edmunds (Mr. Griffiths) said.

PRIME MINISTER

IF WE JOIN THE ERM: PRESENTATION

If (and it is a big if) we decide to join the ERM, presentation will be vital. It certainly is too important to leave to the two departments mainly interested: Treasury will concentrate too much on the technicalities of £M3, MO et al, and the FCO will regard it as an exercise in Europhilia.

Presentation needs to go wider:

What it means for control of inflation?

What it means for British industry?

What it means for jobs?

What it means for future mortgage rates?

Why HMG's control over economic policy won't be diluted?

Why now is the right time to enter?

Our presentation must be positive, not reactive. So we need to have material ready for all those points (and no doubt others too), directly the decision is announced. We will only get the presentation right if it is planned in advance. This is difficult in view of the need to keep the decision to the "need-to-know" circle. (Just the sort of situation that we faced with GCHQ and TSRB.) Nevertheless, the following Ministers, besides the two principals, need to be ready to join the presentation campaign right at the beginning.

/Mr. Brittan

Mr Brittan
Lord Young/Mr Clarke
Mr Tebbit
Mr Walker (?)

and in the second wave, because there may be special opposition in Scotland and Wales to entry:-

Mr Younger
Mr Edwards

Treasury officials would, I think, have to provide the briefing material, not departmental officials in view of the sensitivity. Sir Peter Middleton ought to be put in charge of arrangements so that the material can be prepared. Bernard ought to be involved.

Monday's Meeting

If the meeting inclines towards joining, it would be worth

- emphasising again the importance of presentation especially the questions in paragraph 2 above.

- commissioning work from the Treasury on presentation

- considering whether the presentational ground can be prepared before any announcement (eg by stimulating helpful articles, speeches by non-Governmental figures). Probably too risky.

N.L.W.

MJ2BDS

PRIME MINISTER

27 September 1985

EMS

Britain should not join the EMS. There are a number of political and economic reasons:

1. **Sovereignty**. As soon as you join the EMS, British monetary policy, the level of interest rates, the amount of the Reserves spent on intervention in foreign exchange markets and, in turn, growth and inflation themselves, will be to a great extent determined by German policy rather than by the British Treasury.

2. **In the pre-Election period** there could be great pressures against the pound. If we were forced into devaluation during this period, it would be seen as a defeat for Government strategy. It will be more difficult to convince the electorate that it was all Labour's fault because devaluation is such a visible national humiliation under the EMS system.

3. **It reverses our overseas borrowing and debt repayment policy**. We have already surprised people by borrowing an extra $2.5 billion to bolster the Reserves; and we may well need more if we are to have enough resources to intervene under the EMS system. It was a much better line for the general public to say that we are the Party that repays overseas borrowings and goes in for sound housekeeping.

4. **The industrial lobby**, which currently favours joining the EMS, would soon change its mind if, for the first 18 months, we did indeed hold the Deutschmark rate level. This is feasible, particularly if we enter at a slightly lower valuation than the current pound/Deutschmark rate. After 18 months of higher cost inflation by British business (which will continue regardless) business will be against

the EMS because they will think it has made them uncompetitive.

5. Sterling is a very different currency from many other European ones, subject to huge capital flows around the world, and part of a much wider international trading system. The cost of defending the pound or defending others' currencies could amount to hundreds of millions of pounds at each attack.

6. There is no evidence that the European currencies, after joining the EMS, have been any more successful in producing similar and lower inflation than before they went in. Messels show this clearly on page 7 of their note (attached). Nor did the current account positions become less volatile after joining the EMS.

7. **The EMS is not a soft option which enables you to drop other types of policy**. It may well force you into raising interest rates when you do not wish; into cutting public expenditure when departments do not wish; or in borrowing overseas to defend the rate.

8. **Sterling has not tracked the European currencies in a stable manner over recent years**. In 1980, sterling rose 20% against the european currency unit. In 1981, sterling fell by 15% from peak to trough. In 1982, sterling again fell 15% from peak to trough. In 1983, sterling rose by 10% at extremes. In 1984, it was more restrained, falling less than 10% at extremes. And in 1985, it has risen by more than 10%. In order to control these strong movements, the Government will need recourse to huge quantities of international reserves, and to a very tough interest rate policy. The band for intervention only allows 4.5% divergence, 2.25% either side of a specified rate - much less than the volatility of the last decade.

Conclusion

The Treasury, Bank and City are uniting behind a new fashion. As each successive monetary target - Sterling M_3, M_1, M_0 - has been subject to distortion or waning interest, the Establishment invents a new one. There is no reason to suppose that we will be any more successful steering by a single currency target than by anything else; whilst there is every reason to say that we have had considerable success through a more pragmatic approach, at times taking care of the exchange rate, and at other times placing more reliance on monetary targets.

This may not be intellectually pure, but it is politically much more sensible; keeps our own destinies in our own hands and not in those of the Germans; and still leaves us free to try and track the DM exchange rate if we wish to do so, and if it suits us. It does not leave us open to City speculators - having lobbied us into the EMS - using all their might and main to try and wobble the Government out of a particular fixed parity. And it avoids adopting one of the main planks of the SDP's programme.

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SHOULD THE UK JOIN THE EUROPEAN MONETARY SYSTEM?

Evidence to the Treasury and Civil Service Committee

Earlier this year I was invited to submit evidence on the pros and cons of full EMS membership to the Treasury and Civil Service Committee. The reply, recently printed in the Committee's collected memoranda on The Financial and Economic Consequences of UK Membership of the European Communities, is given in this paper.

1. Fundamental ideas

Basic questions here are "what is the economic rationale of drawing frontiers between currency areas?" and "why should the nation-state be a more accepted unit for defining a currency's usage than continents or the world?". A sophisticated branch of economic theory, on the determination of optimum currency areas, has developed to answer these questions. They are directly relevant to the issue of the UK's membership of the EMS. The key conclusions are that a nation is more likely to benefit from participation in a currency area if

i. Labour and capital mobility within the area is easy because of the lack of government restrictions (e.g. exchange controls) and for other reasons.

ii. Trade between member countries should be on a substantial scale, promoted by the absence of tariff and non-tariff barriers.

More generally, a currency area will produce better results if the existence of political frontiers does not imply the existence of economic frontiers.

2. Main conclusions on the EMS

Contrary to widespread comment, the EMS has not been a great success. Exchange rates have been stable since early 1983, but exchange rate stability is not in itself an ultimate economic objective. The disappointments have been in the following areas:

i. Growth rates, of both output and trade, in member countries have been slower since the formation of the EMS than they were before.

ii. Economic policy, as measured by the budget deficit g.d.p. ratio, has become more divergent since the establishment of the EMS. There has been an associated increase in the divergence of inflation and external payments performances. (See pages 6 to 8.)

iii. Exchange controls, and other barriers to trade and capital flows within the EEC, are as widespread now as in 1978. (See pages 8 and 9.)

3. Main conclusions on the UK as a potential EMS member

The UK is the least appropriate member of the EMS because, for geographical reasons, labour movement and trade flows are more difficult between it and other EMS members among themselves. Three further major objections are that the UK is a significant oil exporter (see pages 3 and 4), that a fixed exchange rate cannot be easily reconciled with money supply targets (page 11) and that the UK financial system should not be forced into an over-regulated European mould (pages 10 and 11).

Growth in intra-EEC trade of the UK, Germany and France since the EMS's creation

	% change, 1978-84	
	Exports	Imports
UK	+55.8	+47.8
West Germany	+25.4	+25.5
France	+13.4	+23.9

Source: OECD Monthly Statistics of Foreign Trade

Tim Congdon

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Reply to the Inquiry on the European Monetary System by the Sub-Committee of the Treasury and Civil Service Committee - July 1985

The Sub-Committee's inquiry takes the form of a short statement of its scope and a questionnaire. In this reply the questions will be answered after a preliminary discussion of certain theoretical issues which would arise for any country joining a currency bloc. The advantage of the approach is that it enables the subject to be seen in a coherent analytical framework, making the reasoning behind the answers more transparent.

I The Economic Theory of Optimum Currency Areas and Other Considerations.

i. Optimum currency areas

Most of the evidence received by the Expenditure Committee inquiry in 1978 was concerned about the adjustment costs the UK economy would face if it joined a European fixed-exchange-rate system. At that time the underlying inflation rate in this country, at above 10 per cent, was at least twice as high as in West Germany. It was widely thought that the UK would be able to maintain a fixed sterling/deutschemark rate only if an attempt was made to reduce inflation to West Germany's level. It was also believed that such an attempt would result in more output and employment losses than if the UK retained the option to vary the exchange rate. As the inquiry demonstrated, this concern was common to observers on all points of the political spectrum. (In the author's memorandum emphasis was placed on the danger that the loss of monetary sovereignty might entail a more severe recession to curb inflation than if the UK geared a medium-term financial strategy to its own inflation expectations.) In the event inflation in the UK has been brought down virtually to the average EMS level. This has, as was predicted, involved heavy output and employment losses which have not been mitigated in any obvious way by the retention of monetary sovereignty. Perhaps not surprisingly, there is now a common view that full membership of the EMS would have minor adjustment costs and is therefore more appropriate than seven years ago.

Since the transitional problems no longer appear too awkward, it may be interesting to discuss some considerations relevant to determining the size of optimum currency areas in the long run. In economic theory, currency areas have either a common currency issued by a single central bank or complete convertibility between several currencies at a fixed exchange rate. Territory is divided into optimum currency areas when the resulting "frontiers" are most favourable to the simultaneous pursuit of high employment and price stability. The EMS is not yet a currency area in the sense understood here, since its members change the relative values of their currencies from time to time and exchange controls in France, Italy, Belgium and Ireland prevent complete convertibility. However, the ambition expressed by political leaders is that the EMS should eventually become a currency area. The UK can join such an area or remain independent. Is the UK by itself a closer approximation to an optimal currency area than the UK combined with the existing full EMS membership?

The two most influential contributions to the literature on optimum currency areas date from the early 1960s, although the subject was foreshadowed by Meade in a 1957 paper which included a section on the "integration approach" to intra-European payments imbalances. (R. A. Mundell 'A theory of optimum currency areas' American Economic Review 1961, R. I. McKinnon 'Optimum currency areas' American Economic Review 1983 and J. E. Meade 'The balance of payments problems of a European free trade area' Economic Journal 1957.) Both contributions recognised that participation in a currency area confers large benefits to economic agents in terms of simplicity of the payments mechanism and ease of financial flows. But Mundell pointed out that such gains might be offset by a loss of price and wage flexibility between regions with limited factor mobility. If such regions suffered from an adverse demand shift which caused unemployment and they were members of a currency area, they would be precluded from varying the exchange rate to promote the demand for their exports and so for their labour; if they were autonomous currency areas, exchange rate depreciation could counteract the demand shift and help restore the original level of employment. In other words, the damage from barriers to factor mobility should be neutralised by the establishment of separate currency areas. An optimum currency area is characterised by factor mobility within itself and factor immobility with other currency areas.

McKinnon emphasised the importance of the size of the traded sector in the economy. In an economy with a high ratio of traded to non-traded goods, demand management policy should be effective in curing payments imbalances because a small change in demand impacts powerfully on the large traded goods sector. By contrast, demand management is not so suitable an instrument in an economy with a low ratio of traded to non-traded goods since much of any change in demand hits the non-traded sector with only limited effect on the balance of payments. For such an economy variations in the exchange rate are a more attractive means of restoring payments equilibrium. An implication of McKinnon's argument is that large countries, which typically have low ratios of traded to non-traded goods, are more likely to be optimum currency areas than small. This agrees with the real world, in which small countries often have a fixed exchange rate with large neighbours, but to some extent conflicts with Mundell. The Mundell idea would on occasion justify the Balkanization of large countries to create new wage and price flexibility between regions suffering from factor immobility. However, the work of Mundell and McKinnon suggests two conditions for the success of a country's accession to a currency area. These two conditions are:

1. The country should enjoy considerable factor mobility with other participant countries. Capital and labour should be able to move easily across political frontiers, not only because of geographical proximity but also because of the absence of politically-imposed restrictions such as exchange controls. It should be noted that some factors of production, notably natural resources (e.g. oil reserves), are intrinsically immobile.

2. The country should trade a substantial proportion of its output with other participant countries. Free movement of goods, facilitiated by the complete removal of tariff and non-tariff barriers to trade, would obviously promote this end.

ii. Capital market integration and the relevant notion of policy convergence

A few further remarks are in order. Exchange rate misalignments, and the associated payments imbalances, can be eliminated in two ways. Relative domestic price levels of the countries concerned can adjust to inappropriate exchange rates; or exchange rates can adjust to inappropriate relative domestic price levels. It is true, as a general statement, that economists prefer exchange rate adjustments because they are painless in themselves, while changes in domestic price levels can require underemployment of resources. However, there are differences of emphasis. Those who believe that the domestic price level responds quickly to resource underemployment should be - and usually are - more sympathetic to exchange rate fixity than those who believe that prices suffer from inertia in the face of changing market conditions. There is a wider message here. If the UK economy was flexible and adaptable, with resources moving with little friction from declining to expanding industries, anxieties about full EMS membership would be less. The 1978 majority view against membership may therefore be interpreted as symptomising widespread scepticism about the degree of resource mobility in the UK economy.

The discussion about optimum currency areas is undoubtedly helpful in assessing the merits of the UK's full participation in the EMS. In particular, the Mundell/McKinnon work highlights the role of factor mobility in enhancing the viability of a currency area. But there is an important extension which their approaches overlook. Free movement of capital between European countries would be beneficial not only because it would be associated with easier rectification of exchange rate misalignments than currently prevails, but also because it would create an integrated capital market. One of the advantages enjoyed by American companies in international competition is the size of their domestic capital market. This enables them to have larger capital issues than their European counterparts, facilitating investments which exploit more fully economies of scale. While European capital markets remain fragmented on a national basis, European countries will constantly be struggling against bigger and more flexible American rivals. Of course, a key precondition for the emergence of an integrated capital market is the removal of exchange controls in all European countries. If this were combined with fixed exchange rates fixity between currencies, European companies would have access to a more substantial savings pool. Moreover, the equalisation of marginal rates of return on investments throughout the EEC - which would clearly be promoted by capital market integration - is desirable on the usual optimality criteria recognised by economists.

Indeed, it has been argued that the absence of balance-of-payments problems between the regions of the USA is a consequence of the integrated capital market. On this view, the same result would be achieved in Europe if capital markets were integrated and exchange controls removed. In that event, "The entire stock of securities held by a nation's banking system (or other financial institutions) becomes a potential source of foreign exchange to settle a deficit". (J. C. Ingram 'State and regional payments mechanisms' Quarterly Journal of Economics 1959.) Although this argument has force, an important caveat has to be noted. A country can have a payments deficit because its public sector and/or its private sector are incurring debts abroad. In the case of private sector cross-frontier debts, the failure of borrowers to repay is a matter for settlement between the parties. This may create work for bankruptcy lawyers, but should not concern policy-makers. The position is the same as with bad debts between agents in one country. Public sector borrowing is, however, rather different because the failure of one European government to honour its debts to the citizens of another European country would be unacceptable. While several independent European governments exist the possibility of intra-European payments disequilibria and the associated need for policy adjustment remain. In the USA no such possibility arises because there is only one government. One implication deserves emphasis: it is that payments disequilibria in an European currency area could not be a serious cause for concern if all the governments involved either balanced their budgets or ran budget deficits so small that their national debts were growing more slowly than Europe's money gross domestic product. This suggests that the most important aspect of policy convergence is the equalisation, at a low level, of budget deficit/g.d.p. ratios in EMS countries.

Two conclusions emerge.

1. Abolition of exchange controls in all EMS countries would ease the solution of intra-European payments imbalance, contribute to the creation of an integrated capital market and so strengthen the currency area.

2. Harmonisation of fiscal policies would be the most valuable form of policy convergence within the EEC. There is no need for anxiety about payments deficts between the private sectors of the various countries.

Their relevance to the UK is straightforward. The benefits of full EMS membership will be greater the more exchange controls are relaxed within the system and the more fiscal policies are conducted with uniform responsibility throughout the EEC.

II Answers to Questions asked by the Committee

1. In general do you favour British full membership of the EMS or not?

As the transitional problems of full EMS membership are less now than they would have been in the late 1970s, adjustment costs on entry are not such a serious difficulty. However, the theory of optimum currency areas suggests that the UK remains the least suitable member. Factor mobility between the UK and other EMS countries is less than that between the other EMS countries; the ratio of European trade to total trade is also lower for Britain than for other EMS members.

There is a further issue. Oil is an immobile natural resource, of considerable importance to our international trade. If it had not been for the miners' strike, the surplus on oil trade last year would have been almost £10b., equivalent to about 3% of g.d.p. Future changes in the oil price will require, if a satisfactory balance-of-payment position is to be maintained, offsetting changes in the value of non-oil imports and exports. This will necessitate some shifting of resources from non-tradeable goods production to non-oil tradeable goods production. Given the degree of factor immobility within the UK, the option to vary the exchange rate would be helpful. Exchange rate variations cause changes in the relative prices of tradeables and non-tradeables, and so ease resource movement and the process of balance-of-payments adjustment.

Since 1978 the interaction between oil and the structure of the economy has been an important subject, with highly charged political undertones. The appreciation of the exchange rate until early 1981 was damaging to non-oil tradeables (i.e., manufacturing industry) and beneficial to non-tradeables (i.e. services, some parts of construction); its depreciation since then has reversed the pattern to some extent. So there has been undesired economic disturbance even when the exchange rate has been allowed to perform its signalling function. (The debates about de-industrialisation and the North/South divide reflect this.) The problem of moving, say, 2% of g.d.p. into improving the non-oil trade balance would be intensified if the exchange rate against major trading partners could not be altered. The conclusion must be that Britain's oil dependence could make full EMS membership, without the opportunity to change the exchange rate, highly uncomfortable.

Of course, the UK could participate in the EMS with either a wide permitted band for exchange rate fluctuation (similar to Italy's arrangement) or occasional large exchange rate realignments, due to oil price or other changes. (Six major realignments of central rates have occurred since 1979, with the last in March 1983.) But, if the EMS is to be merely a method for effecting exchange rate changes through infrequent, large and officially-managed steps instead of frequent, small and market-determined steps, it is hard to see that full membership for the UK would represent significant progress on the current position. The position might, nevertheless, be changed radically for the better if full membership was accompanied by major advances within the EMS itself. Exchange control abolition and harmonisation of financial regulations are the key areas here.

The UK is quite clearly the least appropriate member of the EMS. The UK combined with the existing EMS countries is less obviously an optimum currency area than the existing EMS group by themselves. This is, however, not a decisive case against full membership since political considerations also need to be remembered. Perhaps the most important point here is that the EMS imposes a constraint on financially irresponsible governments because devaluation against the deutschemark is regarded as symptomatic of policy failure. For historical reasons, this would be particularly so in the UK if it joined. If financial control appears to be breaking down because the Cabinet is in open rebellion against the medium-term financial strategy, Treasury ministers might sensibly advocate full participation in the EMS. Rightly or wrongly, spending ministers are more likely to be intimidated by the threat of sterling devaluation against the deutschemark than they are by news of another sterling M3 overshoot.

In essence, then, full membership of the EMS still seems to have no obvious substantial advantages on economic grounds. Given the strength of opposition to sound financial policies in this country, it might nevertheless be a good idea on political grounds. It should be emphasised that the economic case for full participation in the EMS would be transformed - and transformed very favourably - if this were to be part of a larger attempt to establish an integrated European capital market. (See answer to questions 10 and 15.)

A The EMS 1979-85.

2. What do you see as the major role of the EMS?

It is not clear that the limited degree of exchange rate stability achieved within the EMS has given worthwhile advantages to the member countries. The main original motivation of the West German authorities was to spread the supposed strain from a depreciating dollar to other European countries. This may sound curious today, but it is nevertheless true. In 1978 Emminger, the then president of the Bundesbank, saw the first "driving force" behind a European currency zone as "an attempt to shield the EC area against the untoward effects of the vagaries of the dollar". (Quoted in S.A.B. Page 1 'The Development of the EMS', National Institute Economic Review November 1982, p. 55.) Whether the West German authorities believe that the vagaries of the dollar have diminished since 1979 seems doubtful. The Bundesbank intervened in the deutschemark/dollar market in 1984, selling dollars to the value of 23,158m. deutschemarks, and in the first quarter of 1985 to the value of 13,400m. deutschemarks. (See Report of the Deutsche Bundesbank for the year 1984, p.67.)

There seems to have been no evident benefit to trade or financial flows. The average annual growth of intra-European trade was slower in the five years after 1979 than in the decade before it. Because of the persistence of exchange controls in four EMS participants (among other reasons), no worthwhile progress has been made towards an integrated capital market. It should be emphasised that exchange controls interfere with trade. The expectation of exchange rate changes undoubtedly continues within the EMS, as evidenced by the wide dispersion of Eurodollar interest rates (see Table 1 below), and companies must want to hedge future commitments in forward exchange markets. But exchange controls hinder the development of such markets. (Some observers have praised the Banque de Frances tactics in overwhelming speculators "against" the franc by, on occasions, driving up Euro-franc rates to 2,000 per cent or more. They do not seem to understand that behaviour of this kind makes the Euro-franc market useless for significant commercial transactions since banks are not prepared to take positions against a powerful, artbitrary and spiteful operator.)

Table 1 Euro-currency interest rates for the main EMS members

Market closing rates in % on 24th May, 1985

	D-mark	Dutch guilder	Belgian franc (financial)	Danish krone	French franc	Italian lira
7 days	$5\frac{5}{8} - 5\frac{3}{4}$	$7\frac{1}{16} - 7\frac{5}{16}$	$9\frac{1}{8} - 9\frac{1}{4}$	$9\frac{1}{4} - 9\frac{3}{4}$	$10\frac{1}{16} - 10\frac{3}{16}$	$11\frac{1}{2} - 13$
3 months	$5\frac{5}{8} - 5\frac{3}{4}$	$6\frac{15}{16} - 7\frac{1}{16}$	$9 - 9\frac{1}{4}$	$8\frac{7}{8} - 9\frac{3}{8}$	$10\frac{3}{16} - 10\frac{5}{16}$	$13 - 13\frac{1}{2}$
1 year	$5\frac{3}{4} - 5\frac{7}{8}$	$6\frac{7}{8} - 7\frac{1}{8}$	$9\frac{3}{8} - 9\frac{5}{8}$	$9\frac{3}{8} - 9\frac{7}{8}$	$10\frac{11}{16} - 10\frac{13}{16}$	$14 - 14\frac{3}{8}$

Source: The Financial Times

The interest rate differentials indicate that the foreign exchanges expect the guilder to depreciate, over the next year, by 1.1% against the deutschemark; the financial Belgium franc by 3.4%; the Danish krone by 3.5%; the French franc by 4.5%; and the Italian lira by 7.3%.

The main benefits of the EMS for its existing membership seem to have been twofold:

1. Fluctuations in real exchange rates may have been lower than would otherwise have been the case. This statement is not demonstrated rigorously here, but seems plausible. As a result, production and investment decisions (e.g. the location of new factories and warehouses) may have been more rational.

2. The need to watch their exchange rates with the deutschemark may have caused macroeconomic policy in France, Italy and some of the smaller countries to be more responsible. Again the statement cannot be proved rigorously, but concern about currency weakness within the EMS is often mentioned in the various countries as justification for measures to reduce the budget deficit or raise interest rates.

The first of these benefits is not easy to quantify; the second is of no relevance to the UK at present since it has its own domestically-imposed financial guidelines (i.e., the money supply and PSBR targets in the medium-term financial strategy).

3. How successful has the EMS been in reducing fluctuations in European exchange rates either within the Exchange Rate Mechanism or between member currencies and the US dollar?

The Bank of England has given the answer to this question for the period April 1979 - December 1982 in its article 'The variability of exchange rates: measurement and effects' in its September 1984 Quarterly Bulletin and can presumably update the exercise to early 1985.

A surprising result of the September 1984 study is that exchange rate variability between both Exchange Rate Mechanism currencies and the three major non-ERM currencies (i.e., dollar, yen, sterling) declined after the establishment of the EMS. It is not immediately obvious why there should have been diminished variability in the three cross-rates between the dollar, yen and sterling.

4. What evidence is there to suggest that currency instability has impeded trade and capital flows?

This is a difficult question which can only be handled by sophisticated statistical techniques. The September 1984 Bank of England study is obviously relevant. The International Monetary Fund also published a reseach paper on the subject last year.

Nevertheless, a crude exercise - comparing the growth of intra-EEC trade by the UK, West Germany and France since the formation of the EMS - is interesting. It shows that Britain's trade with other EEC countries grew faster than West Germany's or France's between 1978 and 1984, despite the UK's abstention from the ERM.

Table 2 Trade with other EEC countries by three members with the largest economies

all figs. in $m., monthly averages

	UK		West Germany		France	
	Exports	Imports	Exports	Imports	Exports	Imports
1978	2,256	2,653	5,434	4,977	3,347	3,502
1979	3,162	3,694	6,899	6,423	4,313	4,461
1980	4,037	4,033	7,679	7,208	4,720	5,164
1981	3,569	3,628	6,848	6,461	4,066	4,531
1982	3,372	3,684	7,030	6,217	3,751	4,563
1983	3,352	3,805	6,767	6,247	3,736	4,353
1984	3,515	3,920	6,812	6,102	3,795	4,339
% change 1978-84	+55.8	+47.8	+25.4	+25.5	+13.4	+23.9

Source: OECD Monthly Statistics of Foreign Trade

5. To what extent have member states' economies shown signs of convergence?

Participants in the EMS's exchange rate mechanism have had widely divergent inflation and balance-of-payments performances since 1979. Table 3 below, using a simple measure of the dispersion of these two variables among the ERM countries (excluding Luxembourg), suggests increased divergence after the establishment of the EMS. The standard deviation of inflation rates and current account imbalance/g.d.p. ratios in the ERM countries was higher in the five years, 1979-1983, than in the five years, 1974-78.

In the preliminary discussion it was argued that harmonisation of fiscal policy - measured by the narrowing of differences in the budget deficit/g.d.p. ratios in the ERM countries - is the key aspect of policy convergence. Once again a simple measurement of fiscal policy, the standard deviation of budget deficit/g.d.p. ratios in six of the ERM's eight members, indicates increased divergence. Indeed, the heightened contrast between the fiscal responsibility of West Germany, the relative responsibility of France and the Netherlands and the irresponsibility of Italy, Belgium and Denmark may help to explain the widening disparity in inflation and balance-of-payments performance. (Figures on the general government financial balance are not given for Ireland and Luxembourg in the OECD's Economic Outlook.)

Table 3 Dispersion of inflation and balance-of-payments performances in ERM countries

1. Current account position as percentage of g.d.p.

	Average of ERM countries	Standard deviation of ERM countries
Before EMS		
1974	-2.0	4.2
1975	0.0	1.2
1976	-1.3	2.8
1977	-1.3	2.4
1978	-1.1	2.9
After EMS		
1979	-3.0	4.7
1980	-3.9	3.5
1981	-3.7	5.0
1982	-2.8	4.0
1983	-1.1	2.7

Average value of standard deviations before EMS 2.7
" " " " after " 3.6

2. Increase in consumer prices (%)

	Average of ERM countries	Standard deviation of ERM countries
Before EMS		
1974	13.5	3.9
1975	12.6	4.6
1976	10.8	4.5
1977	9.8	4.2
1978	7.2	3.2
After EMS		
1979	8.8	4.2
1980	12.0	5.7
1981	12.0	5.2
1982	10.8	4.4
1983	7.9	3.8

Average value of standard deviations before EMS 4.1
" " " " after " 4.7

Sources for data: OECD Economic Outlook December 1984, Tables R5 and R10, and L. Messel & Co. estimates.

Luxembourg has been excluded from the countries in the calculation because it consistently runs a large current account surplus (of 20% or more of g.d.p.), which would distort the first part of the table, and its inflation rate is virtually identical to Belgium's, which would distort the second part.

Table 4 General government financial balances as share of nominal GNP/GDP (%) in ERM countries

	1979	1980	1981	1982	1983	1984*
Germany	-2.7	-3.2	-3.8	-3.4	-2.7	-1.7
France	-0.7	+0.2	-1.8	-2.5	-3.4	-3.5
Italy	-9.5	-8.0	-11.9	-12.7	-11.8	-13.5
Belgium	-7.0	-8.6	-14.1	-12.7	-13.4	-11.2
Denmark	-1.9	-3.3	-6.9	-9.3	-7.7	-4.9
Netherlands	-4.0	-3.9	-5.3	-7.0	-6.4	-5.9
Average of 6 ERM countries	-4.3	-4.5	-7.3	-7.9	-7.6	-6.8
Standard deviation of 6 ERM countries	3.0	3.0	4.4	4.0	4.0	4.2

Source: OECD Economic Outlook December 1984, Table 2 and L. Messel & Co. estimates.

It follows that the ERM member countries must have been able, to a large extent, to pursue independent economic policies. But a qualification must be made. In the absence of the EMS, the divergence between policies in the various countries may have been even greater than it actually was. To suggest that increased divergence after March 1979 was caused by the EMS is obviously unjustified.

6. Have there been any significant changes in the way in which the EMS has operated, and what further changes are desirable?

No major changes in the method of operation have occurred in the EMS since 1979, although the absence of a major exchange rate realignment since March 1983 is notable.

Intervention tactics and the responsiveness of interest rates to exchange rate pressures are important subjects, but they cannot be dealt with effectively in a few paragraphs. As expected, the Bundesbank has become the lynchpin of the system and lends deutschemarks to other member central banks when their currencies are weak. Market awareness of the Bundesbank's preparedness to act in this way has discouraged speculation. In 1984 Bundesbank intervention to protect the existing EMS exchange rates amounted to only 3,637m. deutschemarks. (See Report of the Deutsche Bundesbank for the Year 1984, p.67. The 3,637m. deutschemark figure includes intervention by other central banks where they affect the external position of the Bundesbank.)

The big disappointment is that there have been no significant moves towards easing exchange controls. This disappointment is felt keenly by the Bundesbank. In its 1984 Report it refers specifically to the continuing two-tier exchange market system in Belgium and is critical of the lack of progress on exchange restrictions throughout the EMS. It says, "the liberalisation of financial transactions in the member countries of the system has made practically no progress. In recent years, indeed, new restrictions on foreign exchange and capital movements have been introduced and some of them are still in force." (p.68)

There is a possibility that the existence of the EMS has delayed exchange control relaxation and capital market integration. It arises because governments may have been tempted to buttress a weak exchange rate against the deutschemark by imposing new restrictions on foreign exchange and cross-frontier capital transactions. The potential loss of economic efficiency from such retrograde steps must be balanced against gains in other areas.

7. What has been the role of the ECU and how do you think the ECU's role will develop in the short- to medium-term future?

The ECU's prospects have been rather exaggerated, partly because the emergence of an ECU-denominated bond market suggests that the private sector has a genuine commercial interest in the unit. In fact, the purpose of issuing ECU-denominated bonds is largely to evade central bank restrictions on bond issuance in particular currencies. For example, the Bundesbank has until recently required that deutschemark bond issues be managed by German institutions and the Bank of England continues to operate a queuing system for sterling bond issues. Non-bank holdings of ECU deposits are trivial at about $1½b., with a considerable part of this sum accounted for by the balances of EEC institutions. (This contrasts with total non-bank Eurocurrency deposits of over $600b.)

The main function of the ECU is to act as a generally acceptable unit of account - and, to some extent, as a means of settling debts - within the EEC, without damaging the amour propre of particular countries. It should be emphasised that the retention of exchange controls reduces the tradeability of several ECU currencies. As the Bundesbank notes in its latest Report, "the ECU combines currencies of widely differing quality".

8. Are the obligations on debtors and creditors in the ERM symmetrical?

Under existing EMS rules creditor central banks are obliged to accept only up to 50 per cent of their net claims in ECUs in settlement operations with debtor central banks. The obligations on debtors are therefore not symmetrical. (This state of affairs has a simple rationale. The ECU contains lira, francs and sterling as well as deutschemarks. The Bundesbank is not prepared, since it is almost invariably the main creditor institution, to have deutschemark obligations covered - except to a limited extent - by payments in these other currencies. Its views on their "quality" have been made clear in the anwser to question 7.)

Trade surpluses and deficits are not necessarily indicative of macroeconomic imbalance. Indeed, a country with a high marginal rate of return on capital compared to neighbouring countries should be a capital importer. The counterpart to the capital account surplus will be a current account deficit, including almost certainly a deficit on trade. The current account deficit can be extremely large as a proportion of g.d.p., without any problems emerging, if the capital-importing country is content to see part of its capital stock in foreign hands and its growth rate is high enough to service the foreign-owned capital without difficulty. South Korea, Singapore and Hong Kong have all had substantial current account imbalances during their hyper-growth period. Within the USA it is likely that capital imports into the South-West and the West Coast have been substantial in the last twenty years. In view of the wide disparities in wage and profit levels in the EEC, there must be considerable scope for efficiency-improving capital flows. The abolition of exchange controls and capital market integration might encourage more such flows between the private sectors of member countries, causing larger trade and current account imbalances than at present observed.

However, the existing pattern of current account imbalances seems instead to reflect the contrasting fiscal positions of the various countries. Capital flows are not, therefore, motivated by private sector attempts to search out the most profitable opportunities within a unified currency area, but by judgements about the ability of taxpayers in countries with large budget deficits to honour commitments to savers in countries with low budget deficits. The answer to question 5 shows that the situation has not been significantly changed by the establishment of the EMS.

B The EMS and the UK

Several of the answers to the questions in this section are contained in the answer to question 1. Where there is little further to say, the question will be answered only briefly. Questions 10 and 15, and questions 13 and 14, will be answered together.

9. To what extent have the reasons given for not joining in 1978 been borne out by subsequent events?

The concern about transitional adjustment costs has been fully justified. Reducing inflation to 5 per cent has been very expensive in terms of lost output and employment. However, an important related issue - the impact of oil on the balance of payments and the UK's economic structure - was not properly recognised in late 1978. This was understandable as oil was less valuable before the second oil shock in 1979 and 1980 than it has subsequently been.

It is not possible to say whether the output and employment costs of inflation reduction would have been greater under the discipline (such as it might have been) imposed by the EMS than under the discipline (such as it is) imposed by the medium-term financial strategy.

10. What advantages have the UK gained from membership of the EMS and what advantages and disadvantages would arise from full membership of the ERM?

15. Can the ERM function with both the pound and the deutschemark as participants?

It will be assumed, in answering these two questions, that Britain's membership in the ERM is meaningful. In other words, the intention is to maintain a relatively stable exchange rate between the pound and the deutschemark. The maximum permitted fluctuation between the two currencies might be rather more than indicated by the divergence threshold between the existing ERM members, in recognition of the UK's oil-supported economic structure. It will also be assumed that both the UK and West Germany avoid exchange controls. (The discussion would be similar in character, but with more participants, if France, Italy and other countries scrapped their exchange restrictions. As the Netherlands and Denmark do not have exchange controls, "Germany" should be interpreted as West Germany, the Netherlands and Denmark combined.)

The promise of a stable exchange rate should cause the virtual elimination of an interest rate differential between the pound and the deutschemark; the absence of exchange controls should stimulate capital flows between the UK and Germany to take advantage of differences in the rate of interest paid to savers and in the rate of return on investment. The capital flows would pass through the banking system, stock markets and other channels (e.g. direct investment by companies). The efficiency gains from the amalgamation of the two nations' savings and investment mechanisms could be extremely large.

However, there are problems, most of them arising from differences in financial regulations, tax arrangements, and legal and accounting standards. In principle, the absence of exchange controls should make it easy for a bank in Britain to lend deutschemarks to a company in Germany and to take deutschemark deposits from German residents. In practice, it is unclear that the Bundesbank would like these developments. It imposes more onerous reserve requirements of deutschemark bank intermediation in West Germany than the Bank of England imposes on sterling bank intermediation in Britain. It is also less flexible about the provision of rediscounting facilities to new foreign entrants to banking than it ought to be. It interferes in the bond market, particularly when bonds are to be issued by foreign entities. The lack of a tradition of self-regulation, which is well-established in the City of London, may explain the contrast between the Bundesbank's approach and the Bank of England's. But the Bundesbank's probable hesitation about a harmonisation of regulatory systems is not the only obstacle to a fully integrated capital market. Also relevant are German restrictions on the operations of insurance companies and building societies.

There is much more to say, but the central thrust of the argument may already be obvious. Britain at present has the most liberal, flexible and efficient financial system in Europe. It would therefore have more to gain from capital market integration than Germany, although both countries could benefit enormously from easier cross-frontier flows of savings and investment. An implication is that, if the UK were to join the ERM, it should bargain for a relaxation of restrictions on its exports of financial services. In Germany the restrictions are mostly administrative and prudential in character; in the rest of the EMS

they take this form as well, but exchange controls are more important. It could be mentioned to other European governments and banking authorities that savers are already "voting with their feet". An increasing proportion of financial intermediation takes place in the offshore markets, free from many of the regulations applicable to onshore markets. Much of the legal, accounting and transactions work required for so-called "offshore intermediation" is actually conducted in London. This pattern will continue unless the existing EMS member governments ease the panoply of controls, restrictions and interferences they now regard - for reasons best known to themselves - as necessary.

One final point should be made. It is a logical development of the preceeding argument. If ERM membership for the UK would require our financial system to adjust to European standards (of over-regulation), rather than ERM countries' financial systems to liberalise in the British manner, the UK should stay out of the ERM.

11. What modifications, if any, would have to be made to the ERM, to make British entry feasible and economically and politically acceptable to the UK and to member states?

Because of the oil problem, the UK should have a wider permitted band for exchange rate fluctuation than other ERM countries. The Italian arrangement is the obvious precedent.

12. What would be the appropriate rate of exchange for the pound against the ECU and on what principles would it be determined?

Britain's bilateral trade position with the rest of the EMS is of no direct relevance to the correct setting of the exchange rate between the pound and other EMS currencies. A trade deficit with EMS partners may be offset by a surplus with other countries. Even if it is not so offset, it may not be symptomatic of the excess supply of sterling which alone can undermine the pound/deutschemark exchange rate. An excess supply of sterling is most likely to result from a mismatch between UK and European monetary policies.

13. How would the pound's rate within the ERM be fixed and how much influence would the UK and the other members have in determining it?

14. What constraints would full participation place on domestic monetary and fiscal policy?

If the UK joined the ERM and was determined to avoid a devaluation against the deutschemark, macroeconomic policy would have to be co-ordinated with that in Germany. An independent financial strategy, whether short-term, medium-term or long-term, could no longer be pursued. However, control of the PSBR and the monetary aggregates would certainly still be necessary. The government might quantify the targets it deemed appropriate for stability of the pound/deutschemark exchange rate and these targets might on occasion trigger short-run policy adjustments. (Both this and the previous answers have taken the pound/deutschemark exchange rate as the lynchpin of the ERM for the UK if we joined. Strictly speaking, the central rate against the ECU is supposed to determine intervention decisions and subsequent policy moves. But the deutschemark has the largest weight of any single component in the ECU and, in reality, it is the EMS's key currency.)

16. Does the UK have to become a member of the ERM to enable a European "dollar policy" to be formulated and implemented?

The notion of a European "dollar policy" is fantasy after the events of the last few years. In effect the markets and central banks (mostly the Bundesbank) decide what the deutschemark/dollar exchange rate should be and the EMS arrangements decide the associated franc/dollar, lira/dollar and other exchange rates.

Existing agreements about sharing the obligation to intervene to affect the dollar cross-rates could be extended. But - as was pointed out in the author's evidence to the 1978 inquiry - there is a lack of obvious criteria for deciding how much of its reserves each central bank should have to commit. This problem is more serious for the Bank of England than for other European central banks, apart from the Bundesbank, because the pound/dollar market is deep and active.

17. What are the arguments for setting targets on the exchange rate as opposed to sterling M3 or the PSBR?

In one member of a currency union macroeconomic policy is directed towards exchange rate stability; in an independent currency area it should be guided instead by targets for the money supply and the PSBR.

In other words, this question reduces to the issue discussed at the outset, "is Britain by itself a closer approximation to an optimum currency area than the UK and the existing full EMS membership in combination?". The conclusion, in broad terms, was that an enlarged ERM, with the UK as a full member of the EMS, would move closer to an optimum currency area if four conditions were more fully satisfied:

1. Increased mobility of labour and capital within the EMS, with complete exchange control abolition as the most important single step to achieve this.

2. Increased trade between EMS member countries leading to higher ratios of trade to national output.

3. Strengthened capital market integration.

4. Macroeconomic policy convergence, in particular the restoration of balanced budgets or the harmonisation of budget deficit/g.d.p. ratios at low levels throughout the EMS area.

12th June, 1985

Tim Congdon

J.D. Lloyd R.A. Seligman D.H. Hunter P.D.H. Oswald J.G.S. Coode-Adams K.W. Wright, F.I.A. M. Cannon Brookes J.S.A. Cecil C.S. Elliott J.D. Carr M.J. Whittles N. Wood
N.F. Barns D.B. Wotton J.Matheson, F.C.A. A.N. Haddon G.I. Bowman O. Gates J.H. Mullett P.M. Thomas P. Kelly R.C. Boxhall, F.C.A. R.G. Fearn P.W. Kane
M.B. Del Mar P.L. Jones T.G. Congdon D.D.B. Carleton Paget O.R. Clarke M.A.B. Donati, F.C.A. R.C. Goodwin K.I. Hodgkinson J.L. Hunter K.P. Windsor E.G. Abbott
D.R. Baggs, F.C.A. A.G. Thom, C.A. O.R. Backhouse, F.C.A. C.A. Wood D.H. Newton, F.I.A. N.P. Coombes, F.C.A. N.J.F. Forde P.D. Shaw, F.C.A. J.N. Thornley E.G. Dunnoos C.J. Preen D.L. Tyler Sir S. Le Marchant

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PRIME MINISTER

27 September 1985

SHOULD WE JOIN THE EUROPEAN EXCHANGE RATE MECHANISM?

Brian Griffiths and I are sceptical of the Treasury's case for joining the ERM. They need to offer convincing answers to the following questions.

Why should this financial rule prove to be the true guiding light, any more than the other targets we have picked so far?

We doubt if there is any one financial or monetary indicator which is so good a guide to policy that you can follow it even if all other indicators are pointing in a different direction. Indeed, the Chancellor envisages keeping our monetary targets, which may tell a different story from the exchange rate. Imagine that the inflation rate is coming down, the PSBR is under control and domestic financial conditions look sound but, because of some outside shock, the £/DM rate is weakening. Would you be prepared to see interest rates rise, or to spend the Reserves, in such circumstances?

What will we have to do to maintain Deutschmark parity?

The Chancellor rightly and honestly says that joining the ERM is not an easy option. But how frequently does he think

we will have to move interest rates, and by how much, so as to keep within the mechanism? Will we be drawn into wasting large amounts of the Reserves to defend any given parity, with the speculators enjoying rich pickings if they succeed in driving us off parity? And there might be domestic political pressure to impose capital controls to defend the rate - as, for example, the French do.

Aren't the UK and Germany very different economies?

If God had intended us to join the Exchange Rate Mechanism, we would be as productive and as moderate in our wage demands as the Germans. The Chancellor may argue that putting us into a German monetary framework will make us behave like Germans (the exchange rate may be a better discipline for wage bargainers than Sterling M_3). But if the two economies differ deeply, then changes in the exchange rate between them are legitimate and normal ways of adjusting for that different performance. The opposite effect of oil price changes on Britain and Germany is just the most vivid example of the difficulty of yoking our two economies together.

Applause now and tears later?

One of the Chancellor's cleverest arguments is that the moaning industrialists want us to join the EMS. Next time we need to raise interest rates, he can point out that it

has to be done to stay within the ERM - which, after all, was what they wanted. That is logical, but will it actually make rises in interest rates less politically painful? Will the average home-owner happily accept a rise in his mortgage rate once he knows its purpose is to maintain the pound's value against the German Mark?

Will the Europeans want us in?

Joining the ERM would change it fundamentally from a Deutschmark system to a bipolar monetary system. Are the Germans and the French prepared to contemplate this?

Is Germany so stable?

The assumption on which all these arguments for the ERM rests is that, whatever vagaries and uncertainties afflict us, Germany carries on for ever. But the Kohl Government is getting a heavy buffeting. There will be an Election in January 1987, and the SPD - which is less moderate than in Helmut Schmidt's day - is ahead in the polls. It would be a final irony if we found we had linked our financial policy to that of an irresponsible Socialist Government.

David Willetts

DAVID WILLETTS

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PN

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Draft - for 3 up only

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for my folder please.

DRN

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

27 September 1985

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David

ERM

... I attach a joint paper by the Treasury and the Bank for discussion at the Prime Minister's seminar on Monday. The papers for the last seminar in February are of course still relevant.

I am copying this to Len Appleyard (Foreign Office) and John Bartlett (Bank of England).

Yours ever
Rachel.

RACHEL LOMAX
Principal Private Secretary

SECRET

STERLING AND THE EUROPEAN RATE MECHANISM

(Joint Note by Treasury and Bank of England)

Introduction

The public stance of the Government has consistently been that sterling would join the Exchange Rate Mechanism (ERM) when the time was right. Answering Dr Owen on 31 January this year in the House of Commons, the Prime Minister said:

> "We have always said that we shall join the exchange rate mechanism of the EMS when we believe that the time is appropriate. It is kept under review from time to time, but I must make one thing clear. Joining the EMS would not obviate increases in interest rates, it would not obviate the need for financial discipline and, indeed, it might increase it."

2. The subject was last reviewed with the Prime Minister on 13 February and the papers for that seminar are still relevant.

3. Circumstances have changed since February. When we last discussed the question, the dollar had risen sharply. Sterling had fallen not only against the dollar but also against European currencies, reflecting market doubts about the Government's commitment to its counter-inflation strategy. UK interest rates had been forced up sharply.

4. Inflation is now falling. There is a good chance that we will do even better than the Budget forecast of 4½% inflation by mid-1986 and this view is gaining widespread acceptance. Monetary conditions, are consistent with lower inflation. We have pursued a cautious policy towards interest rate reductions. Since 13 February, the pound has risen by 7% against the DM and 32½% against the dollar.

Reinforcing the Strategy

5. In spite of sterling's strength, and the much improved outlook for inflation, we have run into difficulties over the operation and exposition of the Government's financial strategy. Though we may receive credit for the results of our policy, this is offset by criticism of the way in which we operate it.

6. The background of currency upheavals, the removal of controls at home and far-reaching changes in the structure of financial markets has meant that the various measures of money have been difficult to interpret. The target measures have been pointing in different directions. For reasons we discussed at the Prime Minister's monetary seminar in July, we have recently had particular difficulty with £M3 - the measure which in the public mind is most closely associated with our monetary strategy. Although there can be no question of doing without the discipline of monetary targets, we have to recognise that the monetary aggregates have, for the present, become a less reliable guide to the conduct of policy.

7. So we have been forced to place increasing emphasis on the exchange rate. We have always acknowledged that, in assessing monetary conditions, the exchange rate has an important role alongside the monetary indicators. There are those who argue that it is wrong to place weight on the exchange rate when movements can reflect changes in monetary conditions in other countries - particularly the US - and other factors, for example, oil prices, that are independent of UK financial conditions. But the exchange rate has a direct impact on the price level and inflationary expectations and sharp movements have often coincided with changes in the market's perception of monetary ease or stringency.

8. In practice, the exchange rate has had a good record of reflecting domestic monetary conditions. Significant changes have usually been a good guide to interest rate decisions - for example in January this year when the monetary aggregates were giving uncertain signals, partly because of the effects of the

BT privatisation on the statistics. Domestic financial markets too have been increasingly influenced by it. It is clear to them what the direction of the interest rate response of a Government committed to low inflation must be, and market interest rates almost always react to sharp exchange rate changes.

9. We have, however, had considerable difficulty in explaining, at any particular time, what weight it has in policy decisions. This has itself become a source of confusion in presenting policy. Markets and commentators continually speculate about the exchange rate level which the Government would like to see; many different exchange rate bands are hinted at. The Chancellor intends to provide a further explanation of the monetary strategy in his Mansion House Speech on 17 October. He will deal with the issues raised at the Prime Minister's seminar on 16 July. But there will still be an inevitable degree of uncertainty in the minds of commentators and the markets.

10. There is a strong case for greater clarity. It would simplify some of the problems of day to day conduct of policy; it would greatly improve the presentation of policy; it would remove fears that we were exercising too much discretion. The discipline of an exchange rate regime is more readily comprehensible than money supply targets on their own. Better public understanding would itself be valuable both politically and in influencing economic behaviour - by reinforcing the discipline of sound money.

11. The only practicable possibility of strengthening and clarifying this part of our policy would be to join the ERM. It would be no soft option. It would mean linking sterling to the DM, the currency of the strongest economy in Europe, which has an inflation rate of little more than 2%.

12. It would be crucial to retain the MTFS. Like the Germans, we would continue to set and pursue monetary targets. We would need to consider further whether it would be right at the time of joining to make any changes in the chosen target aggregates.

13. Our primary objective would remain to keep monetary conditions firmly in a counter-inflationary direction. Although realignments

are permitted within the rules of the system, we would aim to avoid changes, especially in the first year or so, and build credibility in the market. In the event of realignments we would seek to keep in line with the DM. This should ensure that there is no conflict between keeping the exchange rate within ERM limits and reducing inflation.

Impact on Industry

14. Linking sterling to the DM would be of value in reinforcing industry's determination to control its costs. There have been signs that firms are beginning to ease up on this front, following the strong improvement in their profitability. Manufacturing costs have risen much faster than in other major countries over the past year. Recent statements by the CBI and other industry spokesmen about the need for a lower exchange rate have not been helpful. Such statements both unsettle the markets and encourage firms to believe that they will be bailed out by depreciation.

15. Provided we are satisfied with the realism of the exchange rate at which we join and make it clear that the Government's monetary and fiscal stance remains determinedly counter-inflationary, membership of the ERM would be a valuable discipline. Holding to something like the present £/DM exchange rate would reinforce downward pressure on industrial costs and prices. The CBI, Institute of Directors and others who in recent months have come to support our joining the ERM, could hardly argue publicly against this stance. They know that this is the essence of the ERM, and would have no ready excuse if they found that keeping up with the deutschemark was tough going.

Could We Make It Work?

16. There is no way in which we can confidently rule out the possibility of bouts of heavy pressure against sterling in the ERM. They could arise from differential movements into or out of the dollar if that currency were under pressure either way; or from a severe movement of oil prices; or from a weakening

of confidence if our inflation performance seemed to be faltering. Given the scale of financial flows through London, the pressure on us might be very large. And particularly in the early months, the markets might well seek to test our resolve. If so, we would need to demonstrate that resolve.

17. The view that our reserves were inadequate for membership of the ERM was one of the main concerns expressed at the Prime Minister's seminar in February. We still have smaller reserves in relation to our volume of trade, and even more so in relation to our potential exposure to international capital movements, than other countries of the Community. This remains true even though we recently strengthened our reserves substantially by borrowing $2.5 billion on satisfactory terms.

18. We would not want to spend massive reserves, as the French did in late 1982, in defence of the indefensible. We would hope in the first instance to avoid pressure by maintaining the cautious approach to interest rates that we have followed since the beginning of this year. If in spite of this pressures emerged we would hope to recognise the need for policy change in good time and act on that. In such circumstances we would have to be prepared to adjust domestic interest rates vigorously, as indicated by the exchange rate, and maintain them at these levels for as long as necessary.

19. To a considerable extent we follow this approach now outside the ERM. Though at times in the past it might have seemed more sensible to take part of the pressure on the exchange rate (rather than interest rates), recent experience - particularly around the turn of the year - has clearly demonstrated that this option leads to great problems and in practice it now scarcely exists.

20. Our best protection would be our own financial strategy and performance. Some commentators have drawn attention to the UK's failure to live within the "Snake" in 1972. But the UK's relative fiscal and monetary position is now quite different from what it was in 1972; then monetary conditions were easy

and getting easier, and there was a widespread view that the UK authorities wished to see a lower exchange rate. After a period of achieving a track record and consequent credibility in the ERM we could hope to benefit from the reinforcing effects of membership of a mechanism that has been successful in limiting exchange rate variations among European currencies. The fact of being a member could then help to stabilise expectations and to reduce some of the speculative flows.

Who Decides Parities?

21. At the discussion in February there was some concern about the influence of other Community countries over our exchange rate. The constitutional position is that initial parities and any subsequent changes are decided by unanimous judgement of all Community Finance Ministers, who meet for the purpose at "realignment conferences". At these there is often a good deal of argument as to whether X should devalue or Y revalue (the same thing in market terms but different in terms of political presentation), and at the margins about the amounts of any changes (with a tendency for resistance against demands for large changes).

22. At the end of the day it is usual for a compromise to be reached, but in practice an individual country only really loses its freedom of action when that country is seeking special financial assistance, in which case attempts may well be made by others to impose policy conditions - an IMF-type situation. There is certainly an in-built pressure in the system against devaluation. But that is what we would want.

Conclusions

23. We are able now to contemplate joining the ERM from a position of some strength. This is based on our success in reducing inflation. There is widespread acceptance of our determination to continue in that direction and a growing expectation that we shall succeed.

24. We face a period of difficulty over the conduct and presentation of financial policy.

25. Joining the ERM now would reinforce our basic strategy, clarify its operation in some respects and greatly improve its public presentation.

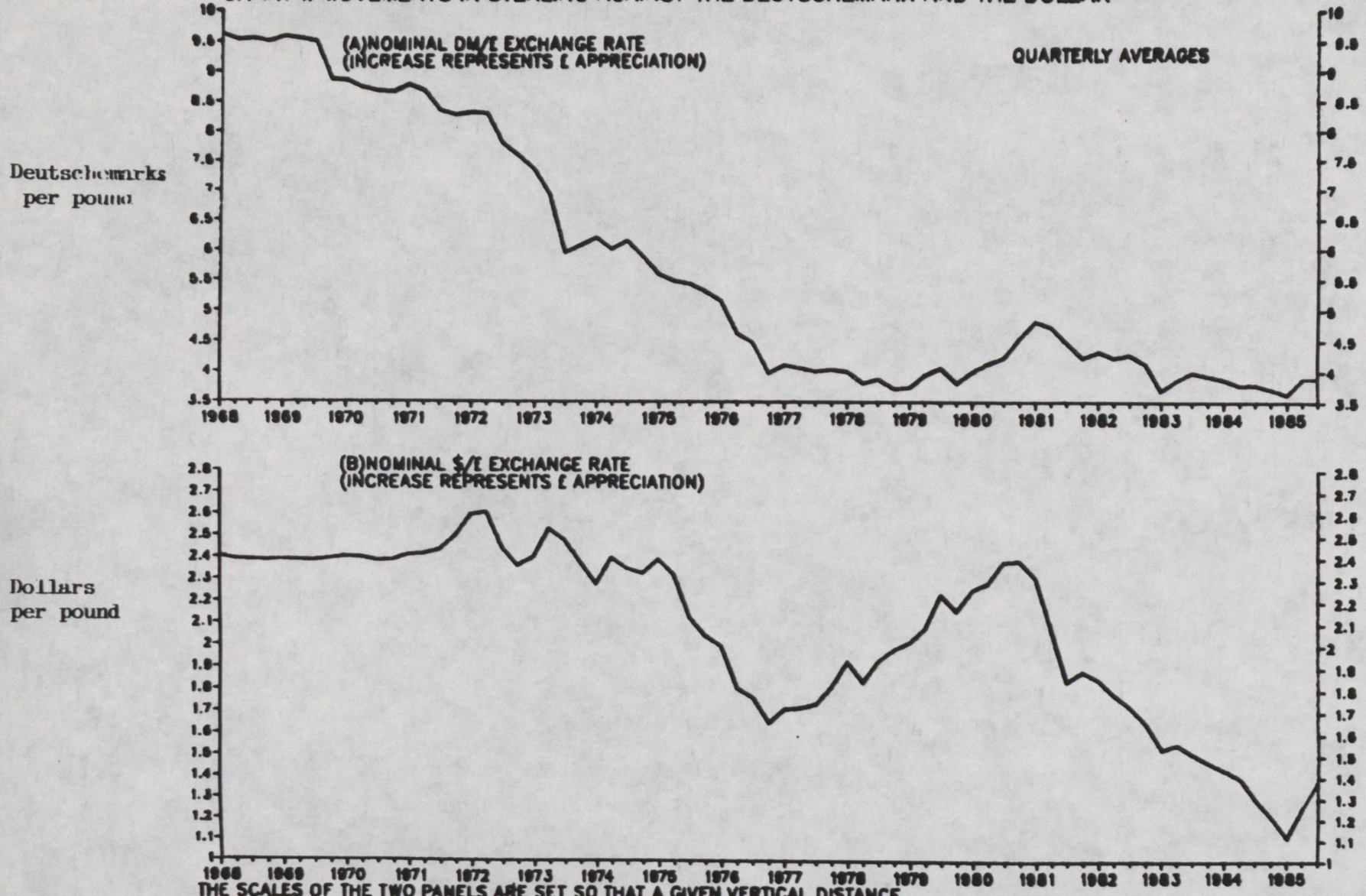
26. Joining the ERM would be a natural extension of the present strategy in which the exchange rate has come to play an increasingly important part in the assessment of monetary conditions.

27. It would impose a discipline on the Government and on industry. It would also be generally well received by the markets. It would be a significant political initiative which we would take care to present as an evolution of present policy, and in no way a relaxation of that policy.

28. There are always risks of severe exchange rate pressures - difficulties which we have not escaped by staying outside the ERM. Interest rates would need to adjust rapidly. But the advantages now outweigh the risks.

29. It is the considered view of the Chancellor and the Governor that we should become full members of the EMS, joining the ERM at the earliest practicable opportunity.

CHART I: MOVEMENTS IN STERLING AGAINST THE DEUTSCHEMARK AND THE DOLLAR

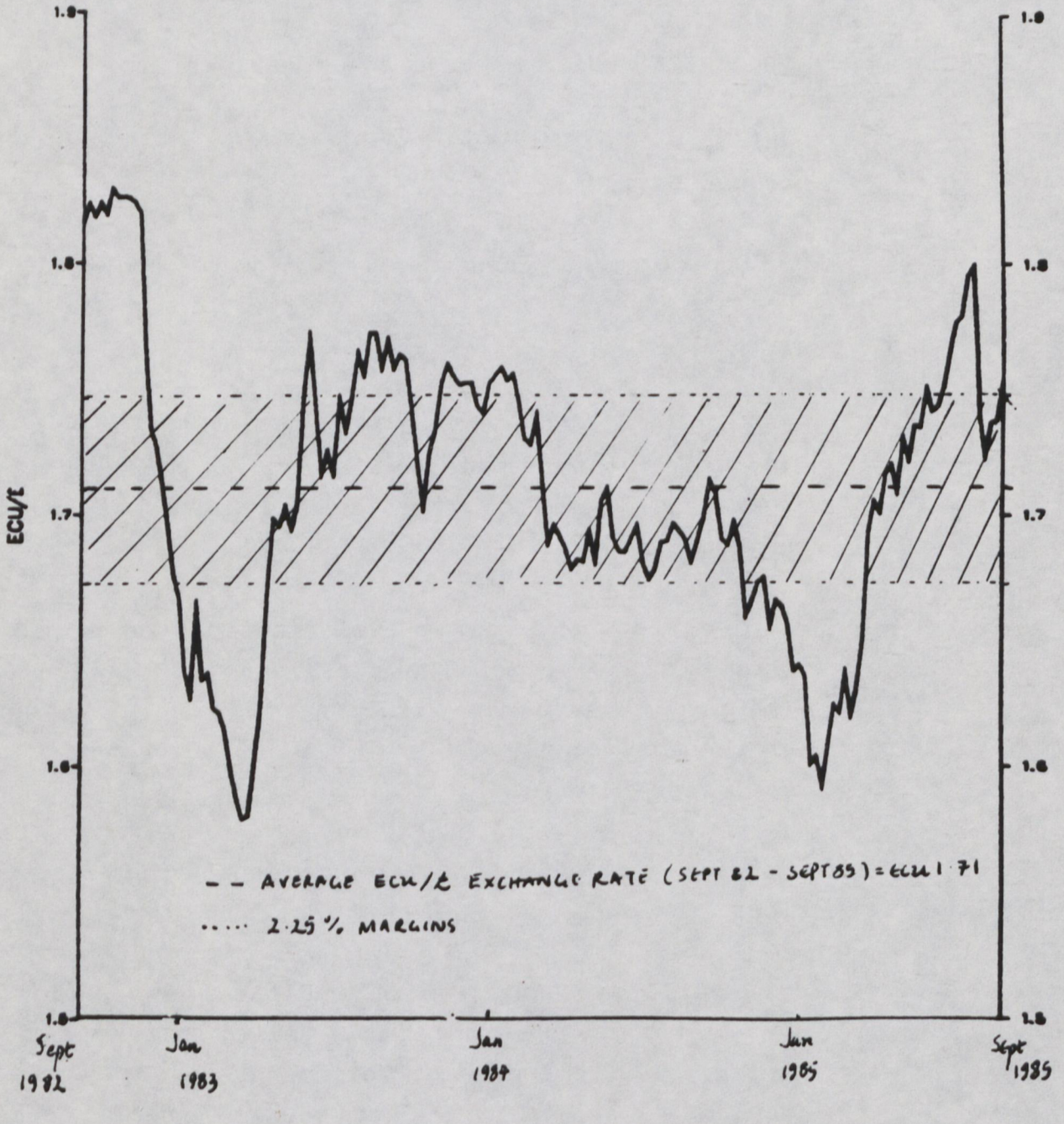


THE SCALES OF THE TWO PANELS ARE SET SO THAT A GIVEN VERTICAL DISTANCE REPRESENTS THE SAME PERCENTAGE APPRECIATION/DEPRECIATION AGAINST BOTH CURRENCIES
THE LAST OBSERVATIONS (1985Q3) ARE BASED PARTLY ON FORECASTS

CHART II: **SHORT-TERM MOVEMENTS IN STERLING**

(WEEKLY DATA – FRIDAYS)
INCREASE REPRESENTS £ APPRECIATION

NOMINAL ECU/£ EXCHANGE RATE



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ANNEX A

QUESTIONS OF PROCEDURE

In the Community

The formal process of joining would be as follows:

- we would notify our intention to the Commission and to our partners;

- a "realignment" conference would be convened, almost certainly over a weekend (notice could be given as late as Friday evening);

- the form of the conference is a preliminary meeting of the Monetary Committee (Treasury and Bank officials), followed by a meeting of Finance Ministers and Central Bank Governors;

- subject to the possible qualifications mentioned below, the sole purpose of the conference would be to settle the rate at which sterling would join, and the consequent complete new grid of cross-parities and ecu central rates.

2. There are just two qualifications about the substance of the discussion:

- it would have to cover in addition any special points or conditions we wanted to raise: but this does not arise, because a mark of moving into the system strongly would be that we were not seeking special conditions and, in particular, we would be accepting the standard margins of variation of +/- 2.25%;

- there would be additional but by no means insuperable complications if, at the time of our entry, some other Community country wanted to take the opportunity of realigning its own currency.

3. The rate at which sterling would join would, in theory, be an open matter for negotiation with and among all the partners. In practice, there would be a strong sense among all concerned, and this would include the UK, that the chosen rates could not be very far from the prevailing market rates: to choose otherwise would risk confusion when markets re-opened. This still leaves some room for manoeuvre over the precise rates (which could be such as to give an immediate market effect of sterling being in the middle or upper or lower part of the permitted range). We would want to decide for ourselves within this limited room for manoeuvre. We would have to explain and argue for our choice, but there must be a very strong probability that the general satisfaction of others with our joining at all would give us a strong hand to play.

4. With sterling in the ERM, the relationship between sterling and the DM would be particularly important for the authorities of both countries. Indeed, the ERM would become a different animal: a binary system instead of one with satellites around a single currency. The behaviour of the new system is not predictable - a point which we suspect the Germans and others have not fully recognised. We would want after entry to have some intensive discussions with our German opposite numbers on two main points. First, we would want to explore the possibility of a bilateral "swap" arrangement to be used by agreement in order to meet special DM/£ financial flows. Secondly, we would want to establish very close consultation procedures between our Finance Ministries and Central Banks on any measures of developments in the monetary field.

Parliament

5. The previous Labour administration gave an undertaking to consult Parliament in advance if and when there was a decision

by them to join the ERM when it was set up. (Mr Healey on 29 November 1978 - the passage is well worth reading and is attached). We cannot trace any such undertaking having been given by the present administration.

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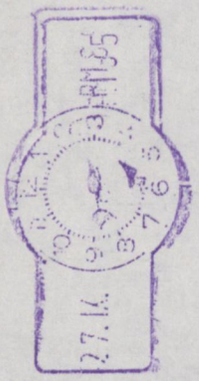

Mr. Healey:

On the other hand, if the changes which I have described, and for which the Government are pressing, are made in the exchange rate regime in the next few days —and many other countries besides ourselves are pressing for these changes— if the Heads of Government were to agree next week on the necessary commitment to concerted action and resource transfers, and if, therefore, the Government decided that it would be in Britain's interest to join the exchange rate regime, then—I was asked this question at Question Time the other day—the Government would submit their view to Parliament for debate, and, if necessary, a vote, before the regime came into operation at the beginning of January.

I hope that that allays the anxieties which some of my hon. Friends, and indeed some of my right hon. Friends, have expressed.

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SECRET

JOINING THE ERM: AN ANNOTATED AGENDA

1. Reasons for considering now?

What are the difficulties in maintaining downward pressure on inflation by sticking to the existing strategy and targets?

2. Purpose of membership and implication for macro-economic policy

a It is agreed that the purpose would be to reinforce - not to relax - financial discipline - with the implication that our firm intention would be not to re-align against the DM?

b In principle, keeping up with DM would require more rapid progress against inflation than the present plans. Do we want/could we achieve this. What would be the implications for interest rates and fiscal policy, and would these be acceptable?

3. Exchange rate vs. monetary targets

a Could we continue to have monetary targets? If so, how would we resolve conflicts when they occurred? (Presumably in the short run we would have to give precedence to the exchange rate).

b To be consistent with parity with DM, should we reduce the target ranges for the monetary aggregates?

4. Presentation of policy

a There have undoubtedly been problems with market understanding of present policy - in particular the role of the exchange rate. How far would membership of the ERM help in providing a simpler framework?

/b And how far

And how far would it be damaging, given the difficulty of explaining the continuity of policy, and the presentational capital built into the strategy as set out in successive MTFS's.

5. Practicality of keeping the £ within the permitted bands

a How great a problem, in general, would it pose having two reserve currencies in the system, in neither case with exchange controls? And how difficult would the petro-currency factor be?

b How would we operate to withstand pressure, when it came (accepting particular importance of doing so successfully on the first occasion, for obvious market reasons)? Do we think we could hold the position, when the market had a possible weekend re-alignment conference in its sights, without very large scale intervention? If so, how high would short term interest rates have to go, and how far could base rates and mortgage rates be insulated?

c Could there be exceptional arrangements (automatic re-alignment, or temporary withdrawal) in the case of fluctuations caused by oil? (And could the conditions be defined closely enough to reassure markets there was no relaxation of financial discipline?)

6. Political Arguments

a Joining would be a symbol of our European commitment and welcomed by our partners. How much weight should we give that? Is there anything we could look for in return?

b Is there any difficulty about accepting, as a condition of joining, that our partners would have to agree to any re-alignment for sterling (and might on occasion seek to attach some form of policy conditions to that agreement)?

Timing

What is the case for and against waiting for:

i) a calmer oil market;

ii) a further fall in the $ against the DM?

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SECRET AND PERSONAL

14

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

PRIME MINISTER

EXCHANGE RATE MECHANISM

I have not thought it right to cover in what is a joint Treasury/Bank paper one further contingency.

Whether or not sterling is in the ERM, it must be likely that, during the immediate run-up to the next General Election, fears of a possible change of Government would lead to a massive precautionary move of funds out of London, leading to intolerable pressure on the exchange rate. (The only reason this did not occur before the last General Election was that the polls consistently gave us a substantial lead: the result was never in doubt. But that was exceptional.)

Either way, given that the pressure would not only be wholly political in origin but would be for a strictly limited duration, it would be absurd to respond other than by letting the exchange rate take the strain - and we would need to draw the obvious political lesson, too.

If, when this occurred, we were in the ERM, we would need to announce our temporary cessation from operating the system, coupled with an undertaking that, on our return to office after the election we would immediately resume operating the system at the same parity as before.

I can't see why the Government should give this hostage.

Although there is no formal provision in the rules of the EMS for a manoeuvre of this kind, temporary infractions have already been condoned on a number of occasions on the basis of force majeure, and given the absence of any sensible alternative course, not to mention the lack of any sanctions that could be used against us, I have little doubt that our partners would recognise that they had no option but to go along with it.

I am copying this to the Foreign and Commonwealth Secretary.

N.L.

20 September 1985

Dated in error

11G

SECRET

STERLING AND THE EUROPEAN RATE MECHANISM

(Joint Note by Treasury and Bank of England)

Introduction

The public stance of the Government has consistently been that sterling would join the Exchange Rate Mechanism (ERM) when the time was right. Answering Dr Owen on 31 January this year in the House of Commons, the Prime Minister said:

> "We have always said that we shall join the exchange rate mechanism of the EMS when we believe that the time is appropriate. It is kept under review from time to time, but I must make one thing clear. Joining the EMS would not obviate increases in interest rates, it would not obviate the need for financial discipline and, indeed, it might increase it."

2. The subject was last reviewed with the Prime Minister on 13 February and the papers for that seminar are still relevant.

3. Circumstances have changed since February. When we last discussed the question, the dollar had risen sharply. Sterling had fallen not only against the dollar but also against European currencies, reflecting market doubts about the Government's commitment to its counter-inflation strategy. UK interest rates had been forced up sharply.

4. Inflation is now falling. There is a good chance that we will do even better than the Budget forecast of 4½% inflation by mid-1986 and this view is gaining widespread acceptance. Monetary conditions, are consistent with lower inflation. We have pursued a cautious policy towards interest rate reductions. Since 13 February, the pound has risen by 7% against the DM and 32½% against the dollar.

Reinforcing the Strategy

5. In spite of sterling's strength, and the much improved outlook for inflation, we have run into difficulties over the operation and exposition of the Government's financial strategy. Though we may receive credit for the results of our policy, this is offset by criticism of the way in which we operate it.

6. The background of currency upheavals, the removal of controls at home and far-reaching changes in the structure of financial markets has meant that the various measures of money have been difficult to interpret. The target measures have been pointing in different directions. For reasons we discussed at the Prime Minister's monetary seminar in July, we have recently had particular difficulty with £M3 - the measure which in the public mind is most closely associated with our monetary strategy. Although there can be no question of doing without the discipline of monetary targets, we have to recognise that the monetary aggregates have, for the present, become a less reliable guide to the conduct of policy.

7. So we have been forced to place increasing emphasis on the exchange rate. We have always acknowledged that, in assessing monetary conditions, the exchange rate has an important role alongside the monetary indicators. There are those who argue that it is wrong to place weight on the exchange rate when movements can reflect changes in monetary conditions in other countries - particularly the US - and other factors, for example, oil prices, that are independent of UK financial conditions. But the exchange rate has a direct impact on the price level and inflationary expectations and sharp movements have often coincided with changes in the market's perception of monetary ease or stringency.

8. In practice, the exchange rate has had a good record of reflecting domestic monetary conditions. Significant changes have usually been a good guide to interest rate decisions - for example in January this year when the monetary aggregates were giving uncertain signals, partly because of the effects of the

BT privatisation on the statistics. Domestic financial markets too have been increasingly influenced by it. It is clear to them what the direction of the interest rate response of a Government committed to low inflation must be, and market interest rates almost always react to sharp exchange rate changes.

9. We have, however, had considerable difficulty in explaining, at any particular time, what weight it has in policy decisions. This has itself become a source of confusion in presenting policy. Markets and commentators continually speculate about the exchange rate level which the Government would like to see; many different exchange rate bands are hinted at. The Chancellor intends to provide a further explanation of the monetary strategy in his Mansion House Speech on 17 October. He will deal with the issues raised at the Prime Minister's seminar on 16 July. But there will still be an inevitable degree of uncertainty in the minds of commentators and the markets.

10. There is a strong case for greater clarity. It would simplify some of the problems of day to day conduct of policy; it would greatly improve the presentation of policy; it would remove fears that we were exercising too much discretion. The discipline of an exchange rate regime is more readily comprehensible than money supply targets on their own. Better public understanding would itself be valuable both politically and in influencing economic behaviour - by reinforcing the discipline of sound money.

11. The only practicable possibility of strengthening and clarifying this part of our policy would be to join the ERM. It would be no soft option. It would mean linking sterling to the DM, the currency of the strongest economy in Europe, which has an inflation rate of little more than 2%.

12. It would be crucial to retain the MTFS. Like the Germans, we would continue to set and pursue monetary targets. We would need to consider further whether it would be right at the time of joining to make any changes in the chosen target aggregates.

13. Our primary objective would remain to keep monetary conditions firmly in a counter-inflationary direction. Although realignments

are permitted within the rules of the system, we would aim to avoid changes, especially in the first year or so, and build credibility in the market. In the event of realignments we would seek to keep in line with the DM. This should ensure that there is no conflict between keeping the exchange rate within ERM limits and reducing inflation.

Impact on Industry

14. Linking sterling to the DM would be of value in reinforcing industry's determination to control its costs. There have been signs that firms are beginning to ease up on this front, following the strong improvement in their profitability. Manufacturing costs have risen much faster than in other major countries over the past year. Recent statements by the CBI and other industry spokesmen about the need for a lower exchange rate have not been helpful. Such statements both unsettle the markets and encourage firms to believe that they will be bailed out by depreciation.

15. Provided we are satisfied with the realism of the exchange rate at which we join and make it clear that the Government's monetary and fiscal stance remains determinedly counter-inflationary, membership of the ERM would be a valuable discipline. Holding to something like the present £/DM exchange rate would reinforce downward pressure on industrial costs and prices. The CBI, Institute of Directors and others who in recent months have come to support our joining the ERM, could hardly argue publicly against this stance. They know that this is the essence of the ERM, and would have no ready excuse if they found that keeping up with the deutschemark was tough going.

Could We Make It Work?

16. There is no way in which we can confidently rule out the possibility of bouts of heavy pressure against sterling in the ERM. They could arise from differential movements into or out of the dollar if that currency were under pressure either way; or from a severe movement of oil prices; or from a weakening

of confidence if our inflation performance seemed to be faltering. Given the scale of financial flows through London, the pressure on us might be very large. And particularly in the early months, the markets might well seek to test our resolve. If so, we would need to demonstrate that resolve.

17. The view that our reserves were inadequate for membership of the ERM was one of the main concerns expressed at the Prime Minister's seminar in February. We still have smaller reserves in relation to our volume of trade, and even more so in relation to our potential exposure to international capital movements, than other countries of the Community. This remains true even though we recently strengthened our reserves substantially by borrowing $2.5 billion on satisfactory terms.

18. We would not want to spend massive reserves, as the French did in late 1982, in defence of the indefensible. We would hope in the first instance to avoid pressure by maintaining the cautious approach to interest rates that we have followed since the beginning of this year. If in spite of this pressures emerged we would hope to recognise the need for policy change in good time and act on that. In such circumstances we would have to be prepared to adjust domestic interest rates vigorously, as indicated by the exchange rate, and maintain them at these levels for as long as necessary.

19. To a considerable extent we follow this approach now outside the ERM. Though at times in the past it might have seemed more sensible to take part of the pressure on the exchange rate (rather than interest rates), recent experience - particularly around the turn of the year - has clearly demonstrated that this option leads to great problems and in practice it now scarcely exists.

20. Our best protection would be our own financial strategy and performance. Some commentators have drawn attention to the UK's failure to live within the "Snake" in 1972. But the UK's relative fiscal and monetary position is now quite different from what it was in 1972; then monetary conditions were easy

and getting easier, and there was a widespread view that the UK authorities wished to see a lower exchange rate. After a period of achieving a track record and consequent credibility in the ERM we could hope to benefit from the reinforcing effects of membership of a mechanism that has been successful in limiting exchange rate variations among European currencies. The fact of being a member could then help to stabilise expectations and to reduce some of the speculative flows.

Who Decides Parities?

21. At the discussion in February there was some concern about the influence of other Community countries over our exchange rate. The constitutional position is that initial parities and any subsequent changes are decided by unanimous judgement of all Community Finance Ministers, who meet for the purpose at "realignment conferences". At these there is often a good deal of argument as to whether X should devalue or Y revalue (the same thing in market terms but different in terms of political presentation), and at the margins about the amounts of any changes (with a tendency for resistance against demands for large changes).

22. At the end of the day it is usual for a compromise to be reached, but in practice an individual country only really loses its freedom of action when that country is seeking special financial assistance, in which case attempts may well be made by others to impose policy conditions - an IMF-type situation. There is certainly an in-built pressure in the system against devaluation. But that is what we would want.

Conclusions

23. We are able now to contemplate joining the ERM from a position of some strength. This is based on our success in reducing inflation. There is widespread acceptance of our determination to continue in that direction and a growing expectation that we shall succeed.

24. We face a period of difficulty over the conduct and presentation of financial policy.

25. Joining the ERM now would reinforce our basic strategy, clarify its operation in some respects and greatly improve its public presentation.

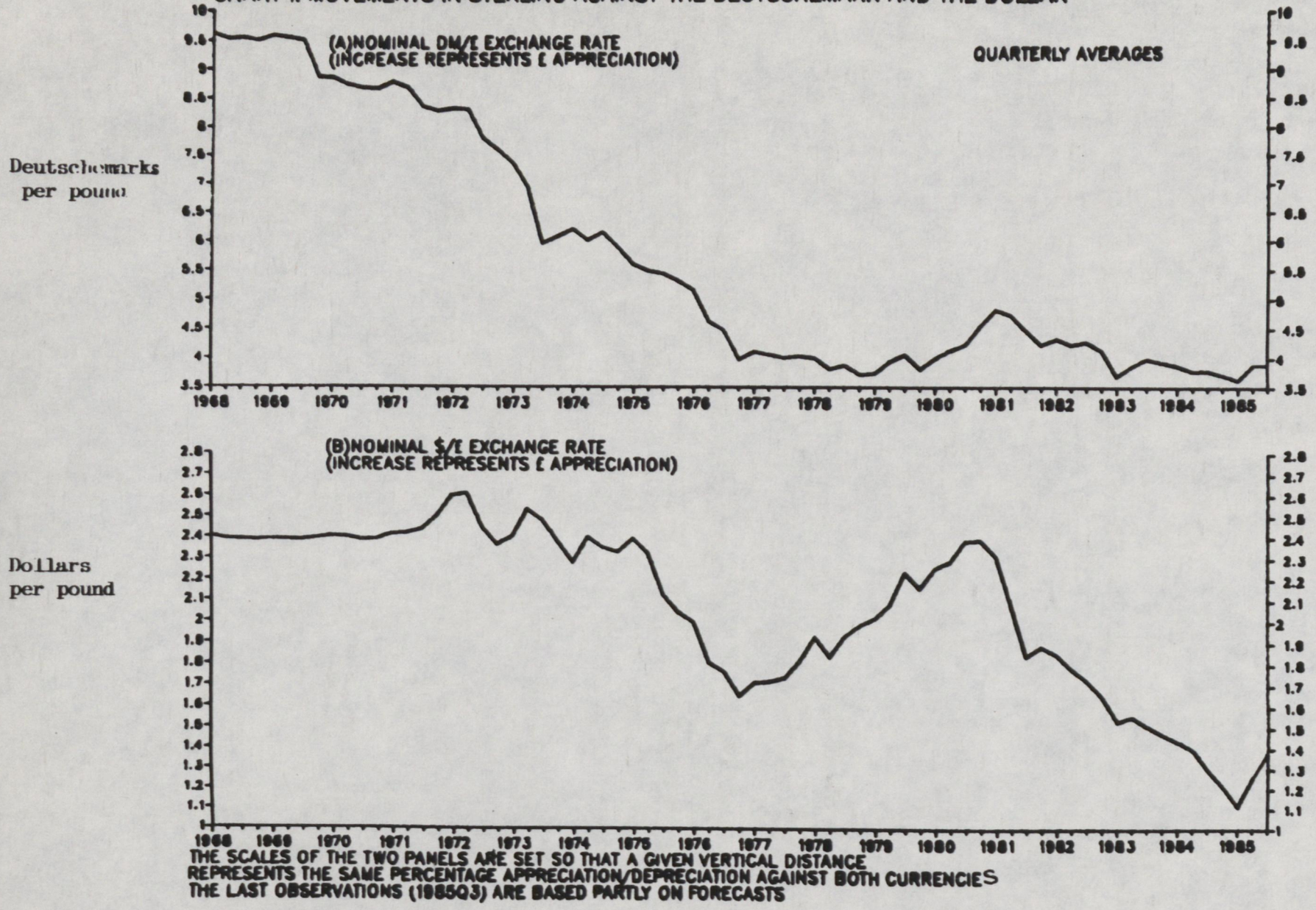
26. Joining the ERM would be a natural extension of the present strategy in which the exchange rate has come to play an increasingly important part in the assessment of monetary conditions.

27. It would impose a discipline on the Government and on industry. It would also be generally well received by the markets. It would be a significant political initiative which we would take care to present as an evolution of present policy, and in no way a relaxation of that policy.

28. There are always risks of severe exchange rate pressures - difficulties which we have not escaped by staying outside the ERM. Interest rates would need to adjust rapidly. But the advantages now outweigh the risks.

29. It is the considered view of the Chancellor and the Governor that we should become full members of the EMS, joining the ERM at the earliest practicable opportunity.

CHART 1: MOVEMENTS IN STERLING AGAINST THE DEUTSCHEMARK AND THE DOLLAR

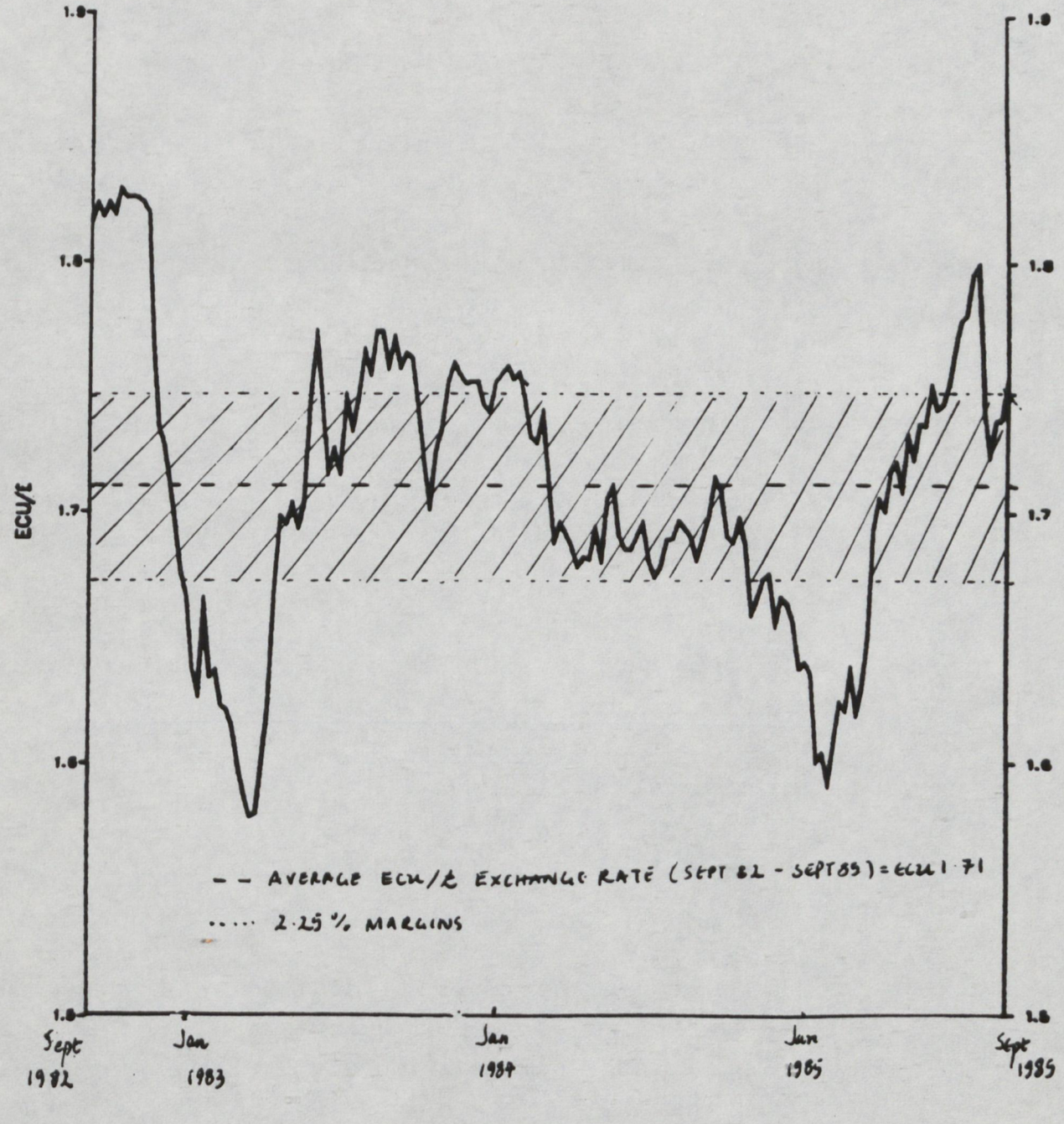


THE SCALES OF THE TWO PANELS ARE SET SO THAT A GIVEN VERTICAL DISTANCE REPRESENTS THE SAME PERCENTAGE APPRECIATION/DEPRECIATION AGAINST BOTH CURRENCIES
THE LAST OBSERVATIONS (1985Q3) ARE BASED PARTLY ON FORECASTS

CHART II: SHORT-TERM MOVEMENTS IN STERLING

(WEEKLY DATA – FRIDAYS)
INCREASE REPRESENTS £ APPRECIATION

NOMINAL ECU/£ EXCHANGE RATE



SECRET

ANNEX A

QUESTIONS OF PROCEDURE

In the Community

The formal process of joining would be as follows:

- we would notify our intention to the Commission and to our partners;

- a "realignment" conference would be convened, almost certainly over a weekend (notice could be given as late as Friday evening);

- the form of the conference is a preliminary meeting of the Monetary Committee (Treasury and Bank officials), followed by a meeting of Finance Ministers and Central Bank Governors;

- subject to the possible qualifications mentioned below, the sole purpose of the conference would be to settle the rate at which sterling would join, and the consequent complete new grid of cross-parities and ecu central rates.

2. There are just two qualifications about the substance of the discussion:

- it would have to cover in addition any special points or conditions we wanted to raise: but this does not arise, because a mark of moving into the system strongly would be that we were not seeking special conditions and, in particular, we would be accepting the standard margins of variation of +/- 2.25%;

- there would be additional but by no means insuperable complications if, at the time of our entry, some other Community country wanted to take the opportunity of realigning its own currency.

3. The rate at which sterling would join would, in theory, be an open matter for negotiation with and among all the partners. In practice, there would be a strong sense among all concerned, and this would include the UK, that the chosen rates could not be very far from the prevailing market rates: to choose otherwise would risk confusion when markets re-opened. This still leaves some room for manoeuvre over the precise rates (which could be such as to give an immediate market effect of sterling being in the middle or upper or lower part of the permitted range). We would want to decide for ourselves within this limited room for manoeuvre. We would have to explain and argue for our choice, but there must be a very strong probability that the general satisfaction of others with our joining at all would give us a strong hand to play.

4. With sterling in the ERM, the relationship between sterling and the DM would be particularly important for the authorities of both countries. Indeed, the ERM would become a different animal: a binary system instead of one with satellites around a single currency. The behaviour of the new system is not predictable - a point which we suspect the Germans and others have not fully recognised. We would want after entry to have some intensive discussions with our German opposite numbers on two main points. First, we would want to explore the possibility of a bilateral "swap" arrangement to be used by agreement in order to meet special DM/£ financial flows. Secondly, we would want to establish very close consultation procedures between our Finance Ministries and Central Banks on any measures of developments in the monetary field.

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by them to join the ERM when it was set up. (Mr Healey on 29 November 1978 - the passage is well worth reading and is attached). We cannot trace any such undertaking having been given by the present administration.

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SECRET AND PERSONAL

13.

COPY No: 2 of 17

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

24 September 1985

David Norgrove Esq
10 Downing Street
London SW1

pa

Dear David,

ERM

I attach a nearly final draft of the joint Treasury/Bank paper on ERM for discussion at the Prime Minister's seminar next week. I will be sending you (and the FCO) a final version, complete with charts, by the end of the week.

As agreed, I have sent copies via the FCO bag, to Alan Walters and Brian Griffiths in the United States.

I am also copying to John Bartlett (Bank of England).

Yours ever
Rachel

RACHEL LOMAX

11G

SECRET

STERLING AND THE EUROPEAN RATE MECHANISM

(Joint Note by Treasury and Bank of England)

Introduction

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2. The subject was last reviewed with the Prime Minister on 13 February. Since then circumstances have changed.

3. When we last discussed the question, the dollar had risen sharply. Sterling had fallen not only against the dollar but also against European currencies, reflecting market doubts about the Government's commitment to its counter-inflation strategy. UK interest rates had been forced up sharply.

4. Inflation is now falling. There is a good chance that we will do even better than our Budget forecast of 4½% inflation by mid-1986 and this view is gaining widespread acceptance. Monetary conditions, are consistent with lower inflation. We have pursued a cautious policy towards interest rate reductions. The dollar is now [10%] below its February peak even though it has risen from its late August level. Since 13 February, the pound has risen by [8%] against the DM and [23%] against the dollar.

Reinforcing the Strategy

5. In spite of sterling's strength, and the much improved outlook for inflation, we have run into difficulties over the operation and exposition of the Government's financial strategy. Though we may receive credit for the results of our policy, this is offset by criticism of the way in which we operate it.

6. The background of currency upheavals, the removal of controls at home and far-reaching changes in the structure of financial markets has meant that the various measures of money have been difficult to interpret. The target measures have been pointing in different directions. For reasons we discussed at the Prime Minister's monetary seminar in July, we have recently had particular difficulty with £M3 - the measure which in the public mind is most closely associated with our monetary strategy. Although there can be no question of doing without the discipline of monetary targets, we have to recognise that the monetary aggregates have, for the present, become a less reliable guide to the conduct of policy.

7. So we have been forced to place increasing emphasis on the exchange rate. We have always acknowledged that, in assessing monetary conditions, the exchange rate has an important role alongside the monetary indicators. There are those who argue that it is wrong to place weight on the exchange rate when movements can reflect changes in monetary conditions in other countries - particularly the US - and other factors, for example, oil prices, that are independent of UK financial conditions. But the exchange rate has a direct impact on the price level and inflationary expectations and sharp movements have often coincided with changes in the market's perception of monetary ease or stringency.

8. In practice, the exchange rate has had a good record of reflecting domestic monetary conditions. Significant changes have usually been a good guide to interest rate decisions - for example in January this year when the monetary aggregates were giving uncertain signals, partly because of the effects of the

BT privatisation on the statistics. Domestic financial markets too have been increasingly influenced by it. It is clear to them what the direction of the interest rate response of a Government committed to low inflation must be, and market interest rates almost always react to sharp exchange rate changes.

9. We have, however, had considerable difficulty in explaining, at any particular time, what weight it has in policy decisions. This has itself become a source of confusion in presenting policy. Markets and commentators continually speculate about the exchange rate level which the Government would like to see; many different exchange rate bands are hinted at. The Chancellor intends to provide a further explanation of the monetary strategy in his Mansion House Speech on 17 October. He will deal with the issues raised at the Prime Minister's seminar on 16 July. But there will still be an inevitable degree of uncertainty in the minds of commentators and the markets.

10. There is a strong case for greater clarity. It would simplify some of the problems of day to day conduct of policy; it would greatly improve the presentation of policy; it would remove fears that we were exercising too much discretion. The discipline of an exchange rate regime is more readily comprehensible than money supply targets on their own. Better public understanding would itself be valuable both politically and in influencing economic behaviour - by reinforcing the discipline of sound money.

11. The only practicable possibility of strengthening and clarifying this part of our policy would be to join the ERM. It would be no soft option. It would mean linking sterling to the DM, the currency of the strongest economy in Europe, which has an inflation rate of little more than 2%.

12. It would be crucial to retain the MTFS. Like the Germans, we would continue to set and pursue monetary targets. We would need to consider further whether it would be right at the time of joining to make any changes in the chosen target aggregates.

13. Our primary objective would remain to keep monetary conditions firmly in a counter-inflationary direction. Although realignments

are permitted within the rules of the system, we would aim to avoid changes, especially in the first year or so, and build credibility in the market. In the event of realignments we would seek to keep in line with the DM. This should ensure that there is no conflict between keeping the exchange rate within ERM limits and reducing inflation.

Impact on Industry

14. Linking sterling to the DM would be of value in reinforcing industry's determination to control its costs. There have been signs that firms are beginning to ease up on this front, following the strong improvement in their profitability. Manufacturing costs have risen much faster than in other major countries over the past year. Recent statements by the CBI and other industry spokesmen about the need for a lower exchange rate have not been helpful. Such statements both unsettle the markets and encourage firms to believe that they will be bailed out by depreciation.

15. Provided we are satisfied with the realism of the exchange rate at which we join and make it clear that the Government's monetary and fiscal stance remains determinedly counter-inflationary, membership of the ERM would be a valuable discipline. Holding to something like the present £/DM exchange rate would reinforce downward pressure on industrial costs and prices. The CBI, Institute of Directors and others who in recent months have come to support our joining the ERM, could hardly argue publicly against this stance. They know that this is the essence of the ERM, and would have no ready excuse if they found that keeping up with the deutschemark was tough going.

Could We Make It Work?

16. There is no way in which we can confidently rule out the possibility of bouts of heavy pressure against sterling in the ERM. They could arise from differential movements into or out of the dollar if that currency were under pressure either way; or from a severe movement of oil prices; or from a weakening

of confidence if our inflation performance seemed to be faltering. Given the scale of financial flows through London, the pressure on us might be very large. And particularly in the early months, the markets might well seek to test our resolve.

17. The view that our reserves were inadequate for membership of the ERM was one of the main concerns expressed at the Prime Minister's seminar in February. But we still have smaller reserves in relation to our volume of trade, and even more so in relation to our potential exposure to international capital movements, than other countries of the Community. This remains true even though we recently strengthened our reserves substantially by borrowing $2.5 billion on satisfactory terms. We would not want to spend massive reserves, as the French did in late 1982, in defence of the indefensible. We would hope instead to recognise the need for policy change in good time and act on that. In such circumstances we would have to be prepared to adjust domestic interest rates vigorously as indicated by the exchange rate. We have to do that now outside the ERM; though at times it might seem more sensible to take part of the pressure on the exchange rate (rather than interest rates), in practice that option scarcely exists.

18. Our best protection would be our own financial strategy and performance. Some commentators have drawn attention to the UK's failure to live within the "Snake" in 1972. But the UK's relative fiscal and monetary position is now quite different from what it was in 1972; then monetary conditions were easy and getting easier, and there was a widespread view that the UK authorities wished to see a lower exchange rate. After a period of achieving a track record and consequent credibility in the ERM we could hope to benefit from the reinforcing effects of membership of a mechanism that has been successful in limiting exchange rate variations among European currencies. The fact of being a member could then help to stabilise expectations and to reduce some of the speculative flows.

Who Decides Parities?

19. At the discussion in February there was some concern about the influence of other Community countries over our exchange

rate. The constitutional position is that initial parities and any subsequent changes are decided by unanimous judgement of all Community Finance Ministers, who meet for the purpose at "realignment conferences". At these there is often a good deal of argument as to whether X should devalue or Y revalue (the same thing in market terms but different in terms of political presentation), and at the margins about the amounts of any changes (with a tendency for resistance against demands for large changes). At the end of the day it is usual for a compromise to be reached, but in practice an individual country only really loses its freedom of action when that country is seeking special financial assistance, in which case attempts may well be made by others to impose policy conditions - an IMF-type situation. There is certainly an in-built pressure in the system against devaluation. But that is what we would want.

Conclusions

20. We are able now to contemplate joining the ERM from a position of some strength. This is based on our success in reducing inflation. There is widespread acceptance of our determination to continue in that direction and a growing expectation that we shall succeed.

21. We face a period of difficulty over the conduct and presentation of financial policy.

22. Joining the ERM now would reinforce our basic strategy, clarify its operation in some respects and greatly improve its public presentation.

23. Joining the ERM would be a natural extension of the present in which the exchange rate has come to play an increasingly important part in the assessment of monetary conditions.

24. It would impose a discipline on the Government and on industry. It would also be well received by the markets. It would be a significant political initiative which we would take care to present as an evolution of present policy, and in no way a relaxation of that policy.

25. There are always risks of severe exchange rate pressures - difficulties which we have not escaped by staying outside the ERM. Interest rates would need to adjust rapidly. But the advantages now outweigh the risks.

26. It is the considered view of the Chancellor and the Governor that we should become full members of the EMS, joining the ERM at the earliest practicable opportunity.

ANNEX A

QUESTIONS OF PROCEDURE

In the Community

The formal process of joining would be as follows:

- we would notify our intention to the Commission and to our partners;
- a "realignment" conference would be convened, almost certainly over a weekend (notice could be given as late as Friday evening);
- the form of the conference is a preliminary meeting of the Monetary Committee (Treasury and Bank officials), followed by a meeting of Finance Ministers and Central Bank Governors;
- subject to the possible qualifications mentioned below, the sole purpose of the conference would be to settle the rate at which sterling would join, and the consequent complete new grid of cross-parities and ecu rates.

2 There are just two qualifications about the substance of the discussion:

- it would have to cover in addition any special points or conditions we wanted to raise: but this does not arise, because a mark of moving into the system strongly would be that we were not seeking special conditions and, in particular, we would be accepting the standard margins of variation of +/-2.25%;

- there would be additional but by no means insuperable complications if, at the time of our entry, some other Community country wanted to take the opportunity of realigning its own currency.

3. The rate at which sterling would join would, in theory, be an open matter for negotiation with and among all the partners. In practice, there would be a strong sense among all concerned, and this would include the UK, that the chosen rates could not be very far from the prevailing market rates: to choose otherwise would risk confusion when markets reopened. This still leaves some room for manoeuvre over the precise rates (which could be such as to give an immediate market effect of sterling being in the middle or upper or lower part of the permitted range). We would want to decide for ourselves within this limited room for manoeuvre. We would have to explain and argue for our choice, but there must be a very strong probability that the general satisfaction of others with our joining at all would give us a strong hand to play.

4. With sterling in the ERM, the relationship between sterling and the DM would be particularly important for the authorities of both countries. Indeed, the ERM would become a different animal: a binary system instead of one with satellites around a single currency. The behaviour of the new system is not predictable - a point which we suspect the Germans and others have not fully recognised. We would want after entry to have some intensive discussions with our German opposite numbers on two main points. First, we would want to explore the possibility of a bilateral "swap" arrangement to be used by agreement in order to meet special DM/£ financial flows. Secondly, we would want to establish very close consultation procedures between our Finance Ministries and Central Banks on any measures or developments in the monetary field.

Parliament

5. The previous Labour administration gave an undertaking to consult Parliament in advance if and when there was a decision by them to join the ERM when it was set up. (Mr. Healey on 29 November, 1978 - the passage is well worth reading and is attached). We cannot trace any such undertaking having been given by the present administration.

6. This means that we could choose between the two options of informing Parliament before or after joining. In either case we would need to move fast in order to minimise the risk of any uncertainty and speculation affecting sterling's position in the market or actually or potentially within the ERM. The two options have different implications and problems:

(1) Undoubtedly best from the point of view of minimising market disruption would be to avoid any hint of our intentions up to Friday night; then arrange a weekend "realignment" conference; and begin to operate within the ERM when markets opened on Monday. A Statement to the House would be necessary on the Monday and a very early full debate would be inevitable. We would want and need to present the whole decision to join including the terms and agreed rates as a package and would have to resist any suggestion that we could adjust the rate at which we joined. We would of course have to

explain at the weekend conference that there would need to be a debate and vote in Parliament which, if lost, would effectively overturn our decision to join; but we would operate in the market as members at once. We see no reason why this should cause problems with other Community countries - or with markets, provided we made it clear that there was no question of the debate affecting our agreement on the rate.

(2) The alternative would be a Statement in the House on a Thursday announcing our intention to join "at the current market rate". The last point would be essential to minimise the risk of heavy speculation. But some speculation would be bound to develop - and it could affect existing ERM currencies in ways which would be unwelcome (rumours that a conference on sterling joining could provoke general realignment). There would certainly be pressure from some MPs for us to seek some different rate and for any rate agreed with other Community countries to be subject to reference back to Parliament. This would have to be resisted but could be embarrassing both in Parliament and in the markets. In any case, Parliament would be unlikely to give authority to the Government to negotiate entry without demanding opportunity for debate when the terms were known; so we would still expect to face that problem after the weekend and in the face of well prepared opposition.

7. The mood of some in Parliament would not be helped by such an important decision being effectively taken before they are told

of our intention. On the other hand, the double dose of the second option is unlikely to be helpful. And the market arguments point pretty strongly to the advantages of the first option. On balance we judge the first option preferable.

Risk of Leakages

8. The decision on handling Parliament - and on timing generally - may be affected by risks of leakages. We should obviously take all possible steps to avoid these risks. But we cannot do anything to prevent an invented story; and the amount of enthusiasm for a decision to join in some quarters of the press makes such a possibility a real one. For the present our response is that the question is of course under regular/continuous review - leaving the implication that nothing has changed. This position should be held for as long as possible: the moment we depart from it we are at risk of market speculation and a build-up of noisy argument: if we wished to enter we would need to move fast into one of the two options indicated above.

9. The worst risk of leakage would arise if we had to talk in advance with other Community countries or the Commission. We have concluded however that this would not be necessary given that our entry must be welcomed and that we would not be seeking special conditions.

Mr. Healey:

On the other hand, if the changes which I have described, and for which the Government are pressing, are made in the exchange rate regime in the next few days —and many other countries besides ourselves are pressing for these changes— if the Heads of Government were to agree next week on the necessary commitment to concerted action and resource transfers, and if, therefore, the Government decided that it would be in Britain's interest to join the exchange rate regime, then—I was asked this question at Question Time the other day—the Government would submit their view to Parliament for debate, and, if necessary, a vote, before the regime came into operation at the beginning of January.

I hope that that allays the anxieties which some of my hon. Friends, and indeed some of my right hon. Friends, have expressed.

Mr. J. Enoch Powell (Down, South): When the right hon. Gentleman says " before the regime came into operation ", does he mean before this country is committed to participate in it or after we are committed but before it begins to operate?

Mr. Healey : If the House were to take a view that was different from that of the Government, on a matter of this importance, it would indeed be a very serious matter. There is not the slightest question but that the Government would be guided by the views of the House. But I hope that the right hon. Gentleman, who is a stickler for constitutional precedent here, is not suggesting that the Head of the British Government should go to an international conference and enter into negotiations and reach conclusions *ad referendum* to votes in this House. I think that that would be a total breach of all historical precedent. If the right hon. Gentleman was suggesting it, he would have difficulty in reconciling it with his views on many other issues of a constitutional nature.

I have made it absolutely clear that the essence of democracy in this country is that the Government repeatedly have to take decisions on many matters and submit them to the view of the House. If the House rejects their views, they either resign or change their policies.

005/12

SECRET

12

(file)

D. Norgrove's instruction

Joining the ERM: An Annotated Agenda

1. Reasons for considering now?

a) Is it accepted that if we were to join it would best be done at time of a Budget, when it can be presented as a coherent part of monetary/fiscal strategy?

Delete

b) What are the difficulties in maintaining downward pressure on inflation by sticking to the existing strategy and targets?

2. Purpose of membership and implication for macro-economic policy

a) Is it agreed that the purpose would be to reinforce - not to relax - financial discipline - with the implication that our firm intention would be not to realign against the DM?

b) In principle, keeping up with DM would require more rapid progress against inflation than the present plans. Do we want/could we achieve this. What would be the implications for interest rates and fiscal policy, and would these be acceptable?

3. Exchange rate vs monetary targets

a) Could we continue to have monetary targets? If so, how would we resolve conflicts when they occurred? (presumably in the short run we would have to give precedence to the exchange rate).

b) To be consistent with parity with DM, should we reduce the target ranges for the monetary aggregates?

4. Presentation of policy

a) There have undoubtedly been problems with market understanding of present policy - in particular the role of the exchange rate. How far would membership of the ERM help in providing a simpler framework?

b) And how far would it be damaging, given the difficult of explaining the continuity of policy, and the presentational capital built into the strategy as set out in successive MTFS's.

5. **Practicality of keeping the £ within the permitted bands**

a) How great a problem, in general, would it pose having two reserve currencies in the system, in neither case with exchange controls? And how difficult would the petro-currency factor be?

b) How would we operate to withstand pressure, when it came (accepting particular importance of doing so successfully on the first occasion, for obvious market reasons)? Do we think we could hold the position, when the market had a possible weekend realignment conference in its sights, without very large scale intervention? If so, how high would short term interest rates have to go, and how far could base rates and mortgage rates be insulated? If not, how much larger reserves do we need than at present; and how much foreign borrowing should we be undertaking? (cf. French experience in 1983; and our experience in 1972 in the "snake").

Delete

c) Could there be exceptional arrangements (automatic realignment, or temporary withdrawal) in the case of fluctuations caused by oil? (And could the conditions be defined closely enough to reassure markets there was no relaxation of financial discipline?)

6. **Political Arguments**

a) Joining would be a symbol of our European commitment and welcomed by our partners. How much weight should we give that? Is there anything we could look for in return?

b) Is there any difficulty about accepting, as a condition of joining, that our partners would have to agree to any realignment for sterling (and might on occasion seek to attach some form of policy conditions to that agreement)?

7. **Timing**

a) What is the case for and against waiting for:

i) a calmer oil market;

(ii) the long expected fall in the $ against the DM?

b) How long would the necessary preparations take? (especially rebuilding reserves, if that were thought sensible).

8. **Operational issues**

What view do we take of other operational questions summarised at the end of Paper 2: in particular the procedure for determining a central rate, the width of fluctuation margin, and possible mutual bilateral support arrangements with the Germans?

10 DOWNING STREET

(1)

Resubmitted with fresh note top right

CR 10/9.

Cathie

To note PM's agreement to 30 Sept.

David

SECRET

Prime Minister

Caroline has rearranged the diary so that the meeting can be on Monday 30 September at 1600. It would be useful for Brian Griffiths to be in on this critical meeting. Content for me to try to arrange that?

DCW 6/9.

11

(1)

PRIME MINISTER

Yes EMS

You agreed with the Chancellor on Friday that you would hold another Seminar on the EMS.

The Chancellor is keen that this should be held before the Party Conference so that the Government could move towards an announcement early in the new session, if that is the way the decision eventually goes.

Your diary between your return from the Middle East and the Party Conference is very difficult indeed as you well know. If you would like a Seminar in that time something else will have to go. The main possibility seems to be to postpone your Seminar on Education now scheduled for 1700 on Wednesday 2 October which would allow a discussion of two hours or more (the invitations for this were to have gone out today but we have held them). The only alternative seems to be two hours at 1715 on Thursday 3 October, but this is at the end of a bad day, which includes Cabinet, E(A), and Sonny Ramphal.

The Gov. may not now be able to make 3 October (Scot).

We will take this decision.

The Treasury intend to have the paper for the meeting ready for your return from the Middle East.

Questions:

I don't like postponing the Education Seminar - we need it very much.

(i) Do you want a meeting on EMS at 1700 on 2 October, postponing the Education Seminar?

(ii) If so do you want Brian Griffiths there if that can be arranged? (He has accepted the appointment; formally from 1 November but in the office from 4 November; no announcement yet because his PV is not finished.)

I would ask whether Alan Walters could also manage to be there.

SECRET

The Treasury are also aiming to send over a paper on banking supervision for your return from the Middle East. You might first discuss this with the Chancellor at a Bilateral and then decide whether a wider meeting is needed at that stage.

DAVID NORGROVE

4 September 1985

SECRET

10

10 DOWNING STREET

From the Private Secretary

2 September 1985

EMS

The Prime Minister and Chancellor have agreed that it would be useful to have a further discussion about the possibility of the UK joining the exchange rate mechanism of the EMS. A note will of course be needed as a basis for this meeting.

I am copying this letter to John Bartlett (Bank of England).

David Norgrove

Mrs Rachel Lomax
HM Treasury

SECRET

GRS 210

CONFIDENTIAL

CONFIDENTIAL
DESKBY 221430Z [FRANC ECONOMIC]
FM PARIS 221225Z JUL 85
TO IMMEDIATE FCO
TELEGRAM NUMBER 629 OF 22 JULY
AND TO IMMEDIATE ATHENS, BONN, BRUSSELS, COPENHAGEN, DUBLIN, THE HAGUE, LUXEMBOURG, UKREP BRUSSELS, WASHINGTON.

MIPT: REALIGNMENT OF EUROPEAN CURRENCIES.

TEXT OF EC COMMUNIQUE.

ON 20 JULY 1985, THE MINISTERS AND CENTRAL BANK GOVERNORS OF THE EEC MEMBER COUNTRIES HAVE BY MUTUAL AGREEMENT, IN A COMMON PROCEDURE INVOLVING THE COMMISSION AND ON THE BASIS OF A PROPOSAL FROM THE MONETARY COMMITTEE, DECIDED ON AN ADJUSTMENT OF CENTRAL RATES WITHIN THE EUROPEAN MONETARY SYSTEM.

THE NEW BILATERAL CENTRAL RATES RESULT FROM THE FOLLOWING RELATIVE CHANGES:

IRISH POUND	:	PLUS 2 PERCENT
FRENCH FRANC	:	PLUS 2 PERCENT
DANISH KRONE	:	PLUS 2 PERCENT
DUTCH GUILDER	:	PLUS 2 PERCENT
GERMAN MARK	:	PLUS 2 PERCENT
BELGIAN FRANC	:	PLUS 2 PERCENT
LUXEMBOURG FRANC	:	PLUS 2 PERCENT
ITALIAN LIRA	:	MINUS 6 PERCENT

THE NEW ECU CENTRAL RATES ARE THE FOLLOWING:

IRL	0.724578
FF	6.86402
DKR	8.12857
HFL	2.52208
DM	2.2384
BFR	44.832
LFR	44.832
LIT	1520.6
UKL	0.555312
DRA	100.719

THE NEW BILATERAL CENTRAL RATES AND THE COMPULSORY INTERVENTION RATES WILL BE COMMUNICATED BY THE MONETARY AUTHORITIES IN TIME FOR THE OPENING OF FOREIGN EXCHANGE MARKETS ON 22 JULY 1985.

CONFIDENTIAL

/FCO

FCO PLEASE PASS ADVANCE COPIES DESKBY 221430Z TO:-

HM TREASURY	:	PS/CHANCELLOR.
	:	SIR P.MIDDLETON.
	:	MR LAVELLE.
	:	MR FITCHEW.
BANK OF ENGLAND	:	GOVERNOR.
	:	MR BALFOUR.
	:	MR GILL.
	:	SIR M.FRANKLIN.
MAFF	:	MR EDDY.
NO 10.	:	MR TURNBULL.

FRETWELL

(ADVANCED AS REQUESTED)

FRAME ECONOMIC
ECD(I)

SECRET

9

10 DOWNING STREET

From the Private Secretary

16 May 1985

Dear Rachel.

FOREIGN CURRENCY BORROWING

The Prime Minister discussed with the Chancellor his minute of 8 May. It was agreed that HMG should undertake a substantial foreign currency borrowing in its own name. The precise form and amount should be decided in the light of market circumstances at the time. If the market reaction was particularly favourable the size of the issue could be raised.

Yours sincerely,

Andrew

ANDREW TURNBULL

Mrs Rachel Lomax
HM Treasury

SECRET

CST

P16

SECRET

B/F for bilateral

Prime Minister (2)
Agree for discussion at bilateral?
AT 10/5

8

C

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

PRIME MINISTER

FOREIGN CURRENCY BORROWING

At our meeting on 13 February to discuss the EMS you asked me to consider how best to augment the foreign exchange reserves. You will recall that, although there is no very precise way of determining the level of the reserves we ought to have, I expressed the view then that they were too low for comfort, even if we remained outside the EMS exchange rate mechanism. At the end of April total reserves stood at the equivalent of $14.0 billion of which the convertible currency reserves accounted for $5.8 billion.

2. I have concluded that in current circumstances the most appropriate way to augment the reserves would be to make a substantial eurodollar bond issue in the Government's own name.

3. This would be the first direct HMG dollar borrowing since 1978. Our recent policy has been to obtain the foreign currency we needed to refinance existing debt as it matured by indirect borrowing through the nationalised industries under the exchange cover guarantee scheme. This has proved to be low-key and uncontroversial. It has also allowed us to exploit relatively lost cost borrowing opportunities such as the New York commercial paper market which are not accessible to us in our own name. I therefore intend to continue with it to the extent that opportunity offers.

4. But it has become very difficult to put together a sufficiently large programme relying on indirect borrowing alone even to raise the $1 billion a year or so we need simply to

stand still. A number of the nationalised industries on which we used to rely have now been privatised. Others soon will be, or are expecting to, run down their debt rather than to increase it. In consequence there was a shortfall in the programme of about $100 million last year and we are again facing considerable problems in finding enough suitable borrowers this year. A significant addition to the reserves can therefore only be achieved by direct HMG borrowing.

5. The market reception of a direct issue in current circumstances is likely to be very favourable. I would not wish to proceed with it unless that were the case. A UK Government issue will now have considerable scarcity value and I have little doubt therefore that it will be able to command fine terms, comparing favourably with those achieved by other recent sovereign borrowers such as Sweden or France. We could no doubt make something of this as reflecting confidence in the policies we have been following.

6. The exact form and amount of the issue would be for decision in the light of advice from the issuing houses. But what I have in mind at present is something of the order of $1½ billion to $2 billion, probably in the form of some kind of floating rate note.

7. An issue of this kind will undoubtedly attract attention both because of its size, because it will be the first time we have gone to the markets in this form and because of the credit we have previously taken for repaying so much of the overseas debt inherited from the Labour government. Its presentation will therefore need careful handling and it will be important to maintain strict secrecy until we are ready. But we ought to be able to present it as a sensible development

of policy in response to changing circumstances and a step taken from strength particularly if, as seems likely, it proves to be in strong demand.

N.L.
8 May 1985

Euro POST: EMS P12.

10 MAY 1985

SECRET

SUBJECT.

cc Master.

Bill Bemais.

7

cc DW.

10 DOWNING STREET

From the Private Secretary

13 February 1985

EMS

The Prime Minister held a meeting today to discuss whether the UK should join the exchange rate mechanism of the EMS. Present were the Chancellor of the Exchequer, the Economic Secretary, Sir Peter Middleton, Sir Terry Burns, Mr. Littler, the Foreign Secretary, Mr. Braithwaite, Mr. Renwick, the Governor of the Bank of England, the Deputy Governor, Mr. George, Mr. Loehnis and Mr. Redwood.

Opening the discussion, the Chancellor said the Government's public position was that the UK was ready to join the exchange rate mechanism of the EMS when conditions were right. A number of factors made it appropriate to consider this question; recent exchange rate developments had brought the EMS to the fore in public debate, and the agreement at Fontainebleau had cleared a major political obstacle in Europe. As time went by the argument of unripe time looked less and less credible. It was for consideration whether the Government should decide one way or the other and say so.

The Chancellor said that whatever view one took of fundamental arguments, it would not be appropriate to enter in current circumstances. The UK's foreign exchange reserves were too low, perhaps even outside the EMS, but certainly for membership of it. In the light of recent developments, entry into the EMS would look defensive; it would be important to enter having re-established confidence in financial markets.

The fundamental arguments against joining EMS remained. Sterling was far more widely held than any of the other EMS currencies apart from the DM; the UK's trade was less integrated with Germany than the other members'; and oil was still a major factor in the markets' view of sterling. If the UK were forced to seek a realignment, possibly in the run-up to an election, the Government would be in an extremely difficult position.

Nevertheless, other arguments had strengthened. The essence of EMS was to provide a financial discipline bearing down on inflation and many people argued that it was easier to present this through the mechanism of fixed exchange rates than

DC

through monetary targets. EMS would also help to correct the existing preoccupation with the £/$. Those who advocated entry into EMS would be less able to argue against measures made necessary by adherence to its financial discipline.

The Chancellor concluded that the balance of argument still came down against joining the exchange rate mechanism of EMS, though the Government should not close the door on the option.

The Foreign Secretary recognised that the decision had to be taken on economic grounds. Although Britain's European partners would welcome our entry, this was unlikely to secure any of our major negotiating objectives in Europe. He believed that EMS had benefited the existing members by providing greater exchange rate stability. Realignment had spurred the weaker countries into taking appropriate financial measures. He doubted whether linking sterling and the deutschmark would prove an insuperable problem. If sterling had been in EMS it might have been better placed to cope with recent exchange rate pressures. He agreed that current circumstances were not right but thought the UK should be looking for an appropriate opportunity to join.

The Governor felt that the balance of argument led the Bank to look more sympathetically on membership of EMS. The arguments against entry - that this could destabilise the whole of the exchange rate mechanism and that the link with the deutschmark might prove an excessive restraint on the UK - carried less and less weight. He believed it was easier to present the commitment to stable money in the context of fixed exchange rates than monetary targets, particularly when the credibility of ££ M3, control of which was increasingly dependent upon over-funding, was coming under strain. Though not unanimous, the Bank leant towards joining at some stage though current circumstances were not right. He believed that the Government should make preparatins by raising the level of the foreign exchange reserves by around $5b.

In discussion, the following points were made:-

i) Entry into EMS would not make the conduct of policy easier at the points where it really mattered. Within the EMS it might be easier to cope with minor variations in the exchange rate as there would be no expectation of a change in parity. But where sterling was under major pressure the speculative flows could be aggravated. The worst position of all would be to enter and then be forced to withdraw shortly afterwards.

ii) The present framework of policy had served the Government well and had achieved broadly what had been asked of it. Greater clarity about policy in relation to the exchange rate would be secured only at the cost of more uncertainty about the conduct of monetary policy.

iii) In conditions of turbulence, sterling could be expected to behave differently from the other EMS currencies. Sterling was more widely traded than any currency apart from the DM, and oil and the dollar, plus the interaction between them, continued to exert a significant on sterling. Unless these fundamental factors changed and there was no indication of this happening, conditions would never be right for sterling to enter EMS.

iv) Although the policy framework had delivered lower inflation, there were increasing difficulties in operating it. The more often the authorities were forced to raise interest rates in response to a weakness of the exchange rate, the more the impression would grow that the UK was operating an exchange policy. Against this it was argued that the increases in interest rates had been the response, not to the fall in the exchange rate per se but to what the exchange rate was signalling about excessively loose domestic financial conditions.

Summing up the discussion, the Prime Minister said it was agreed that conditions were still not right for sterling to join the exchange rate mechanism of EMS. The existing public line should be maintained. The Treasury and the Bank of England should consider how best to augment the foreign exchange reserves.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and John Bartlett (Governor of the Bank of England's Office).

(Andrew Turnbull)

Mrs. Rachel Lomax,
HM Treasury

SECRET

6

PRIME MINISTER

JOINING THE ERM

In addition to their four papers (and the note by Sir Alan Walters), the Treasury have produced an annotated agenda. Perhaps the best way to conduct the meeting is to invite the Chancellor to make the opening statement. You could then ask the Governor and the Foreign Secretary if they have anything to add. You could then work through the annotated agenda in the order set out. At the conclusion of the meeting you will want to identify any further work, including any consultations with other Governments if a decision were taken to proceed.

AT

12 February 1985

SECRET

PRIME MINISTER

12 February 1985

Money Policy or EMS?

You cannot have an independent money policy and an exchange rate policy. If you try both, you may achieve neither at considerable cost.

If you choose the exchange rate target, then you are surrendering sovereignty: your policy in part is decided by what foreigners do with their money supply.

If you choose a money target and stick to it, you have more flexibility.

Recent interest rate moves can be presented as a response to clear recent monetary laxity caused by a high PSBR and high private borrowing.

Should we join the EMS?

When Ireland and UK had same money policy, pound and punt had the same value. As soon as Ireland joined EMS and had a different money policy, the punt fell heavily against the pound. It subsequently rose again.

If Germany and UK had the same money policy, DM/£ would be stable. If not, joining EMS means trying to defend the

indefensible. There have always been many adjustments within the EMS, and some currencies are costly to defend and consistently crisis ridden. Alan Walters' paper sets this out definitively.

EMS fans want us to match tight German money policy. That means even higher interest rates and a lower PSBR to get there.

I doubt if EMS supporters have in mind a hair shirt of teutonic prickliness. Nor would they wish to be forced into tightening just before an Election because the Germans have.

J. Redwood

JOHN REDWOOD

ECONOMIC APPENDIX

STERLING

Has it fallen because the oil price has been weak?

Approx. OIL per b.	1978	1979	1980	1981	1982	1983	1984	now
$ price	13	27	34	34	33	29	26	29
£ price	7	15	15	16	18	19.5	23	26
SDRs					28	28	29	

(Sources: Esso Hoare Govett & Philips & Drew graphs)

Falling dollar oil price has affected sentiment. Joining the EMS would not change that.

But the sterling oil price has risen sharply.
Real oil price has been stable (measured in international units of account SDRs).
The falling dollar oil price merely shows how strong the dollar has been.

Sterling's fall dates from before a decisive change in trend of dollar oil prices.

Has it fallen because money policy has been lax?

Sources: International Financial Statistics & Simon & Coates

	% changes in real money growth				
	Real M_1	Real £M_3	Real PSL_2	End	$/£
1979/80	-13.9	-5.8	-7.9	1980	2.4
1980/81	-6.4	2.7	-1.2	1981	1.9
1981/82	0.5	8.2	3.8	1982	1.6
1982/83	8.0	7.0	5.0	1983	1.4
1983/84	9.1	5.1	7.5		
1984/85	10.1	5.3	8.1		

(Tsy.est.)

Change in trend of sterling from rise to fall reflects change from tight to loose money.

ie: When the rapid growth in real pound notes and bank deposits started, the value of the pound fell. The velocity of circulation of money did not fall enough to offset the effect.

F.R.

Why didn't inflation pick up?

Because:

a. Wage claims remained under some control - attitudes had been affected by the recession and by numbers of jobless.

b. World commodity prices were falling.

c. There was a lot of spare capacity world-wide.

d. The world picture was deflationary, because the crucial US banking system became risk-averse and was short of liquidity.

F.R.

Where did all the money go?

a. Into consumer spending - new record high.

b. Into profits - much needed increase.

c. Into investment.

d. Flowed overseas - for the purchase of goods, as savings, and for speculative purposes.

a-c were good news, meaning a better balance between output and inflation in response to the stimulus. d meant a sharp decline in our strong balance of trade, pressure against the currency and, for a period, a large outflow of portfolio investment. Only the last of these three was good news.

F.P.

Profits - are they adequate? (Source: Philips & Drew)

They are now better. Since the 1981 trough, up 70% in cash terms (cf. 20% inflation).

But:

Non-oil rates of return (Net replacement cost)

1960	1964	1968	1973	1978	1984
11.2	10.4	9.0	8.5	6.8	6.9

Between 1972 and 1984, efficiency improved so unit wage costs added 3.2% return to profits, but higher employer contributions to National Insurance and pensions subtracted 3.5% from profits.

So better, but still not very good. Long-term downtrend in profits only just reversed.

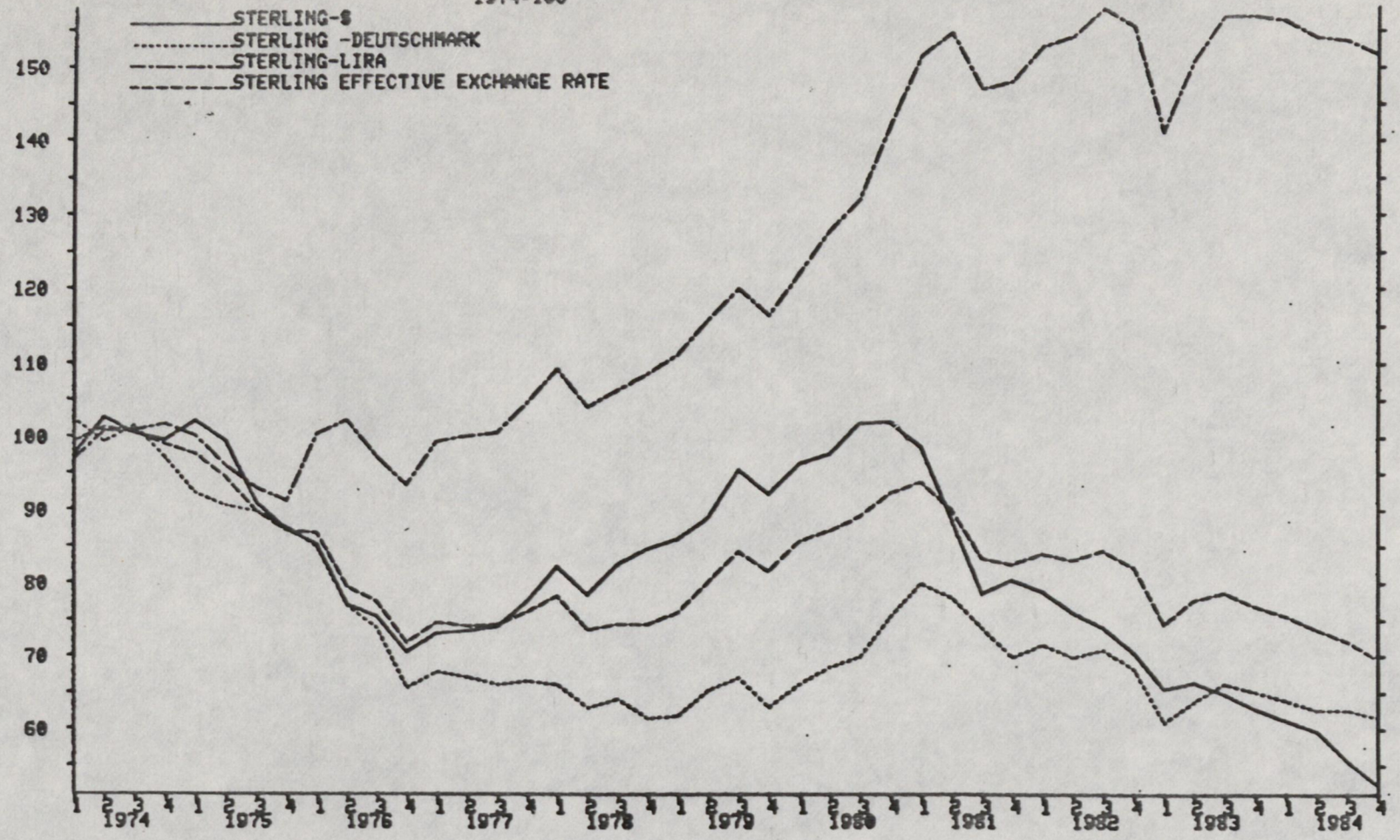
So here is a paradox: industry now has cashflow and profit sharply better than 3 years ago, but because there are so few attractive additional investment projects to spend it on, it can be partly frittered away in extra wages.

We are still suffering from a shortage of entrepreneurs capable of making good investment opportunities.

ANNEX A

STERLING EXCHANGE RATE AND EFFECTIVE EXCHANGE RATE

1974=100

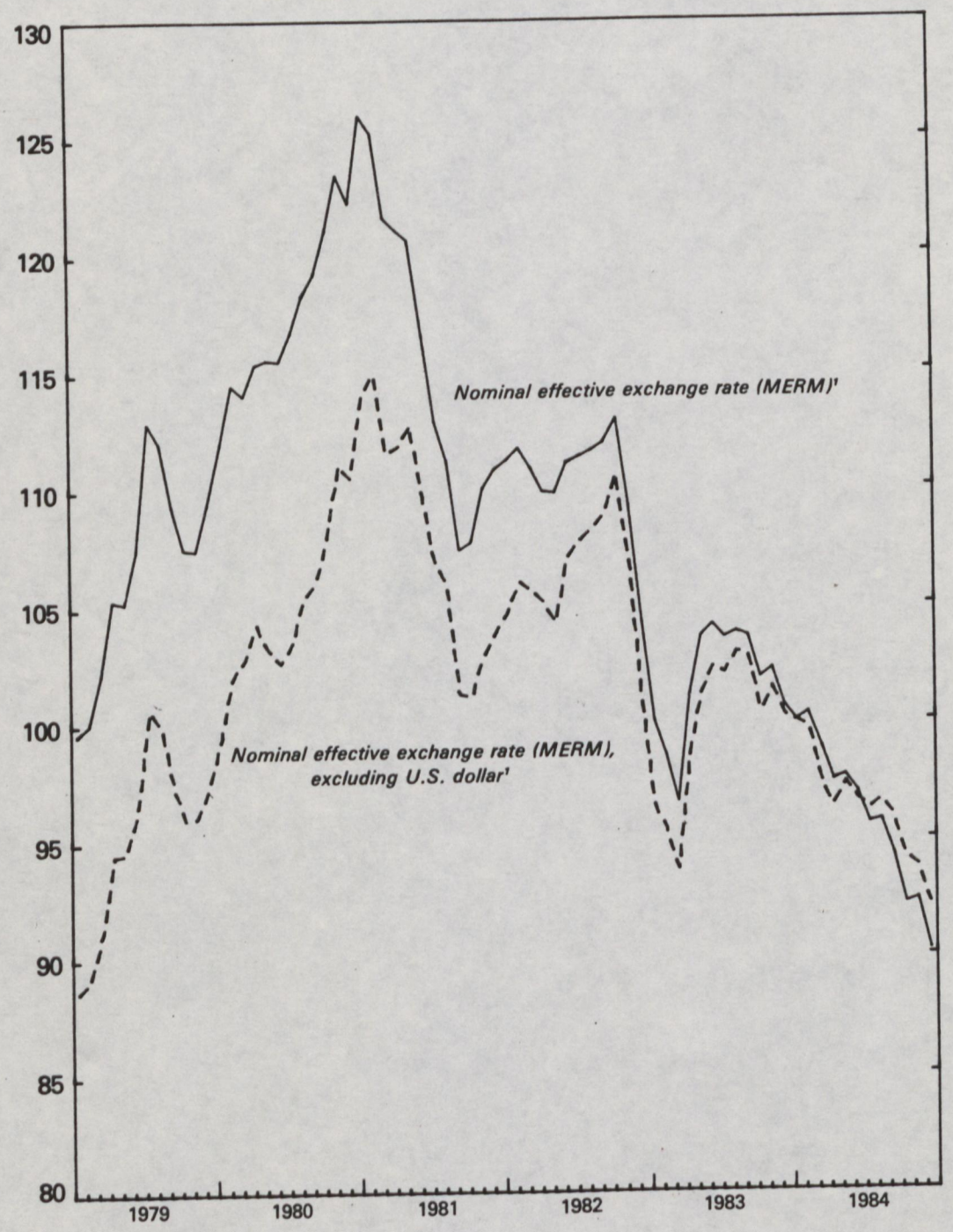


ANNEX B

CHART 5

UNITED KINGDOM

EFFECTIVE EXCHANGE RATES



Sources: IMF, *Datafund;* and staff calculations and estimates.
[1]January 1984=100.

£ has not just fallen against the $

SECRET

10 DOWNING STREET

From the Private Secretary

11 February 1985

I attach a note by Sir Alan Walters which raises some of the questions he feels need to be answered when considering Britain's possible membership of the EMS. This should be included in the papers for Wednesday's meeting.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and John Bartlett (Governor's Office, Bank of England).

ANDREW TURNBULL

Mrs. Rachel Lomax,
H.M. Treasury.

SECRET

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LETTER FROM PROFESSOR SIR ALAN WALTERS TO MR. ANDREW TURNBULL

JOINING THE EMS - SOME ADDITIONAL QUESTIONS

1. Speculation against sterling is one of the main problems of the existing system. The EMS will not prevent such speculation - on the contrary, unless other undesirable measures are taken, it is likely to increase the profitability of shorting sterling. The authorities do not object to gradual movements in sterling - what they object to is sharp downward movements, arguing that it might be a "bottomless pit" which would destroy confidence. Yet the EMS re-alignments are all sudden changes. And, as French experience during 1982 shows, there is no guarantee that, in the EMS, the sudden shift halts the slide. Why is the plan unacceptable outside but good inside the EMS?

2. As is clear from the history of the French franc, joining the EMS is unlikely to reduce speculation against sterling and I would conjecture, because of the "step" movement on re-alignment, it would be made more profitable and so increase. In any case, the only way to deal with this is to make speculation against sterling unprofitable without, at the same time, making investment also unprofitable and depressing the economy. The present techniques and conventions of monetary control make this very difficult and chancy - essentially the need is sharply to raise overnight to seven-day rates without raising three-month (or more) rates. The French experience shows that, in the EMS structure, this is the only effective way of taking out the bears. Since we are a more open economy, the UK would be subject to much more pressure, so the need to tame the bigger bears is the greater.

SECRET

Do the proponents of EMS plan to change the monetary arrangements so that we can squeeze those shorting sterling? If so, could we know the institutional changes involved and how they are to be implemented?

3. It is not true that if we change the present system so that we can punish would-be bears, the difficulty of the bearish rush precipitating a fall of sterling would disappear. Joining the EMS would be likely to, at best, be irrelevant to the main issue.

4. Even if the UK joined, the DM would continue to dominate the EMS. Britain would have a role like France or Italy (the Netherlands is really part of the DM block). Both France and Italy have exchange controls and regulated credit rationing. In spite of the rigorous enforcement of exchange control in 1982-3 and the (3?) devaluations, the French Government had to intervene on a massive scale; indeed, there was much talk of the EMS having, in fact, broken down.

5. In view of our open capital and exchange markets and the continued role of sterling, the UK would come under much greater pressure than France, even if the latter had free credit and exchange markets. But with France and Italy regulated, it is very likely that Britain would have to bear much more speculative activity. Would the sponsors of Britain's entry envisage the introduction of credit rationing and exchange controls in Britain, at least as stringent as those in France as a concomitant of entry? Are we prepared to dismantle our open-market, free-exchange system in order to join the EMS grid?

6. Control of money and credit markets and insulation from the Euro market, a la France, would enable us to immitate the French in raising the overnight rate to tame the bears. However, it is worthwhile noting that this did not offset the need for massive and costly intervention, nor did it prevent the sequence of falls of the franc.

7. To sum up:-

(i) EMS membership will not ease the stability problem and is likely to make it worse;

(ii) To deal with the stability of financial markets one needs either to:-

(a) not validate market expectations as the authorities reaction to a slide in sterling, or

(b) change institutional arrangements to enable the bears to be squeezed;

(iii) joining the EMS is likely to strengthen the argument for the reimposition of exchange controls like those of France and Italy with great disadvantages to a currency such as sterling;

(iv) one can understand the enthusiasm of the EMS members to include the UK since Britain would act as safety valve for much speculation in the System, and as the DM strengthens in the months ahead, sterling's position would continue to be precarious.

PRIME MINISTER

For Wednesday's seminar, the Treasury have provided an annotated agenda and papers on

i) the implications for sterling and the economy of EMS

ii) the procedural aspects of joining

iii) the mechanics of EMS

iv) the history and development of EMS

Also enclosed is the relevant chapter from Alan Walter's book, which has been circulated to those attending the meeting.

FCO may provide a paper but what is needed from them is not waffle about how pleased the Europeans would be (the decision should be taken on its economic merits), but what we can screw out of them in return.

AT

NB Papers i - iv are in folder at back of this file. (+ other seminar papers

Andrew Turnbull
8 February 1985

SECRET

10 DOWNING STREET

From the Private Secretary

4 February 1985

EUROPEAN MONETARY SYSTEM

The Chancellor of the Exchequer discussed EMS with the Prime Minister last night. He said there was growing interest, in Parliament and elsewhere, in the possibility of joining the exchange rate mechanism of EMS. The Government had said that it was ready to join EMS when conditions were right and it would be appropriate, before the Budget, to consider whether this was now the case.

The Chancellor of the Exchequer said that controlling inflation required acceptance of a financial discipline which could be provided either by monetary targets or by a fixed exchange rate. It was essentially a secondary matter which was chosen. The arguments against EMS were familiar, but new arguments were now being put forward in favour of EMS. First, it was proving difficult to get financial markets to understand what the Government's policy on the exchange rate really was - EMS would provide much clearer "rules of the game". There was substantial support in the Conservative Party in favour of EMS and, in arguments about additional spending and borrowing, it would be helpful to be faced with a discipline of their choosing. EMS would move the focus of attention away from the dollar exchange rate. £M3 was becoming increasingly suspect as a monetary indicator as its control depended increasingly on over-funding, with the resulting rise in the bill mountain.

The Chancellor suggested that the Prime Minister should hold a seminar with the Treasury, Bank, Foreign Office and Sir Alan Walters. I hope to be able to arrange this before the Prime Minister leaves for the US. I will be in touch shortly about a date. Meanwhile I have said nothing to the Bank or Foreign Office. We will also need to discuss the papers required for this meeting, which should cover how the EMS works, the implications for the UK of joining the exchange rate mechanism, and the timetable for decisions.

Andrew Turnbull

Mrs. Rachel Lomax,
H.M. Treasury.

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PAPER 1

STERLING AND THE EMS EXCHANGE RATE MECHANISM

This paper recalls the balance of argument on the question of UK entry to the EMS at the time of the Prime Minister's discussion in January 1982. It then considers how the balance of arguments looks now.

Past UK attitude

2. The stance that the UK is prepared to join the EMS when conditions are right has encompassed a wide range of considerations.

3. In the 1982 discussions, the "European" objectives of creation of a zone of monetary stability, and the reduction of exchange rate variations between members were given modest weight. There was some scepticism about the ability of the mechanism to deliver radical effects of this sort given the provision for realignments: or how important they were, given the possibility of hedging short term movements.

4. The general case for greater convergence of European economic policies was given more weight. It seemed likely that membership had achieved one of the original objectives of the founders ie keeping France on the rails.

5. The main potential attraction of UK membership was seen as an anchor to counter-inflation policy. It was suggested that public opinion might respond more easily to an external exchange rate target than to the performance of monetary aggregates.

6. Against this it was recognised that sterling differed from most other EMS currencies. First, it was an international currency and there could be problems about adding a second internationally-traded currency to the mechanism. Second there was the market perception of a petro-currency factor, leading

to differential movements of sterling against EMS currencies at times of oil price developments.

7. However the decisive consideration in the 1982 discussion was a judgement that there was not convincing evidence that entry would provide solid advantages. It was not clear that membership had been an effective discipline for the existing members of the ERM or that it would provide a more effective discipline for the UK than present policy based on the MTFS. Membership would also remove UK freedom of manoeuvre.

8. Some dangers were seen in putting faith in a disciplinary mechanism with a European label.

9. A paper put at that time to the Treasury Committee noted that there were potential conflicts between domestic monetary policy and exchange rate policy although they had not been acute for existing participants. Experience also suggested that in some circumstances membership could add to speculative strains. Expenditure in 1972 of over £1 billion of foreign currencies during membership of the "snake" was recalled.

10. The conclusion in 1982 was that when UK inflation and interest rates were closer to those of the Germans the case for joining a DM-dominated system would be more powerful.

Recent developments

11. In re-examining the question of entry now, some of the past inhibitions to membership have lessened. Although there is at present a substantial differential - over 6% - between UK and German interest rates inflation levels in the UK and Germany have come a little closer together (a gap of 2.5%) and the sterling/deutschemark rate has eased. There is less likelihood now of a conflict, such as there would have been in 1980 between monetary and exchange rate policies. Over this period, however, there has also been a significant rundown in our reserve position with the currency reserves falling from over $16 billion at the beginning of 1981 to less than $6 billion now.

12. There is some modest additional experience of the operation of the mechanism itself. Other relevant factors are the state of the oil market and the continued saga of the dollar. These are considered below. However it is suggested that the central question is probably again that considered in 1982: whether membership would help to achieve the ultimate aims of macro-economic policy. More specifically it seems worth considering the lessons from the exchange rate/interest rate problems last July and in recent weeks.

Operation of the ERM since March 1983

13. Since the realignment of March 1983, caused primarily by the weakness of the French franc and accompanied by strong measures to tighten fiscal and monetary policies, there have been no further realignments. For most of the remainder of 1983 the dollar strengthened and other ERM currencies were able to keep pace with the weakening German currency.

14. The see-saw movement of the deutschemark/dollar rate in 1984 from DM 2.5 to DM 3.2 took its course for the most part without unmanageable difficulties for the mechanism. This partly reflected greater convergence as French and Italian inflation rates fell. The different cyclical positions of France and Germany also helped. The German economy has been recovering at a time when the French were taking steps to reduce their current account deficit.

15. The major exception to this relative calm came in February 1984 at a time of dollar weakness. The strong rise of the deutschemark required the French, Italians and Belgians to spend over $1 billion each defending their currencies during the month. There have not been subsequent periods of dollar weakness. It is possible that further strains between the existing ERM currencies could become greater in the period ahead, eg in the run-up to the 1986 French Parliamentary elections.

The oil and dollar factors

16. In relation to the deutschemark, sterling has had a much bumpier ride from DM3.6 in March 1983 to over DM4.0 in August 1983. In 1984 there was also a wider swing than shown by other ERM currencies, from DM3.96 to under DM3.70. In 1985 sterling has eased further to a low of DM3.50¼. These swings are evidently in excess of a 2¼ per cent margin and have typically been associated with periods of oil price uncertainty. The strength of the dollar has, for the time being, masked the probable differential impact its substantial weakening would have on ERM currencies.

17. In terms of the deutschemark/sterling relationship there are three, additive, potential tests for sterling. The first is some weakening in the real price of oil over the next year or two. Secondly, while the latest US Budget proposals do not give promise of an early weakening of dollar interest rates or the level of the dollar, the underlying position remains unsustainable. When an easement occurs the deutschemark might appreciate substantially more than sterling. Thirdly the difference between the current deutschemark and sterling inflation rates (and in the underlying rates of growth of monetary aggregates) suggests that over time this will also lead to a need for some readjustment either through realignment or tighter policies.

Membership of the ERM and the aims of macro-economic policy

18. The main question about membership remains: would it help us to consolidate the reduction in inflation and set the conditions for a further fall. This objective has hitherto been judged more logically linked with targets for monetary growth than with membership of a regional exchange rate system. Linked with this main question, though separate from it, is the question whether membership of the ERM would make it easier or more difficult for us to cope with the day-to-day management of monetary policy (including the exchange rate itself), given the degree of prospective turbulence from external factors described in paragraph 17 above.

19. The ERM does not automatically operate as a tight discipline. It has shown itself to be more flexible than appeared likely at the time it was launched. At least in the period to March 1983 it has operated not as a fixed exchange rate system, but as a mechanism for short run stability combined with periodic sharp realignments.

20. Existing policies are working broadly as intended. Monetary growth is tolerably under control with £M3 at the top of its range and M0 in the middle. The inflation record has been transformed. The continuing prospect is fair especially following the recent tightening of domestic policy. Since 1981 output has been growing at an underlying rate of 3 per cent a year.

21. The conditions in which membership might help in achieving our counter-inflation aims are if we found operating our current monetary policy too difficult or too ineffective (or if it were perceived as such) and we needed to look elsewhere for a disciplinary mechanism that could be easily explained. In these circumstances, membership of the ERM would substitute an exchange rate target as the primary objective of policy for a monetary one. We would have to target ourselves on and follow German monetary policy and inflation performance much more closely. UK entry seems unlikely to make any major difference to the conduct of German monetary policy except in the situation where, against expectation, sterling appreciated relative to the deutschemark. At periods of significant dollar weakness in the past, the deutschemark has been subject to very substantial speculative inward flows. In that situation the Germans have shown themselves ready to either abandon or modify monetary policies. However that also does not seem an immediate prospect.

22. It perhaps has to be asked if the need to live with German fiscal and monetary policy would necessarily be a helpful rallying cry to expenditure control and fiscal discipline. In any event it would impose a new constraint on the operation of domestic policy. This has not been the case for Germany because the present system is deutschemark-driven. For the UK it could not be certain that a fixed exchange rate against the ERM

currencies would be consistent with achievement of the Government's political or economic aims. In particular for a switch of target to carry any conviction we would have to converge on German performance. At least in the first year or so the UK would have to eschew realignments to establish the credibility of its membership of the ERM (except possibly in the event of a sharp fluctuation unambiguously linked to an oil price change). Given German fiscal and monetary policy this would impose tighter policies on the UK. At the moment the presumption would be that this tightening would come about through higher interest rates. As noted in para 11 above, however, there is already a substantial differential between UK and German interest rates.

The ERM and interest rates

23. Would sterling membership of the ERM have helped in coping with exchange rate/interest rate problems in July or recent weeks? We considered this question in relation to the July interest rate increases, when there was a sharp movement against the DM, at the time. The conclusion reached was that it was difficult to make a convincing case that the increase in interest rates would have been any less if we had been in the mechanism: and it could have been more. If we had established a credible position for some time where sterling had been stable against the deutschemark combined with the presumption of infrequent exchange rate realignments, membership might have been helpful provided that we were able and prepared to intervene heavily. But these are strong assumptions. Nor would membership have enabled us to delay action. It is possible that we might have had to act on interest rates a little more quickly.

24. In October market behaviour was rather different. The DM/£ rate fell 3¾% from DM3.81 on 12 October to DM3.67 on 19 October, but interbank rates moved relatively little - from 10 7/16% to 10¾%. On that occasion membership of the ERM would almost certainly have required an interest rate increase which seemed unjustified by monetary conditions, and did not take place.

25. As regards recent events, there is room for argument about the mix of influences on the rate. But whatever the proportionate influence of dollar strength, oil price uncertainty, underlying doubts about the Government's commitment to firm monetary policies or the temporarily bearish influence of the miners' strike, there is no reason to suppose that membership of the ERM would have offered any protection. Those who have so argued have produced no evidence to support the suggestion that membership makes a country speculation-proof. The Owen/Steel approach seemed largely built on a misconception about access to others' reserves in the operation of the mechanism.

26. The recent experience has revived the line of thought that if it is impossible to persuade the markets of our approach to the exchange rate, we might as well give up and have an explicit exchange rate policy. It is true that we cannot give a precise or quantitative description of the implications of "taking account of the exchange rate" in interest rate decisions. It may not always be apparent which exchange rate we are most interested in and the nature of our concern. In the event some commentators have come to the view that there is a commitment to defend the sterling/dollar exchange rate. The need to demonstrate concern for the exchange rate, while not having a view about precise levels, is a further complication. This has become more acute with the record lows reached by sterling over this period. However the visibility of the exchange rate does not increase its merit as a target if the external influences upon it are volatile or even perverse: and clearly not under the Government's control.

Realignments and the reserves

27. The ERM combines the tendency of all fixed rate systems to set up "one-way bets" when a realignment is considered inevitable with a rather dilatory procedure for agreeing the realignments. In the past those ERM members that have requested weekend realignment meetings have often been expected to sweat it out for a while and in any case domestic events in ERM countries sometimes rule out particular weekends. In this context to delay a meeting from one weekend to the following one could

give rise to substantial problems of monetary management and involve sharper fluctuations in interest rates and reserves than under the present system. If the intention is to realign from time to time the markets will be constantly on the lookout for signs of impending changes and will tend to doubt the authorities' determination or ability to resist them. Speculative flows between two reserve currencies with no exchange controls, like the DM and £, are likely to be especially strong.

28. The likelihood is therefore that if the UK joined the ERM it would have to be prepared to deal in the early years at least with significant exchange rate crises. These would occur either if the intention was to defend the initial parities for a considerable time or if the intention were to adjust by realigning quite often. The UK is probably less well equipped to deal with such short-run problems than other ERM currencies such as the French and Italians partly because of the absence of exchange controls and also because of the low level of our reserves. In principle these problems could be eased if the procedures for changing parities could be made faster and simpler. But we could not be confident of being able to negotiate that. And if realignments were frequent the discipline would be reduced and problems of market management increased.

29. In the past overseas borrowing has been undertaken through the nationalised industries. There are now less of them and those that remain are more profitable and so have no need to borrow. Any substantial accretion to our reserve levels, other than intervention purchases which would tend to depress sterling, would therefore require borrowing in the Government's own name. Such action would tend to reinforce the impression that entry was a course of policy forced on us against our will. The worst outcome of all would be inability to maintain a chosen parity and repetition of the 1972 experience. At that stage it would be difficult to reassert the primacy of monetary aggregates.

Political arguments

30. Though other member states will welcome our membership of the ERM with varying degrees of enthusiasm, there is no reason

to suppose that our joining the ERM would make it any easier to achieve our other objectives in Europe, eg a budgetary control and the internal market. Nor is it likely to add to the popularity of Community membership.

31. It is sometimes suggested that the stronger Community currency bloc which would result from sterling membership might help to make it possible to develop a more coordinated response to US policy. This is certainly a desirable objective. But it is far from clear that membership is either a necessary or sufficient condition to achieve it.

The central issue

32. A check list of the arguments for and against membership of the ERM is annexed.

33. The fundamental issue is whether entry would provide the Government with an opportunity to restate its economic policy and give a new impetus to counter-inflation policy. Inflation is for the moment lodged at 5 per cent and there are pressures on the horizon which could put this at risk. Linked with this would be a possible gain in presentation associated with a more general understanding for the exchange rate.

34. The argument against this conclusion is the possibility that by joining we replaced uncertainty about the exchange rate for uncertainty about monetary policy. While the ERM remained as flexible as it has been so far there would be no necessary increase in discipline. Homing on German performance would, however, set a fierce pace. The expectation must be that over coming months and in particular over the period of prospective realignment of the dollar the rest of the Community would undergo repeated realignments. Would membership make difficult decisions any easier to take? Would the markets see it as an attempt to relax policy whatever was said?

35. Joining the ERM would not alter the centrepiece of the Government's strategy namely the determination to reduce inflation further. Retention of domestic monetary targets for the medium

term would give reassurance about the continuity of policy. But it would need to be accepted that such targets did not have primacy in the short term in relation to maintenance of ERM parities. There might need to be some reassessment of the chosen targets with perhaps a downgrading of £M3. This would not necessarily be unwelcome. We think £M3 will become increasingly subject to distortion and hard to interpret; and the policy of controlling it through "overfunding" results in a rise in debt interest and thus a rise in public expenditure offset by a rise in the Bank's holdings of commercial bills (the "bill mountain").

36. However it must be recognised that the markets might not necessarily see joining as a strengthening of policy. It would come against the background of advocacy of entry, in general, by those whose commitment to counter-inflationary policy was in doubt. While the natural time for such a decision would be the Budget, by March the memories of recent weeks will not have faded and the decision would not evidently be taken from strength.

37. To sum up: entry would at the very least present a substantial presentational task. But beyond this the central question for consideration is whether the credit to be put at risk in such a task, and the unknowns in the subsequent evolution of policy, would be matched by the gain from a potentially more intelligible anchor for counter-inflationary policy. If the answer to that is in principle positive, is this the right moment to take this step, bearing in mind the market and political pressures of recent weeks, the reserve position and the extent of the persisting gap with German performance?

ANNEX

Membership of the ERM: Checklist of arguments for and against

For	Against
A. Nature of Sterling	
1. Should help reduce market's preoccupation with £/$ rate [assuming we wish to down-grade its importance.]	1. Problem of running a system containing two reserve currencies, subject to very large speculative flows between them. 2. Sterling's petro currency status, causing £ to move against DM on oil price prospects.
B. Size of UK Reserves	
1. Membership would give automatic access to very short term borrowing facility. [But existing members have found this only of limited use.]	1. Currency reserves too small to withstand for long even temporary market pressure by intervention - as rules of ERM would require us to do. [In absence of exchange controls, this could put great strain on domestic interest rates.] 2. Rebuilding reserves would take time, and substantial foreign borrowing in HMG's own name.
C. Financial discipline to reinforce counter-inflation strategy	
1. Simpler to explain, to public and markets, than present policy.	1. Getting inflation down quickly to German level may be over-ambitious with adverse short term effects on output and employment. But alternative, of accepting occasional realignments, could cause market problems and/or mean relaxation of discipline.
2. In principle, keeping up with DM means more rapid progress against inflation than existing strategy.	2. More generally, could be occasions - eg. when £ was moving for oil reasons - when sticking to DM gave a discipline that was either too tight or too lax.
D.Relationship with Monetary Policy	
1. Joining would provide a good opportunity to reformulate monetary targets. £M3 may be becoming increasingly distorted and misleading.	1. In principle conflicts can occur between exchange rate and monetary targets. Membership means that in the short term, the former will always be given precedence (in setting interest rates, and on occasion in fiscal policy).

E. Handling Periods of market turbulence

1. Membership could sometimes insulate the £ and domestic markets from pressures or potential pressures, having a useful, psychological, calming effect on the markets.	1. In general, would not avoid need to take difficult decisions. In July and January, for example, interest rates might have had to rise sooner and further - since exchange rate can take little none of the strain.
2. Would increase short run certainty for business about exchange rate other EMS currencies.	2. Fixed exchange rate systems are traditionally crisis prone. Expectations of realignments can lead to massive speculative pressures, and very volatile interest rates.

F. Presentation

1. Should make counter-inflation policy simpler to present.	1. Difficult to explain continuity of policy given intellectual and presentational capital invested in present policy and MTFS.

G. Political Arguments

1. A symbol of our commitment to Europe.	1. Would mean on occasion associating unpopular decisions with EC.
2. Would be welcomed by our EC. partners.	2. Problem of having to agree realign ments with our partners.
3. Should assist economic convergence in EC.	

H. Timing: Why now?

1. Sensible to join at time of a budget, when can be presented as part of coherent strategy.	1. Case for waiting for (a) long expected fall of $ (which would probably cause DM to rise against all currencies), and (b) more settled oil markets.
2. Increased need to cut through problems of interpreting £M3, and explaining policy to markets.	2. Risk of joining with inadequate reserves. Would take time to borrow enough abroad to rebuild them to a safe level.
3. EC budget negotiations are over.	3. Might be better to join at a lower level of interest rates and a lower £/DM exchange rate.

211256 :LAWSON SAYS BRITAIN HAS NO EMS MEMBERSHIP PLANS:
LUXEMBOURG, Sept 21 - Britain has no short-term plans to join the exchange rate mechanism of the European Monetary System (EMS) despite mounting pressure from its partners within the currency float, Chancellor of the Exchequer Nigel Lawson said.

Talking to reporters after an informal two-day conference of European Community finance ministers, Lawson said +There is no change in our position ... We have no objection in principle to join the EMS.+

+But it is a question of keeping the situation under review and weighing up advantages and disadvantages,+ Lawson added.

MORE

211256 :LAWSON SAYS BRITAIN =2 LUXEMBOURG:
He denied rumours that an official annoucement on Britain's role within the EMS was due shortly, saying +I have no plans for an announcement.+

Delegates said although the issue of British full EMS membership had been raised only marginally at today's talks, the British government had come under mounting pressure from its partners to join, a move which they said would greatly strengthen the tie-up and boost Europe's role on the international monetary scene.

+The time is as right as can be (for Britain to join),+ Dutch Finance Minister Onno Ruding told reporters.

MORE

211257 :LAWSON SAYS BRITAIN =3 LUXEMBOURG:
Britain has argued that wild fluctuations in sterling's exchange rate, due to its status as a petro-currency, could upset rather than strengthen the system of currencies fluctuating within narrow bands.

British diplomats also say that Britain's refusal to join the exchange rate mechanism, currently adhered to by all other community states save Greece, stems from fears in the Bank of England that it will lose part of its control over monetary policy.

REUTER

SECRET

PAPER 2

PROCEDURAL ASPECTS OF MEMBERSHIP OF THE EXCHANGE RATE MECHANISM

This note explores the procedures that would need to be adopted if it were decided that sterling should join the Exchange Rate Mechanism. Some points for consideration are summarised at the end of the paper.

The Process of Joining

2. The UK has the right to join at any time, but mutual agreement with other participants and the Commission is needed on the choice of central rate. The procedure would resemble a realignment conference. The probable outcome would be a central rate close to the prevailing market rate.

3. There would however be a certain option on timing which could affect the central rate finally chosen. There are three possibilities: to join with immediate effect and without prior announcement; to join unilaterally, announcing the intention to join fully as soon as the agreement of others to a central rate had been arranged; or to announce in advance the intention to participate within a specified fairly short period.

4. The first option would give no time for preparation or possible negotiation. The second would have the disadvantage of accepting the constraint for a possibly uncomfortable period in which arrangements with partners had not been settled. The third possibility would allow a little time for discussion before actually joining, and also allow the market that same period to digest and absorb the news, with whatever effect on the current exchange rate that might have, before the UK were obliged to settle and operate on a central rate in the mechanism.

Margins

5. The standard margin is 2¼ per cent each way. The very strong hope of others would be that we should join the core group at

2¼ per cent margins. It is doubtful whether additional leeway would give a great deal of relief from the difficulties of operating within the system and markets might take badly what could be seen as taking a soft option.

Daily Operation

6. The primary obligation would be to respect the fluctuation margins, short of a demand for realignment. Regard would also have to be paid to the "threshold of divergence", which would be separately calculated for sterling and fixed at 75 per cent of the maximum spread of divergence for each currency. The point of this is that, if sterling crossed this threshold, which can occur before the intervention margin is reached, there is ia "presumption" that the situation needs correction, by whatever choice of action may be appropriate. A decision not to act might have to be explained to the partners and could become the subject of consultations. But recent evidence suggests that these "threshold" arrangements are not operated at all rigorously.

7. The task of maintaining sterling within the required margins could normally be supported by:

- intervention;
- monetary policy/interest rates;
- other domestic policy measures.

8. In practice, as long as the general strategy within the mechanism were the same as the strategy that would have been pursued under our present arrangements, any resort to domestic policy measures, other than monetary changes, would be likely to be much the same either way. What would be new would be a more regular use of intervention and the possible need for prompter, even on occasion larger or more frequent, movements of interest rates.

Intervention

9. A fairly frequent use of intervention, on at least a modest scale, would probably be required. This would typically arise

on fluctuations well short of the limits of the permitted range, and in order to stop any still relatively harmless drift which, if left to itself, might develop into a more substantial speculative market. In principle, such intervention should, over time, broadly cancel out. But it could be one-way for an extended period, and accumulate to quite a large amount.

10. Any large-scale intervention, particularly if over a limited period, would require thought as to the effects on domestic money supply, in either direction: this could also apply to the UK's need to take account of intervention by others in our own currency.

11. Community support facilities are available though we may not want to place much reliance on them. Medium-term support is available only conditionally: it is akin to IMF borrowing, requiring statements of (usually substantially strengthened) domestic policies and expectations. The unlimited and unconditional very short term facility is callable only to finance obligatory intervention at the margin. Both have been used by existing members in the past, most recently by France.

12. In the UK's case prolonged intervention would be constrained by the relatively small size of our currency reserves which at present stand at less than $6 billion. In 1982/83 France - even with their exchange controls - spent over twice this amount in intervention. Past experience, as well as that of other countries, suggests that - with perhaps the occasional rare exception - the need for large intervention argues also a need for some, and prompt, change in interest rates or domestic policies.

13. Thus, in general, the UK may have to be prepared: first, to accept an increase in domestic interest rates quickly if strong pressure against sterling developed; secondly, to recognise quickly the existence of an even deeper problem and seek realignment and/or other domestic policy measures as considered appropriate.

14. There is one possible exceptional situation about which something special could theoretically be done, and which is perhaps worth consideration. The UK and Germany will be by far the largest

and most open capital markets in the Community, with our market the larger of the two in terms of accessibility both ways. Situations can readily be envisaged in which substantial international capital movement, to or from dollars in particular, could have a large differential effect on sterling and the DM, not because of a significantly different judgement about the relationship of the two currencies, but simply because one market was or had in the past been more accessible and was therefore attracting or losing a much larger share of funds in the total movement.

15. One possibility for consideration is whether an arrangement should be set up with the German authorities, in principle, for mutual bilateral support, to be invoked only in circumstances in which the judgement of both sets of authorities was that there was no grounds for a change reflecting underlying conditions, and that a temporary international shift of funds had to be covered with minimal damage. If we could get it, this could be a very useful facility. Its availability would also be relevant to the reserves issue discussed below. But it can by no means be assumed that the Germans would be prepared to contemplate such a special arrangement.

Strengthening the Reserves

16. Joining the ERM, with its consequent need for intervention, would require a return to own-name borrowing. The decision to join the ERM is unlikely to affect very much either way HMG's ability to borrow, or the terms on which it could do so.

17. Consideration would also need to be given to the size of an HMG issue. An operation which might effectively increase the reserves by up to $1 billion, when taken with other borrowing opportunities and net of repayments due, would provide some extra liquidity. To go for very much more might give the impression that the UK was prepared to intervene on a very large scale from the outset. But not to do so might suggest that we would seek a realignment, or take other action, at the first sign of pressure.

18. A subsidiary question which would arise is whether it might make sense to change the pattern of holdings and the relative liquidity of the reserves. The two obvious moves for consideration would be some realisation of gold holdings and some switch from liquid dollar holdings to liquid holdings of DM. In practice, it may not make a great deal of difference whether we intervene in one currency or another.

The Oil Problem

19. This is a problem whose nature is recognised by the potential partners who might accept the proposition that the UK should be entitled to prompt realignment in the event of any significant move in the oil price evidently creating pressure on the exchange rate.

20. Awkward problems arise in practice, however, where there is uncertainty or where the oil price adjusts at an inconvenient time, say on a Monday. A situation could arise where an untenable exchange rate might have to be defended until a weekend realignment conference. One alternative would be for sterling to drop temporarily out of the Mechanism.

The Sterling/DM Relationship

21. This would be of central importance to the UK and should be the key relationship within the Mechanism as a whole. The underlying situation, that the German inflation rate is persistently lower than that of the UK, tending to generate greater market confidence in the German currency than in sterling could exert some pressure from time to time.

22. The importance of the relationship suggests the necessity for a specially close understanding between the British and German authorities; and there is a particular problem in that the Bundesbank carries rather more, and more independent, authority on both foreign exchange operations and monetary policy, than does the Bank of England, and the German Finance Ministry

correspondingly less than the UK Treasury. Careful consideration would need to be given as to the size of the role delegated to the Bank of England.

23. There is something to be said for establishing with the German authorities an understanding that any important actions taken or intended, which could affect the market relationship, should be at least indicated and explained to the other side as quickly as possible, and where possible with an opportunity for consultation, or time to take any corresponding or countervailing action. The arrangement could develop well, but there might be an initial problem in that it would be of less importance to the German authorities, or would seem to them to be of less importance, than it would to the UK.

UK Financial Policies

24. Consideration would need to be given to the presentation and formulation of the Medium-Term Financial Strategy. The focus of market attention would be bound to shift dramatically to the daily exchange rate performance which would have consequences for the operational significance of monetary targets.

Timetable and Checklist

25. The attached Annex contains a very tentative timetable with an indication of points which might arise, and approximately when, in the process of joining.

Summary of points for consideration

26. Emerging out of this note are the following points for consideration:

(i) the process of joining and particularly the question of timing (paras 3-4)

(ii) The width of fluctuation margin at which to join (para 5).

(iii) The effects of intervention on domestic monetary conditions (para 10).

(iv) The question of mutual bilateral support with the German authorities (paras 14-15)

(v) The implications for the external debt programme (paras 16-17).

(vi) The possibility of sterling temporarily dropping out of the mechanism (para 20).

(vii) The nature of communication and consultation with the German authorities (para 23).

(viii) The presentation and formulation of the MTFS (para 24).

ANNEX

TIMETABLE AND CHECKLIST

Start

Decision taken in UK, to join within, say, 4-6 weeks. Should include a provisional decision on the likely/desirable central rate and probably a firm decision on choice of margins.

During first three weeks:

Be ready with announcement, in case of leakage. If no leakage announce after 2/3 weeks the intention to join 2/3 weeks later.

First week:

Secretly approach German authorities to tell them of the decision and discuss:

- arrangements for specially close contact between German and UK authorities;

- possible mutual bilateral support arrangements.

Also discuss with German possibility of temporary drop-out limited strictly to a short period of oil price uncertainty.

Second week

Continue discussions with Germans.
Tell the President of the Commission and seek his support for the idea of a temporary drop-out.

Third week

Aim to conclude discussions with Germans.
Inform other members of the Community (and by now, if not before,

secrecy will have been broken and an announcement should be made). This might be a good time for a meeting of ECOFIN. The announcement could usefully point to a date 2/3 weeks ahead by which time sterling will have joined.

About 4th/5th Week:

A little inside the date which has been publically announced, arrange a week-end meeting to settle the central rate.

PAPER 3

MECHANICS OF THE EMS

Membership

With exception of Greece, all the EEC countries were, and are, members of the EMS. Since 1979, the UK has participated in all aspects of the EMS other than the exchange rate mechanism. 20% of the UK's gold and dollar reserves are placed with the European Monetary Co-operation Fund (EMCF), there is a sterling component in the European Currency Unit (ecu) and the UK plays a full part in all Community discussions about the development of the system.

The Parity Grid and the Fluctuation Margins

(i) The principal intervention rule relates to the cross rates between each EMS currency. At each realignment members agree a matrix of central cross rates between each of their currencies. This collective set of central parities is known as the "parity grid". Members maintain the market exchange rates within a band 2¼ per cent either side of the agreed central rates (except for the Lira which for the time being is kept in a $\pm$ 6 per cent margin).

(ii) Intervention at the intervention limits is compulsory and, in principle, is in Community currencies. Thus the central bank of the strong currency buys the weak currency, while that of the weak currency sells the strong currency. In practice, intervention at the margins also takes place in dollars. There are no formal rules distributing the intervention obligations between the stronger or the weaker country though concertation often takes place. Nor is there a formal limit to the amount of intervention expected. Participants would b e required to intervene as much as would be necessary to remain within the band. If there is a continuing need for intervention then additional action might be taken by a government; a change in monetary, fiscal or other domestic policy, or perhaps the members concerned would seek a realignment.

(iii) Central banks more frequently intervene between the intervention limits, undertaking so-called "intra-marginal intervention". Intervention need not, in this case, be in participating currencies and is usually in $. If intervention is in a participating currency the prior agreement of the issuing central bank is required. Moreover under an agreement between the participating central banks, holdings of Community currencies are limited to working balances only and the limits laid down by the Committee of Governors can only be exceeded with the consent of the central bank concerned.

Divergence Indicator

(i) Whereas the parity grid system specifies bilateral exchange rates and margins, the divergence indicator acts as a warning system designed to limit the tendency for any single currency to depart from the system as a whole.

(ii) The indicator is expressed in terms of divergence from the ecu. First, a calculation is made of how far each currency would diverge from its ecu central rate if it were against the 2¼ per cent limit against all the other currencies simultaneously. In practice the smaller is the weight of the currency in the ECU, the further it can diverge from its ECU central rate. Second, a calculation is made of 75 per cent of each currency's maximum divergence from its ecu central rate. This figure is called the divergence threshold.

(iii) If the divergence indicator reaches its threshold (which may occur even though the $\pm$ 2¼ per cent margin has not been reached against any other currency) then there is a "presumption", rather than an obligation, that authorities will intervene, change policy or call a realignment conference.

EMS Credit Facilities

EMS intervention results in countries buying or selling other participants' currencies.

(i) Intervention at the margins automatically qualifies for the very short-term facility, though this has not been used extensively. Participating central banks are required to open for each other very short-term credit facilities, unlimited in amount, in accordance with certain conditions. The initial date of settlement is 45 days after the end of the month in which intervention took place. This settlement date can be extended automatically by three months, subject to certain limitations, and by another three months, subject to the agreement of the creditor central bank. These intervention debts can be settled in a number of ways. The formal procedures state that, insofar as the debt has not been settled in the first instance by means of holdings in a creditor's currency, then a settlement should be carried out by transferring ecus with the proviso that a creditor central bank should not be obliged to accept ecus in excess of 50 per cent of the claim. If by doing so ecu assets fall short of forward sales then interest is paid to the EMCF (and vice versa if there is a positive net ecu position). The balance can be settled by transferring other reserve assets according to the composition of the debtor's bank reserves (excluding gold). However, in practice, most of the debts resulting from obligatory intervention are settled by offsetting claims or the debtor central bank buys the currency of the creditor.

(ii) A complementary facility is provided by the mechanism of short-term monetary support, which exists to provide temporary balance of payments financing under certain circumstances, with a (renewable) duration of three months. The facility is funded by quota subscriptions.

(iii) Finally, medium-term financial assistance is also available on a conditional basis with funding either by way of country commitments up to agreed ceilings (the MTFA) or through a Community market borrowing (the Community loan mechanism).

PAPER 4

HISTORY AND DEVELOPMENT OF THE EMS

Following the breakdown in 1971 of the Bretton Woods system of fixed exchange rates, a number of European countries set up a currency arrangement known as the "snake". This was inaugurated in 1972 by the six original members of the EEC: joined soon after by the United Kingdom, Ireland, Denmark and Norway (at that time the four new applicant countries).

2. The main provision of the snake was to reduce the permissible margins of fluctuation of the member country's exchange rates vis-a-vis one another. This had been advocated as a first step by the Werner Committee Report in 1970 which had called for the establishment of a complete European Monetary Union by 1980. The Report's recommendations were adopted by the Community in 1971 and the launch of the snake was thus associated with the ultimate objective of EMU.

3. Membership of the snake proved unsustainable for a number of the original members. Sterling left the snake in June 1972 after massive intervention had failed to stem pressure on the £. The Danish krone also left in June 1972 but rejoined in October. The lira left altogether in February 1973; the French franc left in January 1974, rejoined in July 1975 and left finally in March 1976. Eventually the snake became virtually a deutschemark zone, a grouping of smaller currencies, including several from outside the European Community (including Austria and Switzerland who adhered to the system without being members of it) with the deutschemark as the major currency. Throughout the life of the snake there were a number of changes in parity.

4. The target of establishing EMU by 1980 was officially abandoned in December 1974 and the momentum for progress in this area seemed to have disappeared completely by the mid-1970's.

5. Then, in 1978, a Franco-German initiative put forward the idea for a European Monetary System at the European Council in Copenhagen in April of that year. In the run-up to the next European Council in Bremen in July 1978, the Franco-German ideas were worked up into a more detailed proposal which was considered at the European Council and published shortly afterwards. The objective was the creation of a "zone of monetary stability in Europe" and involved a new currency unit, the European Currency Unit (ECU), to replace its predecessor, the European Monetary Unit of account, as the centre of the system. The importance of convergence of economic policies of the success of such a system was also emphasised.

6. Negotiations within the Community took place during the autumn of 1978 and the details of the EMS were approved at the December European Council in Brussels. The system came into operation on 13 March 1979. All the then nine members of the Community were members of the system, but the United Kingdom chose not to participate in the exchange rate mechanism. Greece did not choose to join the EMS when she acceded to the Community in 1981.

7. The document agreed between Community heads of government at Bremen envisaged a move to a second, institutional, stage after two years of operation, which would have involved some permanent transfer of reserves to a new European Monetary Fund (EMF). By general agreement in the Community the move to this second stage has been postponed, and no new target date has been set.

8. Annex A indicates in very broad terms developments in the exchange rate mechanism since March 1979.

9. The system has enjoyed greater stability than many expected at the outset though there have been a number of significant realignments (see Annex B). It is a widely held view that the major reason for this has been the unexpected weakness for much of the period of the deutschemark against the dollar (see attached chart).

ANNEX A

In very broad terms, developments in the foreign exchange markets since March 1979 fall into the following phases:

(i) From spring 1979 until autumn 1979 the deutschemark (DM) was relatively strong against the dollar, and some other EMS currencies (notably the Danish krone) relatively weak. There were realignments in September and November 1979 in which the DM was revalued by 2 per cent and the Danish krone devalued by 8 per cent against other participating currencies.

(ii) From late 1979 to autumn 1980 there were few major tensions within the system, although the DM was generally weak through much of the period.

(iii) From October 1980 the DM began a steep decline against other major world currencies which was not finally halted until February 1981, with a sharp rise in German interest rates. Over this period other currencies, notably the French franc and Dutch guilder, rose to their upper intervention limits against the DM.

(iv) Following the lira devaluation in March 1981 and the French elections in April 1981 there was a period when the DM appeared strong against most other EMS currencies, and the French franc in particular, while it remained comparatively weak against the dollar. This was the background to the general realignment on 4 October 1981.

(v) From October 1981, The DM tended to be at or near the bottom of the ERM band with the French franc and Danish krone towards the top. But the Belgian franc came under severe pressure in mid-December, and remained generally weak until the February 1982 realignment, in which it was devalued by 8½ per cent and the Danish krone by 3 per cent against other EMS currencies.

(vi) From February 1982 to the widely expected general realignment on 14 June, the system was under fairly constant strain, with the currencies broadly in two groups - the DM, Dutch guilder and Danish krone towards the top and the Belgian and French francs and Irish £ at or near the bottom. The lira was also weak throughout this period, remaining below all the "narrow-band" currencies for much of it.

(vii) After the mid-June 1982 realignment, there was a period of considerable calm up to end-August 1982, followed by one of relative volatility and, from mid-November, considerable pressure within the ERM with the Dutch guilder at or near the top of the narrow band, and the Belgian franc and (from mid-December) the Irish £ towards the bottom. From early February 1983, the DM strengthened and the French franc came under heavy pressure ahead of the widely-expected general realignment on 21 March (following the German and French elections in early March).

(viii) From March to August 1983, conditions within the ERM were relatively stable, although it was fully stretched for much of the period. The DM remained at or near the bottom of the narrow band, with the Irish £ and French franc at the top.

(ix) During September and early October 1983, the DM strengthened, leaving the Belgian franc isolated at the bottom of the narrow band with the other currencies grouped closely together at the top. Since then, developments in the ERM have largely reflected the position of the dollar. The system was rather less stretched in December 1983 and January 1984 as the dollar strengthened, but the Belgian franc came under renewed pressure in February and March as the DM benefitted from the dollar's weakness. From April to November 1984, the system was under no pressure against a background of dollar strength, with the DM and Belgian franc respectively at the top and bottom of the band. The Danish krone has generally been at the top thereafter; and in early January

the Dutch guilder replaced the Belgian franc at the bottom, and is currently near its lower intervention limit.

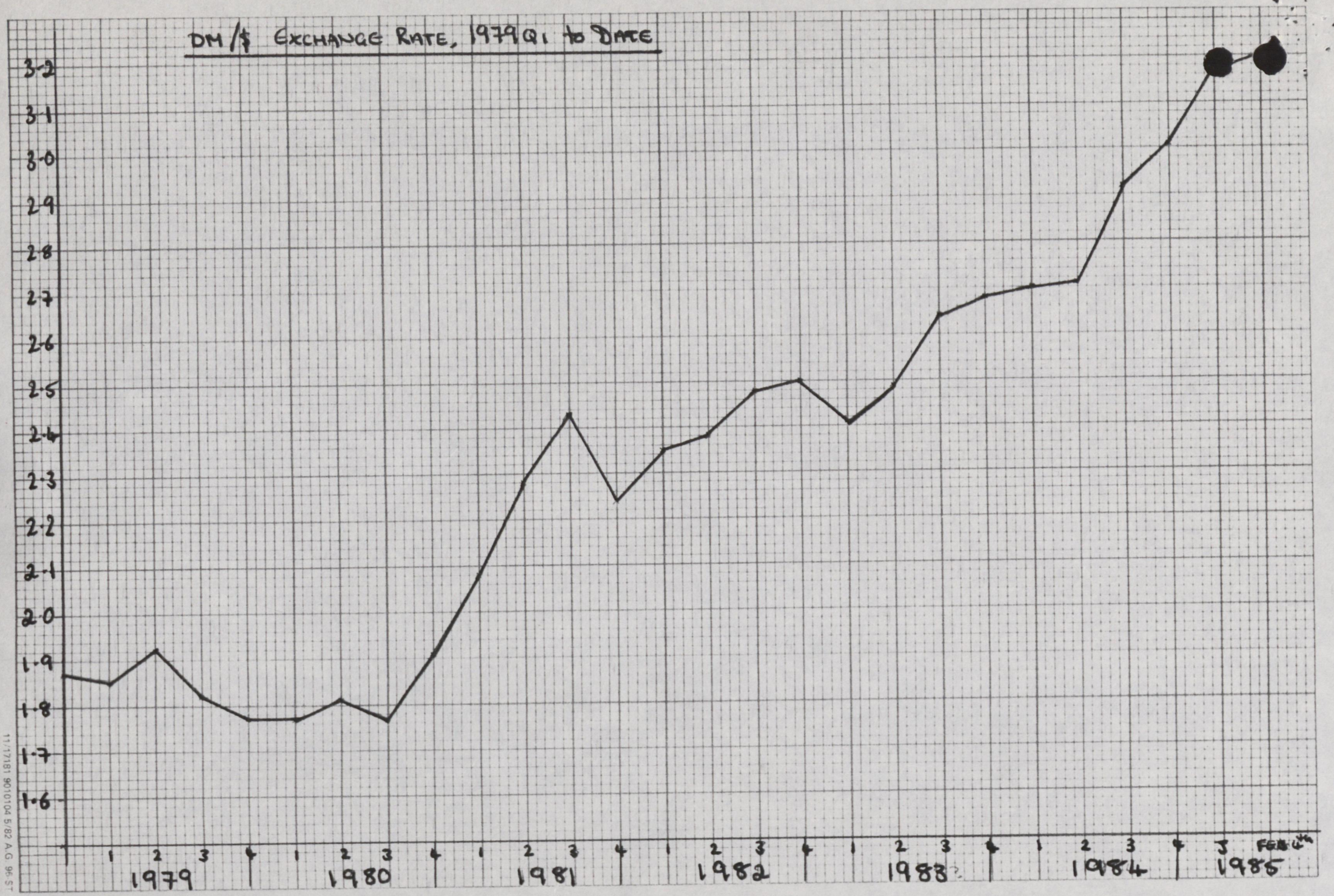
5 February 1985

EMS: Economic Measures in Connection with Realignments[1]

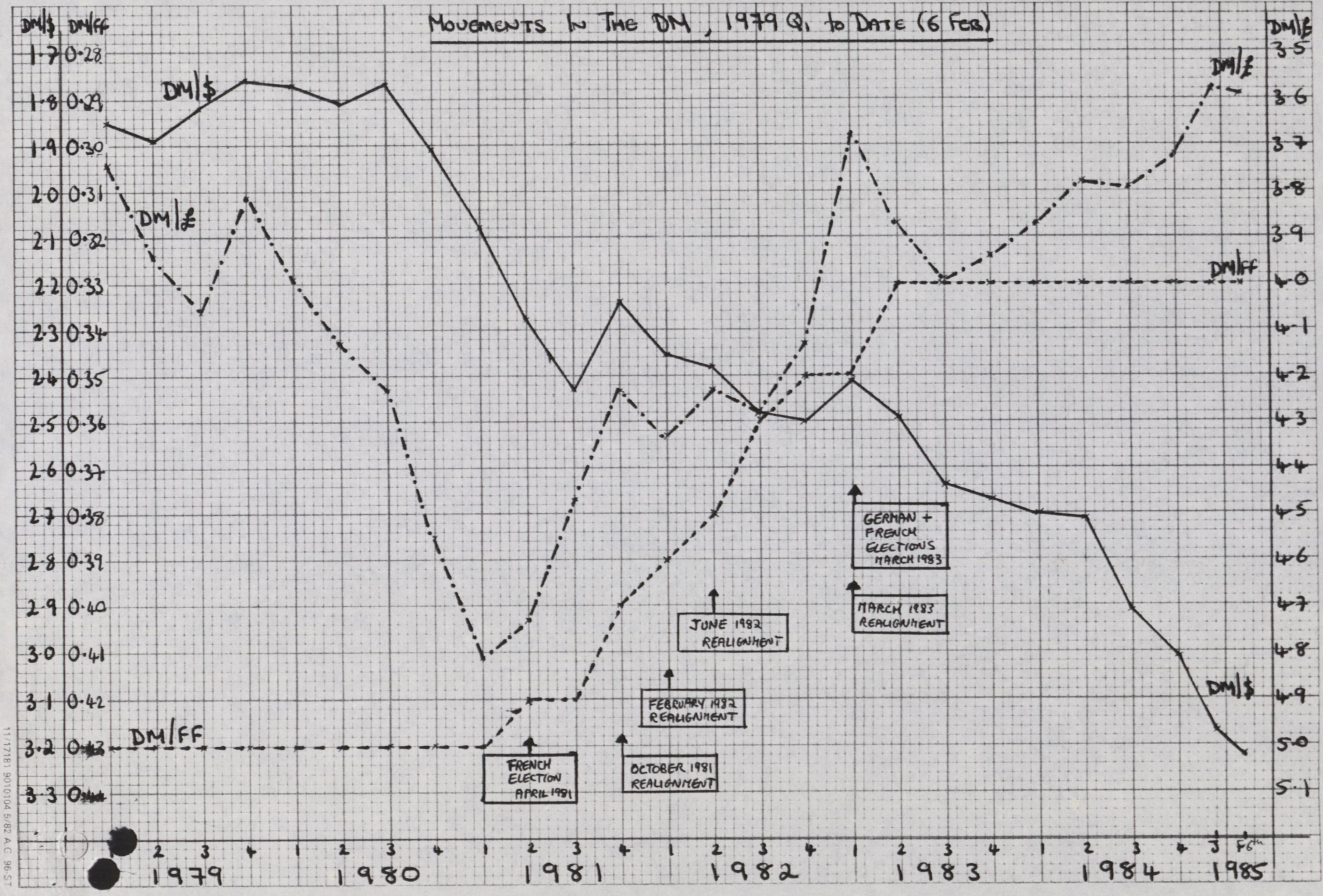
Realignment Date	Realignment: Wording Based on Official Communiqué	Major Measures in: Belgium	Denmark	France	Italy
September 24, 1979	Shift in cross-rate between DM and DKr of 5 percent. Shift in cross-rate between DM and other EMS currencies of 2 percent	—	—	—	—
November 30, 1979	Devaluation of DKr by 5 percent against other EMS currencies (no communiqué)	—	• Energy component removed from wage-regulating index • Short-term price and wage freeze measures • Increases in direct personal wealth and corporate taxes	—	—
March 23, 1981	Devaluation of Lit by 6 percent against other EMS currencies	—	—	—	• Discount rate up 2½ percent to 19 percent • Government spending cut plans
October 5, 1981	Revaluation of DM and f. by 5.5 percent against DKr, BF, Lux F, £Ir. Devaluation of FF, Lit by 3 percent against DKr, BF, £Ir	—	—	• Temporary price and profit freeze • Incomes policy aiming at maintenance of average income purchasing power, narrowing of income range • FF 10.15 billion government expenditure in suspense	—
February 22, 1982	Devaluation of BF, Lux F, by 8.5 percent and of DKr by 3 percent against other EMS currencies	• Temporary freeze of wages and longer-run measures to impede complete wage indexation • Temporary price freeze • Reduction in corporate tax burden • Measures to stimulate the stock market	—	—	—
June 14, 1982	Change in bilateral rates: between FF and DM, f.: 10 percent; between Lit and DM, f.: 7 percent; between DKr, BF, Lux F, £Ir and DM, f.: 4.25 percent	—	—	• Temporary freeze of wages, prices, rents and dividends (except minimum wage) to be followed up by agreements on price and dividend behavior and indexation practices for wages • Revision of 1983 budget to restrict deficit to FF 120 billion (3 percent of gross national product)	• Announcement of budgetary austerity measures, June 23.
March 21, 1983	Change in central rates: Deutsche mark +5.5 Netherlands guilder +3.5 Danish krone +2.5 Belgian franc +1.5 Luxembourg franc +1.5 French franc −2.5 Italian lira −2.5 Irish pound −3.5	—	—	• Package of restrictive measures in budgetary, monetary, and foreign exchange fields.	—

Sources: Commission of the European Communities and Fund staff.

[1]Notation: BF—Belgian franc; DKr—Danish krone; FF—French franc; DM—deutsche mark; £Ir—Irish pound; Lit—Italian lira; Lux F—Luxembourg franc f.—Netherlands guilder.



11/17181 901104 5/82 A.G 96 ST


MOVEMENTS IN THE DM, 1979 Q1 to DATE (6 FEB)
DM/$
DM/£
DM/FF
DM/£
DM/FF
DM/$
GERMAN + FRENCH ELECTIONS MARCH 1983
MARCH 1983 REALIGNMENT
JUNE 1982 REALIGNMENT
FEBRUARY 1982 REALIGNMENT
OCTOBER 1981 REALIGNMENT
FRENCH ELECTION APRIL 1981
1979
1980
1981
1982
1983
1984
1985
6th

SECRET

5

LETTER FROM PROFESSOR SIR ALAN WALTERS TO MR. ANDREW TURNBULL

JOINING THE EMS - SOME ADDITIONAL QUESTIONS

1. Speculation against sterling is one of the main problems of the existing system. The EMS will not prevent such speculation - on the contrary, unless other undesirable measures are taken, it is likely to increase the profitability of shorting sterling. The authorities do not object to gradual movements in sterling - what they object to is sharp downward movements, arguing that it might be a "bottomless pit" which would destroy confidence. Yet the EMS re-alignments are all sudden changes. And, as French experience during 1982 shows, there is no guarantee that, in the EMS, the sudden shift halts the slide. Why is the plan unacceptable outside but good inside the EMS?

2. As is clear from the history of the French franc, joining the EMS is unlikely to reduce speculation against sterling and I would conjecture, because of the "step" movement on re-alignment, it would be made more profitable and so increase. In any case, the only way to deal with this is to make speculation against sterling unprofitable without, at the same time, making investment also unprofitable and depressing the economy. The present techniques and conventions of monetary control make this very difficult and chancy - essentially the need is sharply to raise overnight to seven-day rates without raising three-month (or more) rates. The French experience shows that, in the EMS structure, this is the only effective way of taking out the bears. Since we are a more open economy, the UK would be subject to much more pressure, so the need to tame the bigger bears is the greater.

SECRET

Do the proponents of EMS plan to change the monetary arrangements so that we can squeeze those shorting sterling? If so, could we know the institutional changes involved and how they are to be implemented?

3. It is not true that if we change the present system so that we can punish would-be bears, the difficulty of the bearish rush precipitating a fall of sterling would disappear. Joining the EMS would be likely to, at best, be irrelevant to the main issue.

4. Even if the UK joined, the DM would continue to dominate the EMS. Britain would have a role like France or Italy (the Netherlands is really part of the DM block). Both France and Italy have exchange controls and regulated credit rationing. In spite of the rigorous enforcement of exchange control in 1982-3 and the (3?) devaluations, the French Government had to intervene on a massive scale; indeed, there was much talk of the EMS having, in fact, broken down.

5. In view of our open capital and exchange markets and the continued role of sterling, the UK would come under much greater pressure than France, even if the latter had free credit and exchange markets. But with France and Italy regulated, it is very likely that Britain would have to bear much more speculative activity. Would the sponsors of Britain's entry envisage the introduction of credit rationing and exchange controls in Britain, at least as stringent as those in France as a concomitant of entry? Are we prepared to dismantle our open-market, free-exchange system in order to join the EMS grid?

6. Control of money and credit markets and insulation from the Euro market, a la France, would enable us to immitate the French in raising the overnight rate to tame the bears. However, it is worthwhile noting that this did not offset the need for massive and costly intervention, nor did it prevent the sequence of falls of the franc.

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7. To sum up:-

(i) EMS membership will not ease the stability problem and is likely to make it worse;

(ii) To deal with the stability of financial markets one needs either to:-

(a) not validate market expectations as the authorities reaction to a slide in sterling, or

(b) change institutional arrangements to enable the bears to be squeezed;

(iii) joining the EMS is likely to strengthen the argument for the reimposition of exchange controls like those of France and Italy with great disadvantages to a currency such as sterling;

(iv) one can understand the enthusiasm of the EMS members to include the UK since Britain would act as safety valve for much speculation in the System, and as the DM strengthens in the months ahead, sterling's position would continue to be precarious.

CONFIDENTIAL 6. 2.85

Exchange rates

THE GOVERNOR

Copies to DGC members
Mr M J Balfour
Mr Goodhart
Mr Gill

1 The question of joining the ERM is a complex one, which has been argued back and forth in the Bank for more than five years and on which a very large number of complex considerations can be adduced on both sides. Whether to join or not will always be a matter of broad judgement and may well involve risk. My own, doubtless rough and ready and over-simple, position is now as follows.

2 The main arguments against joining have always been:

(i) we may destabilise the ERM itself and come under strong pressure ourselves when there are large and erratic movements in oil prices or the dollar.

(ii) we may constrain ourselves unsatisfactorily in terms of our effective exchange rate;

(iii) we may blur the lines of policy, losing a clear money supply discipline while gaining something less clear and satisfactory in exchange.

3 These arguments are always likely to have some force. My guess is that they are never likely to have less force than at present. Consequently, there is not much to be said for waiting as a deliberate policy: though it is of course perfectly possible to decide that we should never join.

4 My view on the contrary is that we should join now.

5 The dollar may fall soon, pushing the deutschemark up further than the rest of us and forcing early realigments: but we have been expecting this for a long time, and may have to wait a long time yet. And if it happens, it happens. There is no reason why the ERM should not pick itself up again.

6 The oil price may fall further and cause problems for sterling. But recent experience shows that these are very painful for us outside the ERM: it is not clear to me that they would be worse inside it.

7 As regards getting hooked on to an unsatisfactory exchange rate, it has become very hard to know what that means. Over the past five years, we have had a large variety of exchange rates, many of which have had unsatisfactory features of one kind or another; and there is surely now a general perception that current policies have been accompanied by a rather obvious lack of control over the exchange rate which a wide section of the public, including politicians, find increasingly unsatisfactory. It is hard to believe that, whatever happens after joining, developments in our exchange rate could be less welcome than they have been from time to time in the past.

8 There is a real risk that an entry into the ERM, especially if propelled by some unsatisfactory motives, will blur somewhat unsatisfactorily the thrust of policy. But I think a good deal of blurring has already occurred. The problems of keeping sterling M3 just inside the top of the range, with high interest rates, buoyant bank lending and continued overfunding, do not look as if they are going to go away, and are likely to put us increasingly on the defensive. Thus there may be a question of how much we would actually be losing.

9 On the positive side, I would make three points:

(i) we would be linking ourselves with a demonstrably anti-inflationary bloc: the Germans' record is exemplary - second to none perhaps. Thus, there is no reason why joining should be a soft option. In practice, one could make it a soft option by breaking out or realigning too frequently: but that may be politically unattractive enough not to make it a serious threat.

(ii) at least in my view, the public at large understand better the anti-inflationary constraints of holding the exchange rate than they do one of holding a money target. That, of course, does not go to the economics of the question; but on these it can be surely argued, as Mr Flemming has done, that there are respectable reasons for regarding purchasing power parity to hold at least as well in the long run, as constant velocity of money;

(iii) Floating exchange rates seem to me demonstrably to be getting out of control and producing economic disequilibria and policy difficulties for the world's major economies which by now are surpassing those distortions and difficulties provided by the Bretton Woods system in its late and damaging phase. There is likely (and rightly in my view) to be an increasing desire everywhere to moderate exchange rates fluctuations. How far this will prove practicable for the world as a whole must remain a very open question. But one can certainly argue that our joining the ERM is a step in the right direction: one more building block, even though it leaves large problems untouched.

10 Two final points of a different kind. I have not mentioned Europe. But it cannot be denied that there is something strange about an effectively permanent self-exclusion from a set of arrangements which the rest of the Community regards as central and important. Secondly, if we are to enter the ERM we shall have to equip ourselves to do so by augmenting our reserves on a substantial scale.

Chm

6th February 1985

Memo

From: ALAN WALTERS

To: Andrew Turnbull

Date: 8 Jan

Here is my addendum to my longer piece on the EMS

Hope you get it soon!

AW

Joining the EMS - Some Additional Questions

1. Speculation against sterling is one of the main problems of the existing system. The EMS will not prevent such speculation - on the contrary, unless other undesirable measures are taken, it is likely to increase the profitability of shorting sterling. Now the authorities do not object to gradual movements in sterling - what they object to is sharp downward movements, arguing that it might be a "bottomless pit" which would destroy confidence. Yet the EMS realignments are all sudden changes. And, as French experience during 1982 shows, there is no guarantee that, in the EMS, the sudden shift halts the slide. Why is a plunge unacceptable outside but good inside the EMS?

2. As is clear from the history of the French franc, joining the EMS is unlikely to reduce speculation against sterling and I would conjecture, because of the "step" movement at realignments, it would be made more profitable and so increase. In any case the only way to deal with this is to make speculation against sterling unprofitable without, at the same time, making investment also unprofitable and depressing the economy. The present techniques and conventions of monetary control make this very difficult and chancy - essentially the need is sharply to raise overnight to seven-day rates without raising three-month (or more) rates. The French experience shows that, in the EMS structure, this is the only effective way of taking out the bears. Since we are a more open economy, the U.K. would be subject to much more pressure, so the need to tame the bigger bears is the greater. Do the proponents of EMS plan to change the monetary arrangements so that we can squeeze those shorting sterling? If so, could we know the institutional changes involved and how they are to be implemented?

3. Is it not true that if we change the present system so that we can punish would-be bears, the difficulty of the bearish rush precipitating a fall of sterling would disappear? Joining the EMS would be likely to, at best, be irrelevant to the main issue.

4. Even if the U.K. joined, the D-mark would continue to dominate the EMS. Britain would have a role like France or Italy (the Netherlands is really part of the D-mark block). Both France and Italy have exchange controls and regulated credit rationing. In spite of the rigorous enforcement of French controls in 1982-3 and the (three?) devaluations, the Government had to intervene on a massive scale; indeed, there was much talk of the EMS having, in fact, broken down.

5. In view of our open capital and exchange markets and the continued role of sterling, the U.K. would cave under much greater pressure than France, even if the latter had freee credit and exchange markets. But with France and Italy regulated, it is very likely that Britain would have to bear much more speculative activity. Would the sponsors of Britain's entry envisage the introduction of credit rationing and exchange controls in Britain, at least as stringent as those in France, as a concomitant of entry? Are we prepared to dismantle our open-market, free-exchange system in order to join the EMS grid?

6. Control of money and credit markets and insulation from the Euro-markets, a la France, would enable us to imitate the French in raising the overnight rates to tame the bears. However, it is worthwhile noting that this did not offset the need for massive and costly intervention, nor did it prevent the sequence of falls of the franc.

To sum up:

(1) EMS membership will not ease the stability problem, and is likely to make it worse;

(2) To deal with the instability of financial markets one needs to either (a) not validate market expectations of the authorities reaction to a slide in sterling or (b) change institutional arrangements to enable the bears to be squeezed;

(3) Joining the EMS is likely to augment the arguments to reimpose exchange controls like France and Italy with great disadvantages to a currency such as sterling;

(4) One can understand the enthusiasm of the EMS members to include the UK since Britain would act as a safety valve for much speculation in the System, and as the Dimark strengthens in the months ahead, sterling's position would continue to be precarious.

Monetary Policy and the EMS

There have long been aspirations to form some monetary union of the European Community, which would correspond to the trade and fiscal harmonization implicit in the Treaty of Rome. The breakdown of the Bretton Woods system of more or less fixed exchange rates and the erosion of confidence in the stability of the dollar, added to the European view that there should be some substitute for the role of reserve currency. The initial "snake", introduced in early 1972, was modelled on the late lamented Bretton Woods, with exchange rates "fixed but adjustable".[1/] The EMS was introduced in early 1979 and included all the major currencies of Europe except sterling.

The essence of the EMS consists of agreeing central rates with respect to the European Currency Unit which obtain until the next "realignment". The member countries then use policies of intervention and monetary control in order to keep their rates within a band ± 2-1/2 percent, except Italy where the band is ± 6 percent. In practice, however, the rates are usually maintained fairly close to the central value. Although the system has many of the features of a mini-Bretton Woods, there is no systematic relationship of any currency, including the D mark, to the U.S. dollar. The most important exchange rate in the trading world, the D mark/dollar rate, was excluded from the EMS.

1/ The snake had a checkered history, with the early defection of three of the four major currencies, leaving only the German mark and its satellite currencies. However, by the time of the introduction of the EMS, the snake had become bloated and very permissive indeed and had few pretentions to be a fixed rate system; adjustments were large and frequent.

In assessing the effect on monetary policy of membership of the EMS one must initially draw a sharp but essential distinction between the ideal system and the real system. First the ideal. If the objectives meant anything, then they required the exchange rates to be virtually fixed with respect to one another for a specific period (say one year) before the next realignment. If this is the case, and assuming there are no oscilations around the central values, the markets can expect periods of up to one year when the exchange rate between the Italian lira and the D mark are fixed.

But if the exchange rate is fixed for an average of six months, then this will imply that the rates of interest on financial assets with those maturities will be roughly the same. If, after six months, I can exchange my lira for D marks at the same rate at which I bought them, I will find it proftable to switch into lira deposits if the interest rate in Italy is a tithe above that in Frankfurt. Thus nominal interest rates for those maturities must be approximately equal; portfolio arbitrage will ensure the outcome.[1/] It follows that by joining the EMS, as in any fixed exchange rate system, Britain would have to forego a substantial degree of sovereignty over her monetary policy.[2/]

[1/] There will be some transmission of this effect to other maturities so the level of the yield curve will be largely determined by this arbitrage, but we leave that aside for this argument.

[2/] The government would have a number of other monetary instruments -- such as reserve ratios and varying the maturity structure of public debt -- which could be used, but there is no doubt that interest rate policy is the primary weapon.

This interest rate equality illustrates one of the main difficulties -- an inherent contradiction no less -- with the EMS. One of the objectives of the EMS was to produce "convergence" of the rates of inflation of member countries -- and in these terms it meant converging on the inflation rate of Germany. Thus it was hoped that Italy, with an inflation rate of about 15 percent, would eventually converge to the German inflation rate of about 3 percent. But the requirement that, under a fixed exchange rate, Germany and Italy have the same nominal interest rate -- say 9 percent -- means that the real interest rate in Germany is high and positive (6 percent) whereas the real rate in Italy is negative at minus 6 percent. If the monetary authorities operate an interest rate regime in controlling their domestic money supply, there will be a great pressure to expand money and credit in Italy, whereas in Germany there will be a substantial financial squeeze.

This is precisely the opposite monetary policy to that which would move towards "convergence". Monetary policy has not been merely neutralized by the fixed exchange rate system, it has been made perverse. If countries still seek convergence, then this must be achieved mainly through fiscal policy, and indeed fiscal policy will have to offset the malignant effects of the EMS monetary policy. It is often claimed that the EMS has had a substantial effect in inducing member countries to take stringent fiscal action which they would not have entertained had they not been members of the EMS. This is true. But it is odd to credit the EMS with discipline that arises from its distortions.[1/]

[1/] Am I alone in finding it odd that exchange rate fixity and the concomitant equality of interest rates is described as "closer monetary cooperation

in Europe"? ("Five years of Monetary Cooperation in Europe", EEC, COM (84) 125 final, March 1984.) Fixing exchange rates and interest rates will produce divergent monetary policies.

In reality, however, the EMS diverges substantially from the fixed exchange rates with free capital markets that we have outlined above. First, there are substantial restraints on the free flow of capital -- particularly by France and Italy -- so that arbitrage is nowhere near perfect. Indeed, in the case of France and to a lesser extent in the case of Italy the capital constraints have become considerably more stringent since France has been a member of the EMS. One must be wary of post hoc, ergo propter hoc, but this evidence is not inconsistent with the fact that France would not have needed such controls if she had not been constrained by the psuedo fixity of exchange rates. Willy nilly, regulation of capital flows has enabled considerable deviations in interest rates between member countries, so the countries have been able to pursue more appropriate monetary policies than those which were implied by a strict EMS.

Secondly, even over quite short time horizons, the exchange rates have not been fixed. This is partly because of the width of the band within which currencies can move -- up to 5 percent for all except Italy which can move as much as 12 percent.[1/] But the main reason is that changes in the

[1/] It must be noted that the practice of countries was to attempt to keep their exchange rate on the average close to the central value and not to bump against ceilings and floors.

have been frequent and sometimes quite sudden. The average percentage change (ignoring sign) from month to month (end) in the exchange rate of the French franc and the Italian lira from 1979 to 1983 was 0.8 percent.[1]

[1] See Five Years of Monetary Cooperation in Europe, Table 1.

If the movement is all one way, as it was substantially in the case of Italy, this represents about a 10 percent depreciation of the lira during a year. Although currencies outside the EMS exhibited greater month to month variability, on this measure, there were many more negatives cancelling out positives, rather than the more-or-less steady downward drift of Italy and France.

The forward markets reflect all these uncertainties about future rates of exchange. And it is noticeable that the forward discounts for France and Italy in the EMS group, with respect to the D mark, were and are usually larger than the ones pertaining to the United Kingdom.[2] Being inside the

[2] Thus on March 27, 1984 three month forward dollars commanded a 5 percent premium in D marks, and a 6 percent discount in the lira. This corresponds to the annual 10 percent draft of the lira against the D mark in 1983. Sterling, however, was at a premium of only 1.74 percent. And, of course, three month inter-bank rates reflected these at 5.85 in Germany, 17.4 in Italy, and 9 in London.

EMS did not seem to reduce the insurance premium one had to pay to avoid exchange rate risk. On the contrary, insuring against exchange risk cost more if you were in Italy, France or Eire than if you were outside the

United Kingdom or the United States. Although the EMS has removed some of the short-term, month-by-month unsystematic "random" variations in exchange rates, it has not reduced significantly the systematic variation which can be forecast by the market.[1/] This variation in EMS exchange

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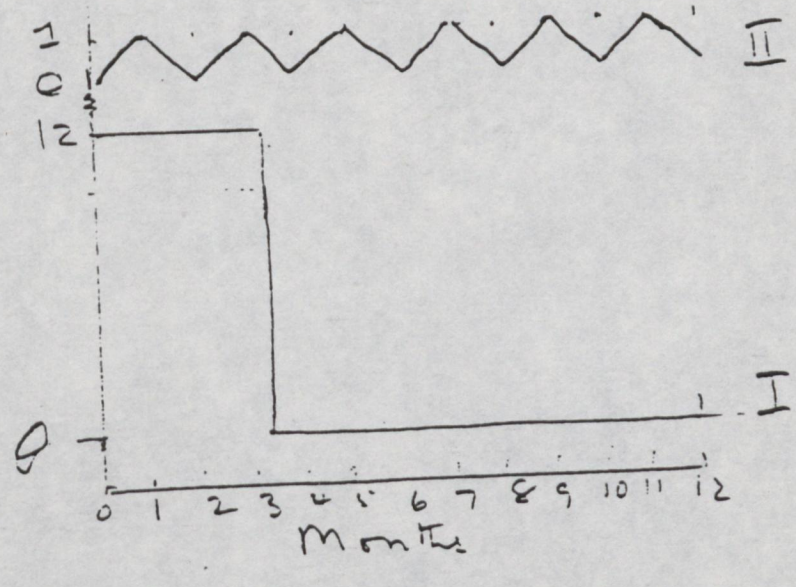
[1/] The ECE Study, "Five Years of Monetary Cooperation in Europe", measures exchange rate instability by the size of the average monthly absolute change in percentage terms. It is worth noting therefore that the same measure of variability (i.e., 1 percent a month) would apply to the following two series. In series I there is one big 12 percent fall (not

Figure No.



atypical of the EMS realignments), whereas in the other series II there is a plus one minus one pattern for each month. Additional unemployment in series I arises from the fact that no one known when the big fall will take place. Thus, the same measured result masks a very distinct and different reality.

rates together with capital controls has enabled the countries to pursue monetary policies, as manifest in their interest rates, which were not entirely counterproductive in inducing "convergence". The basic inconistency between fixed exchange rates and convergence remains.

In the rather messy EMS system, there has been no evidence of convergence. As the ECE paper admits, the mean absolute deviation between annual price inflation increased slightly from 4.2 percent in 1979 to 4.4 percent in 1983, although as always great things are expected for the years to come. The record on convergence so far is rather dismal, but more important is the fact that the EMS has butressed the latent argument for greater capital controls and reductions in the degree of convertibility. It has also provided a rationalization for trade restrictions.

The EMS was also presented as a step in the grand process of monetary integration of Europe -- perhaps ultimately towards one central bank, one currency, and one economic policy. If one entertains such ultimate goals, then the EMS seems to me to be a step backwards. Fixing prices (like exchange rates or, indeed, agricultural prices) creates centrefugal forces and divergence, not centrepetal forces and convergence. The road to convergence is to harmonize the great quantity determinants of monetary conditions -- namely, the rate of growth of money, and the budget deficit. If the members each pursued policies of similar low monetary growth then there would be the basis for eventual convergence. A medium term financial strategy is the right approach.

It has been claimed that the EMS is one way in which member states will accept the fiscal and monetary discipline required for convergence. The policies of France in the period of the socialist government 1981-1984 are presented as an example of such discipline. And it is true that the expansionary program of the Mitterrand government from the assumption of

power in 1981 ran only until March 1983. Then after successive devaluations in October 1981, June 1982, and March 1983, the government instituted an austerity program, aimed at reducing the budget deficit to 3 percent of GNP and monetary growth to 9 percent. Of course one cannot be sure what policy the French government would have pursued if they had not been members of the EMS. But we do know that the behavior of the British Labour government in the period 1974-1976 was quite similar.[1/] Unbridled expansionism

[1/] The main exception is that Britain did not devalue until 1977.

in 1974-1975 was followed by substantial squeeze in 1976. Ironically, in spite of the fact that Britain was not in the snake, the exchange rate against the dollar was pegged over this period! Thus protestations that the French government were largely or even significantly induced to the austerity of 1983 by membership of the EMS must be viewed with skepticism. It is entirely understandable that the supporters of the EMS should claim such credit as falls their way.

The conclusion is that it is difficult to see what the United Kingdom would gain from joining the EMS. Certainly under the Thatcher government, and conceivably under alternative governments, there is no need to bolster the anti-inflationary policies with psuedo fixed parities of the kind practiced in the EMS. At most the EMS might reduce the very short-term weekly, or monthly, variations in the exchange rate against the EMS currencies. But research suggests that because of thick and almost perfect forward markets such short-term movements have little if any effect in inhibiting

trade.[1] On the other hand, those who seek eventual monetary union of

[1] A survey of firms by the British North American Association showed little concern with the short-term variability of exchange rates, and firms were apparently well versed in buying forward cover. Under floating conditions the firms could either buy certainty in the forward market or take their chances on the spot market. With a real fixed rate system that choice is denied them. For a contrary view, however, see M. A. Akhtar and R. Spence Hilton, "Effects of Exchange Rate Uncertainty on German-U.S. Trade", Federal Reserve Bank of New York, Quarterly Review 9, 1 Spring 1984, p. 7-16.

Europe had best pursue it through quantitative convergence rather than exchange rate fixity. Britain will best serve monetary union in Europe by urging the right policies rather than embracing the wrong ones.

Finally, the EMS failed, indeed it was bound to fail, in insulating policies from politics. One of the great attractions of fixed parities of the past, such as the gold standard, is that the rules determined policy. If, for example, there was a run on the gold stock, then no one doubted that a monetary squeeze was on the cards, as manifest in the Horsley-Palmer rule. The room for political discretion and dissembling was small.

It would be nice if the great nations of Europe periodically discussed the existence and rationale for the fundamental disequilibria in exchange markets, and then proceeded to a rational conclusion. Such ideals are far from reality. In the EMS the periodic realignments are grand political events which present many opportunities for horse-trading, threats, counterthreats, bluff, etc. Quid-pro-quos are extracted for any "concession" on exchange rate parities. And exchange rates become another pawn in the grand game of Europe. Indeed, it would be naive to expect anything else. (The same characteristics emerged in the Bretton Woods system, and eventually led to its demise.) At the very least one may claim that it is not clear that the psuedo-fixed rates and other policies that emerge from this political bargaining process are "superior" to the free market solutions.

Exchange Rate Target

Of course it would have been possible for the government to pursue an exchange rate target without joining the EMS.[1] The set of possible exchange rate targets is virtually infinite. However, if one is seeking stability, not merely in terms of ~~the~~ foreign currency but also in terms of domestic monetary-fiscal policy, one should choose that currency, or a combination of currencies, together with an appropriate rules of reaction, which is thought likely to give rise to such stability. If we restrict our search, for the time being, to particular currencies -- suppose it is the U.S. dollar -- then the targetting is an act of faith in the greater likelihood of the United States pursuing suitable stable policies.[2]

[1] Logically it could have pegged at a central rate with respect to the EMS currencies and behaved as if it were in the EMS, without the political hassle of the realignments, etc.

[2] The experience of pegging to the United States in effect through gold in 1925-1931 and in the Bretton Woods system after World War II to 1971 is not reassuring. In the period from 1947 to the 1960s it was complained that the United States was exporting deflation, whereas from the mid 1960s onwards, they were said to be exporting inflation. In the 1970s under the dirty floats they were said to be exporting both. And in 1984 few would claim that the United States is a paragon of financial prudence and stability.

The choice of the EMS is essentially a decision that the German economy is, in the future, likely to be managed in monetary terms so that it is a suitable model for the United Kingdom. Perhaps it will. The post-war years have certainly seen Germany pursue the most stable of monetary and fiscal policies. But things may change, especially with the transformation of the SPD and the emergence of persistent unemployment.

If there was a desire, however irrational and misplaced, for more stable exchange rates in the United Kingdom, then it would have been more sensible and consistent with the objectives if the exchange rate target had been expressed in terms of the effective rate rather than the EMS/ECU package.[1/] This takes the exchange rates and weighs them according to the composition of trade of the United Kingdom. Thus, targetting an effective rate, compared with the EMS regime, would enable us to avoid slavishly following the D mark as it depreciates (or appreciates) with respect to the dollar, and so, by stabilizing with respect to the D mark, introducing greater instability with respect to the dollar.

In the long run an effective exchange rate target would ensure that the United Kingdom inflated, with respect to the prices of traded goods, at roughly the same rate as her trading partners, whereas an EMS target that did not suffer periodically large one-way "realignments" in respect to the D mark would ensure that we inflated at the same rate as Germany.

Interpreting Exchange Rate Movements

One of the main criticisms of adopting either a fixed exchange rate, or an exchange rate target, is that the value of a currency reacts -- sometimes dramatically -- to many factors besides monetary behavior. The exchange rate is the relative price of liquid financial assets. Although the stocks and changes in the stocks of such assets are important determinants of the relative price, they are only part of the story. The exchange rate is much affected by anticipations, expectations and uncertainties, which are in turn affected by political events, rumor and report. In effect the exchange rate has many of the characteristics of the price of an ordinary share of a corporation. One must expect a fair degree of volatility in free markets for the foreign currencies.

Consider, for example, the effects of targetting an exchange rate during the periods of particularly large political uncertainty such as the run up to the general election. A conservative government committed to a policy of sound finance will find the exchange rate coming under increasing downward pressure. The markets will take a view of the likelihood of Labour government and the consequential fall in sterling (or combination of exchange controls and regulations). Provided there is a high enough probability of a Labour government being relected, the markets will anticipate the event.[1/]

[1/] In the 1983 general election the chances of a Labour government, as reflected in the polls, was virtually zero.

The higher the likelihood of a Labour government being elected, and the greater the differences between the expected monetary and fiscal policies

of the two parties, the greater the depressing effect on the exchange rates in the year or months before the date of the election.

Suppose the authorities were pursuing an exchange rate target for monetary policy. Then in the year before the election the authorities would increase interest rates and induce a monetary squeeze in order to maintain the parity. This is likely to result in a decline in real growth, and perhaps a decline in real output, together with other effects such as an increase in enemployment -- hardly the sort of policy which any government would wish to impose during the election year. Furthermore, the greater the difference between the parties -- the Conservative "sound policy" and the Labour "profligate policy" -- the tighter the squeeze. Worst of all, the greater the likelihood of a Labour government, the higher must interest rates go to deliver the exchange rate target, and so the policy will increase still further the probability of a Labour government being elected. Thus a good chance of a Labour government may be turned into a sure thing.[1/]

[1/] The bias induced by this policy to elect profligate governments is still present in the case where the existing government pursues an inflationist policy. If the alternative Conservative government were believed to be in favor of sound finance, then if they had a good chance of being elected, this would have a favorable effect on the exchange rate of the Labour government and so enable them more easily to pursue an appropriate expansionist policy in the run-up to the election.

Clearly the exchange rate target for monetary policy is bad political economy.[1/] But even if it were not, there are strong objections to a

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1/ It is, of course, conceivable that an exchange rate target may be proposed precisely to offset the normal temptations of governments to expand and inflate during the run-up to the general election. But, according to the argument in the previous footnote, it would have the opposite effect on an incumbent profligate government, making it yet more inflationary on the approach to the election. It will restrain only the government that pursues, relatively speaking, a sound monetary policy.

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monetary policy that routinely reflects all the alarms and excursions that affect exchange rates. If, for example, the United States, in order to contain the inflationary impact of the large Federal deficit, induces a very tight monetary squeeze so that the dollar-sterling rate comes under great pressure, why should the United Kingdom respond in a like manner, in order to defend the parity? It may well be that the domestic monetary conditions in the United Kingdom are entirely satisfactory and do not call for any such squeeze. The exchange rate target will induce artificial oscillations and additional instability in monetary conditions in order to preserve stability of exchange rates.

Granted that it is undesirable to make monetary policy a consequence of the vagueries of exchange rate movements, it is worthwhile considering whether the movements in exchange rates can be used to interpret and get useful assessment of prevailing monetary conditions. If, for example, a high exchange rate meant that monetary conditions were "tight" and a low exchange rate implied that monetary conditions were "loose", then the

exchange rate could rank along with interest rates, both nominal and real, as a measure worthy of close attention but not targetting. The exchange rate could provide corroborating evidence for our main targets, the monetary aggregates.

The difficulty with this subsidiary role for exchange rates is one of interpretation. One would need to identify the causes of movements in the exchange rate before it could be used safely for monetary analysis. One would need to filter out those movements which are due to political factors, changes in the policies or prospects of our trading partners, accidents and the vaguries of nature, market "confidence", etc., which account for a substantial fraction of the variation of the exchange values. This is difficult. There is no repetitive historical record so that one can isolate such effects.

Exchange rate movements must, therefore, be considered as generally rather dubious indicators of monetary conditions. There are exceptional circumstances where very large exchange rate movements, combined with other evidence may be used as a clinching argument. (I shall argue that this was the case in the winter of 1980-1981.) But one whould not look to exchange rates for any subtle interpretation of monetary conditions.

Although the authorities may decide to eschew exchange rate targets and to concentrate on delivering a target for monetary growth, it will be difficult to ignore the exchange rate effect if the market still believes that the authorities will react to exchange rate changes. The authorities will be driven by the market. Again one finds that the critical element in the policy is its "credibility."

Consider for example conditions which, as we shall see, broadly apply to the United Kingdom. The authorities announce that the level of short-term interest rates will depend primarily on the assessement of the movements in the monetary aggregates. The exchange rate is to be the object of benign neglect. However the markets are not convinced that the politicians and central bankers can so readily jettison their concern for the level of the exchange rate. (There are many in the Bank of England who have made no secret of the fact that they believe it would be appropriate to pay much more, not less, attention to the exchange rate). The question will be put: "Can ministers stand idly by as the exchange rate sinks (or rises) with all that that will entail?"

Whatever the reasons for the markets distsrust, portfolio managers will act on the basis of these beliefs. Thus suppose that there is a rise in the United States dollar brought about by some draconian tightening of monetary conditions in the United States. The authorities, surveying domestic monetary conditions, observe no surge of monetary growth and broadly believe that monetary conditions are 'right'. The market however sees sterling

sinking against the dollar and anticipates that there is a good chance that the authorities will be driven to raise interest rates to stop the precipitous fall. The expectation of the authorities increasing interest rates substantially will be enough to generate falls in the price of financial assests. Portfolio managers will be induced to sell gilts in the expectation that they will be able to buy in later at a lower price. Similarly the discount market will reduce the price that it offers for new bills. Thus there will be all the appearances of a 'gilt strike'!

Broadly speaking the authorities have two choices. First they could stick to their announced policy and not ratify the market moves, or secondly they could follow the lead of the market and behave as if they were defending the parity of sterling. The first path is a difficult one. Changing ingrained expectations is a harrowing business. The authorities would have to sit out the funding strike and use other sources of funds - such as running down foreign assets or borrowing from foreigners.1/

It would be wise to avoid monetizing any of the borrowing requirement and so inflating the monetary aggregates, but as a temporary measure this might be a last resort. The dangers of such a policy choice - the possibility of inciting inflationary expectations, and indeed the fact that the authorities may lose the confrontation - are clear and present.

1/ The implications for the exchange rate are clear and need not be elaborated here.

The second choice seems to avoid all such risks. If the authorities raise interest rates so that there is no risk of them going up further, then the funding strike is over and the flood begins; and sterling will return to the range at which there are no market fears of authority reaction. The temptation to follow this seemingly obvious path is clear.

But this will simply validate the markets expectations that there is an exchange rate target. The next time the rate comes under pressure, the authorities will be locked ever more closely into the exchange rate target by the more certain expectations of the market. Believing it is so makes it so. All that is needed for an exchange rate target is the belief, however acquired, in the market thta the authorities just could not tolerate substantial depreciation of sterling. Then the authorities can argue that they cannot fight market pressure - or at least it would be foolhardy to do so. Thus does rumour beget policy.

In one sense the second alternative of capitulation to the market has many attractions for governments and monetary managers. The markets and foreigners can be blamed for the painful oscillations in interest rates as well as the instability of exchange rates. It avoids eyeball to eyeball confrontation of the authorities and the market, and the government is unlikely to get a bad press if it does what is expected. The older heads in the corridors of Whiehall and the City will recall that in battles between the authorities and the city (not to mention the gnomes, etc.) it is the latter that always wins.

But the markets may take the view that some pressures on the exchange rate cannot be countered effectively by feasible movements in interest rates. Portfolio managers may be convinced that, on fundamental grounds of purchasing power parity, the exchange rate must move. Their guess about the intentions of the authorities is reciprocated by the authorities trying to adduce what the market foresees or wants, and so on... As in all game-theoretic strategies, such behaviour defies any neat analysis. The extent to which the authorities were driven unwillingly by market expectations cannot easily be assessed from overt behaviour. The attempts to attribute causation in the following pages are tentative. The subject deserves more analysis and reflection.

COMPARISON OF INTERNATIONAL FOREIGN CURRENCY RESERVES

(ie EXCLUDING GOLD AND IMF ITEMS)

	End-November 1984 ($ billion)
UK	6.8
US	6.3
Japan	22.0

EMS countries

W Germany	35.5
France(1)	20.4
Italy	20.0
Belgium	3.6
Netherlands	8.0
Denmark	4.1
Ireland(2)	1.9

(1) All figures valued at end-period rates and include holdings of ecus.

(2) End-October 1984.

MOVEMENTS IN THE DOLLAR SINCE LOW POINT IN OCTOBER 1978

	% change to 7 February+ since	
	30 Oct 1978 ($ low point)	3 May 1979 (Election)
ERI*	+ 71½	+ 56¼
£/$	+ 87½	+ 86
DM/$	+ 87½	+ 70¼
Yen/$	+ 47	+ 16
F franc/$	+147	+126
Lira/$	+152¼	+134½
Sw franc/$	+ 86½	+ 60

* % change to 6 February.

\+ 3 pm rates.

Historic highs for the dollar

F franc	9.8740	in London on 7 February
Lira	1987.50	in London on 7 February
£	$1.1020	in the Far East on 14 January
DM	3.2365 (13 year high)	in London on 7 February
Sw franc	2.7530 (9 year high)	in London on 7 February

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FILE EMS

25 October 1984

MR POWELL

c Mr Turnbull

I see from the 9 October telegram No.124, and other comments, that there is now a revival of interest in the UK joining the EMS.

There is still absolutely no case for the UK to join this mechanism on economic grounds. It is not possible to run an exchange rate policy and a monetary policy at the same time, as other members of the EMS will pursue inconsistent monetary policies.

We should not get back to the position where we have to spend the reserves to try and smoothe the relationship between our currency and EMS block currencies. This can often lead to the speculators enjoying putting pressure on a currency, forcing its central bank to spend too much, only in the end to have the ignominy of a realignment. People would not see this as a technical adjustment, but would see it as a return to good, old-fashioned, crawling peg devaluation.

Similarly, we do not wish to put any more pressure on our interest rate policy, and in the EMS we would often be forced to raising interest rates for external reasons - even though there were no clear domestic monetary policy reasons

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for doing so. Against the background of unacceptably high unemployment in this country, we can live without any further pressures on interest rates.

JOHN REDWOOD

GRS 150

UNCLASSIFIED

FM UKDEL STRASBOURG 091830Z OCT 84
TO PRIORITY FCO
TELEGRAM NUMBER 124 OF 9 OCTOBER
AND PRIORITY UKREP BRUSSELS
AND SAVING TO BRUSSELS, COPENHAGEN, THE HAGUE, ROME, DUBLIN, PARIS, BONN, LUXEMBOURG, ATHENS

FROM UKREP BRUSSELS

EMS

SUMMARY

1. IN DEBATE ON 9 OCTOBER ON THE EC MONETARY SITUATION ORTOLI AND ALL EDG MEMBERS WHO SPOKE SAID UNITED KINGDOM SHOULD BECOME A FULL PARTICIPANT IN THE EMS.

DETAIL

2. VON WOGAU (CD) ADDRESSING HIMSELF TO THE UK SPECIFICALLY SAID THAT THE EMS HAD PROMOTED MONETARY DISCIPLINE RESULTING IN EC INTEREST RATES BEING CUT BY HALF. NOW WAS THE TIME FOR THE UK, WHICH HAD BEEN A QUOTE SHY VIRGIN UNQUOTE FOR TOO LONG, TO JOIN THE SYSTEM . BEAZLEY (EDG) FOLLOWED BY BEMOANING OUR QUOTE CONTINUED FAILURE TO JOIN UNQUOTE. THE UK STOOD TO GAIN FROM A STRONG EUROPEAN ECONOMY WHICH WOULD REINFORCE OUR POSITION AGAINST A STRONG DOLLAR AND YEN. LADY ELLES AND WELSH (EDG) ALSO URGED THE UK TO JOIN THE EXCHANGE RATE MECHANISM. ORTOLI (COMMISSION), AGAINST APPROVING BACKGROUND NOISES, SPOKE OF THE NEED TO ANALYSE THE POSITIVE ECONOMIC ADVANTAGES FOR THE UK. IN HIS VIEW OUR ARGUMENTS (POUND STERLING BEING A RESERVE CURRENCY, PETRO-CURRENCY ETC) DID NOT HOLD. IF THE POUND JOINED THE EMS THE UK WOULD BENEFIT FROM (UNSPECIFIED) EUROPEAN ADVANTAGES AND WOULD BRING A LARGER DIMENSION TO THE EMS. IN CONCLUSION HE EXPRESSED STRONG SENTIMENTS IN FAVOUR OF UK PARTICIPATION ADDING THAT HE WAS OPTIMISTIC THAT THIS WOULD HAPPEN.

| FCO

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EMS file

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EMS MEMBERSHIP & UK MONETARY POLICY

The possibility of sterling becoming a full member of the EMS is being widely canvassed once again. Any decision to join would affect the conduct of monetary policy, to a limited extent, and the environment in which monetary policy operates.

Membership of the EMS would place limits on the movements of sterling against European currencies (summarised as the European Currency Unit - ECU) where none existed before. (The technical appendix at the end of this note includes a description of the operation and technical arrangements of the EMS.) There would be no explicit restraints on the movement of the dollar/sterling rate. However, sterling could only be allowed to fluctuate against the dollar in line with the bloc of EMS currencies as a whole. In effect, European countries would have a common dollar policy either by design or de facto.

The attempt by the authorities to persuade the markets to pay less attention to the sterling/dollar rate and focus on sterling's overall performance has been enhanced by the recent innovation of publishing sterling's effective rate on an hourly basis. Entry into the EMS should further this process in two ways. First, the absence of formal limits on dollar/sterling fluctuations will focus attention on the intervention bands vis-a-vis other EMS currencies. Secondly, the operation of the divergence indicator in the EMS will elevate in importance the ECU value of sterling. In effect, should sterling cross its divergence limit expressed against the ECU, the rules of the EMS presume that a policy response will follow. Such a development will make explicit the downplaying of the importance of movements in the sterling/dollar rate that are due purely to generalised movements of the American currency itself.

Events in July

In early July, pressure built up for higher interest rates from the worsening industrial situation (including the start of the first dock strike), the weakness of the price of oil, an increased short-term interest rate differential in favour of the US and, decisively, a 2% increase in Sterling M3 in banking-June, announced on July 5th. Sterling's effective rate had been declining, prior to this period, as the dollar strengthened. However, the trigger for higher UK rates was a sudden depreciation against European currencies which led to a sharp fall in sterling's effective rate.

These pressures for higher rates would have been similar in force had sterling been a member of the EMS. In one sense, in fact, the authorities behaved as if this were already happening, given their acquiescence in the gradual depreciation of the dollar/sterling rate and the reaction only when a broader decline began. However, there would have been additional support for the authorities in the EMS to cope with the market pressure for higher rates. First, although sterling fell against the ECU by 2.2% in the two weeks to July 10th, it had been fairly steady against the ECU since the rates settled down after the last realignment in March 1983. Even at its crisis level in early July, sterling stood higher against the ECU than the average of daily observations in April last year, the first full month after the realignment. This amounts to saying that sterling, prior to the July pressures, would have been a 'strong' currency in the EMS and the fall that did occur may well have been able to be absorbed without triggering sterling's divergence indicator. (The question of how much further sterling may have fallen against the ECU had interest rates not been raised is an open one.)

R.H. Lawson, G.T. Pepper, The Lord Annaly, J.A. Rickards, L. Gooderham, T. Quinn, M.T. Higgins, D.G. Thomson, H.N. Seely, T.G. Wakeley, J.F.R. Hammond, J. Wigglesworth, E.J. Fenton, A.J. Bonner, N.S. King, G.P.P. Stewart, K.P. Joseph, A.G.P. Davidson, P.D. Jones, R.L. Thomas, K.C. Brown, J.C. Finch, S.J.D. Posford, R.W. Walker, W.E.A. Bain, R.M. Harvey, R.B. Pomphrett, M.R.F. Wonfor, A.L. Bucknall, M.S. Jaskel, P.B. Lilley, A.J.E. O'Sullivan, G.R. Addison, K.M. Feeny, P.H. Beaufrère, K.A.J. Crawford, J.B. Lake, L. Maddy, R.J.M.L. Ottley, S.H. Wamsley, I.S. White

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Secondly, given the type of selling pressure on sterling that developed in July, the EMS arrangements would have helped this pressure to be resisted. In general, two types of selling pressure on sterling may be distinguished:

i) Speculation which builds up when there are strong expectations of a major movement in sterling. This sort of pressure was suffered by sterling in late 1982; given that a major movement in sterling is anticipated and there are no official limits to the movement, this type of pressure is associated with floating exchange rates.

ii) Pressure, perhaps of a transient nature, may develop which forces sterling towards some limits, below which the currency should not be allowed to fall. This limit may be in a clearly-defined fixed rate system such as the EMS or may be implicit, as in the case of the supposed limit of 78 on the effective rate that the authorities were assumed to be adhering to in the first half of 1984.

The response to the first type of selling pressure should not be to smooth the currency's decline. Such action would not alter the expectation of further declines to come and so creates a one-way bet against the currency. The act of intervention itself may actually add to the speculative wave against the currency, with the authorities being the losers. Further, if the fall in the currency is expected to continue, belief grows that the authorities will in time withdraw from the market, so justifying the speculators' selling tactics. In this case, all the authorities achieve is to alter the profile of the currency's fall and by doing so waste tax-payers money.

The correct response to a long-term decline in sterling, in a system with no parity limits, should be for the authorities to allow the fall in the currency to run its course, before intervening heavily to buy sterling just after the market has turned. This tactic squeezes the speculators and encourages a rapid rebound in the exchange rate. Further, any expectation in the market that the authorities might intervene in this way would make speculators very wary about selling the currency when they believe the turning point is imminent. Such a bear squeeze would mean any losses would be suffered by the speculators and not by the authorities.

Intervention in the EMS

The crucial question is which sort of intervention is likely in the EMS. Given the bilateral limits and the function of the divergence indicator in the EMS, a substantial adjustment in the value of sterling would not be feasible without a realignment of the parity limits. In effect, the EMS is a fixed parity system. Given the design of the EMS, neither of the alternatives of smoothing a long-term fall or imposing a bear squeeze when the market turns is likely to apply in exactly the same way as outside the EMS. The best strategy would be for the Bank of England to refuse to smooth any fall (by intra-marginal interventions) and then enter the market decisively when the constraints of the EMS dictate. This approach would be likely to discourage speculative pressure. However, the uncertainty over the rate at which the market would turn of its own volition, so that a bear squeeze could be imposed, would be largely absent. The only doubt in the speculator's mind would be whether intervention would begin when the divergence limit is crossed or when the bilateral limits are reached, assuming these events occur at different times.

The weight of intervention in the EMS at parity limits would be enhanced in at least one further way. Access to the support facilities in the EMS (see technical appendix) would give the authorities a larger pool of funds to draw upon. The existence of this larger support (even if it is not drawn) may be sufficient to

convince the speculators that the authorities would resist the pressure for higher rates such that the resultant pressure would be substantially less. Further, in circumstances where more than one EMS currency is divergent (as defined by the divergence indicator on parity limits), intervention by the other central bank under pressure would be forthcoming. This would not have been expected in July, or in the current bout of sterling weakness however, when there have been few signs of other EMS currencies being under pressure. Despite this, the possibility of intervention by more than one central bank at times of general EMS strain is a clear benefit from membership of the system.

Effects on UK monetary policy

It is unlikely that the techniques of monetary policy in the UK would need to be altered as a direct result of EMS membership. The immediate effect of sterling becoming tied to the exchange rate mechanism would be that the gradual drift away from rigid money supply targetting, as pursued in 1979-82, towards more stability of the exchange rate would be formalised. In this respect, it may be fair therefore to conclude that EMS membership would have little significant impact on the freedom of monetary policy, as currently pursued.

This argument is consistent with the view that the extreme theoretical distinction between completely fixed exchange rates, under which domestic money supply control is lost due to foreign exchange market intervention, and perfectly floating rates, under which the absence of external influences on the money supply allows it to be controlled by the authorities, is not relevant to this discussion. First, some monetary control may be retained under fixed exchange rates by the sterilisation of the effects of, for example, a balance of payments surplus on monetary growth through increased debt sales. However, the rise in interest rates that may follow this increased funding would lead to new capital inflows. The process becomes self-feeding so that the sterilisation option is a short-term one. Nevertheless, some monetary autonomy may be retained even under fixed rates. At the other extreme, complete autonomy may not be guaranteed by floating exchange rates if substantial fluctuations in interest rates and overshooting exchange rates make monetary control difficult. Even with floating rates, external shocks may push monetary growth off target.

Secondly, the EMS includes a number of features inconsistent with a system of completely fixed parities. First, the value of each member currency is permitted to vary by $\pm$ 2¼% from its central rate. Secondly, the system includes transitional arrangements (currently being used by Italy) allowing variation of a currency of $\pm$ 6% from its central rate. For example, should the Italian lira move from one end of its band to the other at the same time as another EMS currency moves in the opposite direction, again to its limits, the cross-rate movement between the two currencies would be 16½% (2 x 6% + 2 x 2.25%). Thirdly, central rate realignments have been frequent, such that the system has, at times, tended to function as a sophisticated form of 'crawling peg'. The conclusion from these two arguments is that considerable independence of monetary policy is retained in the EMS.

The debate on the techniques of monetary control would not, therefore, be significantly altered by EMS membership. However, should sterling reach its lower divergence indicator a policy response would be expected from the authorities, where previously benign neglect towards the exchange rate might have been pursued. Should the authorities intervene, the money supply would decline, so limiting the freedom of the authorities to some extent. In effect, what is required in the long-term is a monetary stance broadly consistent with that of Germany, which has become the focus of the EMS, much as it was in the previous 'snake' scheme. This is likely to be much less difficult at present, with UK inflation only a

little above that in Germany, than it would have been in the mid-1970s or in 1980-1, when the degree of divergence of inflation rates was much greater. In essence, the monetary discipline involved in closer ties to German economic performance would be beneficial.

Summarising, our conclusions for the effect of EMS membership on UK monetary policy are:

i) Basic monetary policy techniques would not need to be changed as a result of membership.

ii) Broad consistency between UK monetary policy and that in Germany would be required.

iii) Speculative pressure on sterling may be lower due to the EMS credit facilities that may be drawn on, so reducing the incidence and strength of market pressure. However, the timing of a bear squeeze in the market may be able to be predicted by the speculators.

iv) The dollar/sterling parity would be reduced even further in importance, to be replaced by sterling's ECU value.

22 October 1984

Geoffrey Dennis

Technical Appendix - The Mechanics of the EMS

The European Currency Unit (ECU)

The ECU, which lies at the heart of the exchange-rate mechanism of the EMS, is a basket of all ten community currencies, in which each currency has a fixed weight in terms of actual amounts of the individual currencies. The currency amounts are set according to the relative importance of member countries in terms of national products, intra-EEC trade and other macroeconomic variables; they are set out in Table 1, on page 6. While the actual currency amounts have only been adjusted once (in September of this year) since the EMS began operation, the percentage weights of each currency have necessarily changed as a result of day-to-day exchange-rate fluctuations. For example, the weight of the Deutschemark rose from 33% in March 1979 to over 37% before the readjustment of the currency amounts in September reduced this to 32% again. The ECU value of any currency may be calculated using an outside currency, such as the US dollar, as a reference point. To establish the exchange-rate mechanism of the EMS, each currency was given a central rate against the ECU.

The Parity Grid

Each member currency's ECU rate is then used to form a set of cross rates, which have become known as a 'parity grid'. Around these bilateral central rates, fluctuation margins of $\pm 2\frac{1}{4}\%$ are defined with the Italian lira having availed itself of a 'transitional' $\pm$ 6% band.

This parity grid will change whenever a realignment of exchange rates in the EMS occurs. The procedure (for the currency to be realigned) is to alter that currency's bilateral central rate against all other currencies. However, given that all currencies in the EMS are part of the ECU, any such change in one country's set of bilateral cross-rates will, by definition, alter the ECU values of all member currencies. For example, suppose the Deutschemark is revalued by 8% in terms of its bilateral central rate and its weight in the ECU is 32%. The rise in the ECU parity of the Deutschemark is given by:

Increase in ECU parity of DM
$= 0.08\ (1.00 - W_{DM})$

where W_{DM} is the weight of the Deutschemark in the ECU

$= 0.08\ (1.00 - 0.32)$
$= 0.0544$
$= 5.44\%$

Accordingly, the ECU parities of all other currencies decline by 2.56% (0.08-0.0544). As a result, any EMS realignment, which in practice is likely to involve more than one adjustment in bilateral rates and therefore to be more complex than the above example, will lead to a new set of ECU central rates being defined. Table 2, on page 7, sets out the bilateral central rates and the upper and lower intervention points in effect since the last realignment on March 22, 1983.

A key feature of the parity grid is that any crossing of intervention points necessarily involves at least two divergent currencies (one being strong and the other weak). Typically, the history of fixed rate systems, including the previous 'snake' scheme in the EEC, has been for the weak currency country to carry the burden of adjustment. Adjustment was therefore generally asymmetrical.

TABLE 1

COMPOSITION OF THE E.C.U.

	Currency Amounts	Approximate (%) Currency Weights (30.9.84)
Deutschemark	0.719	32.1
French franc	1.31	19.1
Pound sterling	0.0878	14.9
Dutch guilder	0.256	10.2
Italian lira	140.0	10.1
Belgian franc	3.71	8.2
Danish krone	0.219	2.7
Greek drachma	1.15	1.3
Irish pound	0.00871	1.2
Luxembourg franc	0.14	0.3

The Divergence Indicator

To assuage the fears of certain members that asymmetrical adjustment would be a feature of the EMS also, the divergence indicator was designed as a warning signal when any one currency moves significantly out of line with all others. This indicator is based on the difference between the market value of a particular currency against the ECU and that currency's ECU central rate itself. The threshold of divergence defined amongst the EMS currencies was 75% of the maximum allowable deviation (under the ± 2.25% rule) between the ECU central and market rates for a particular currency. Due to the different weights of the currencies in the ECU, an adjustment is needed to the divergence indicator to allow for the fact that the larger currencies would take longer to reach their divergence limits as they pulled the ECU itself along with them to a greater extent.

For example, the maximum allowable movement of the Deutschemark against the ECU of 2.25% will (as the Deutschemark was 32.1% of the ECU at the time of the redefinition of the basket) cause the market rate of the Deutschemark to increase by only 1.528% (2.25 x [1-0.321]). The divergence indicator is therefore 75% of this permissible variation and so is equal to 1.146 per cent. In Table 3, on page 8, the current divergence limits are set out in Column 4, with Columns 1 and 2 containing the current ECU central rates and the market rates on October 18th, respectively. It is clear that the greater is the weight of a particular currency in the ECU, the smaller is that currency's deviation from its central rate for the ECU (which has been pulled in one direction or another by a currency with such a large weight) and therefore the narrower are the defined divergence limits in the table.

TABLE 2

BILATERAL CENTRAL RATES (PARITY GRID) AND INTERVENTION MARGINS IN EMS
(AS FROM 22.3.1983)

	AMSTERDAM	BRUSSELS	FRANKFURT	COPENHAGEN	DUBLIN	PARIS	ROME
DUTCH GUILDER (100)	100	1818.- 1777.58 1738.-	90.770 88.7526 86.780	329.63 322.297 315.13	29.3832 28.7295 28.0904	278.35 272.158 266.10	58997.- 55563.- 52329.-
BELGIAN/ LUXEMBOURG FRANC (100)	5.7535 5.62661 5.5005	100	5.106 4.99288 4.882	18.543 18.1312 17.727	1.6530 1.61621 1.5803	15.659 15.3106 14.97	3318.9 3125.76 2943.8
DEUTSCHE MARK (100)	115.235 112.673 110.1675	2048.35 2002.85 1958.50	100	371.40 363.141 355.06	33.1015 32.3703 31.6455	313.63 306.648 299.85	66473.- 62604.3 58960.-
DANISH KRONE (100)	31.7325 31.0273 30.3375	564.10 551.536 539.30	28.165 27.5375 26.925	100	9.1168 8.91396 8.7157	86.365 84.4432 82.565	18305.- 17239.7 16236.-
IRISH POUND (1)	3.5600 3.48075 3.4030	63.2810 61.8732 60.4965	3.160 3.08925 3.021	11.4735 11.2184 10.9687	1	9.6885 9.47313 9.2625	2053.53 1934.01 1821.45
FRENCH FRANC (100)	37.58 36.7434 35.925	668.- 653.144 638.60	33.350 32.6107 31.885	121.11 118.423 115.78	10.7964 10.5562 10.3214	100	21677.- 20415.7 19227.-
ITALIAN LIRA (1000)	1.911 1.79976 1.69500	33.970 31.9922 30.130	1.696 1.59733 1.504	6.159 5.80057 5.463	0.549015 0.517061 0.486968	5.201 4.89819 4.6130	1000.-

TABLE 3

EMS EUROPEAN CURRENCY UNIT RATES

(as at October 18th)

	Ecu central rates	Currency amounts against Ecu	% change from central rate	Divergence limit (%)
Belgian Franc	44.9008	45.1232	+0.50	+1.5428
Danish Krone	8.14104	8.05402	-1.07	+1.6421
German D.Mark	2.24184	2.23459	-0.32	+1.1463
French Franc	6.87456	6.84387	-0.45	+1.3659
Dutch Guilder	2.52595	2.51940	-0.26	+1.5165
Irish Punt	0.72569	0.719740	-0.82	+1.6671
Italian Lira	1403.49	1376.62	-1.91	+4.0511

Two other factors should be noted about the operation of the divergence indicator. First, the divergence limits for the Italian lira of ± 4.0510% reflect the wider margin of ± 6% applying to this currency. Secondly, these movements of the lira outside the ± 2.25% bilateral limits available to all other EMS members and the fact that sterling and now the drachma are part of the ECU, but because they are outside the exchange rate arrangement may (and indeed have done so) move in a much broader range vis-a-vis EMS currencies, create further potential distortions of ECU values of other member currencies. These are eliminated by calculating, when necessary, an adjusted divergence figure of a currency from its central ECU, which ignores the effects of any bilateral fluctuations greater than 2.25% on either side of the parity. In effect, in this adjusted figure, the wider fluctuations of the lira, sterling and drachma are sifted out.

Once any currency has crossed its divergence indicator, there is a presumption that corrective action will be taken by official authorities in the divergent currency country. This action may consist of:

(a) Diversified intervention (i.e. involving more than one other Community currency),
(b) Changes in central rates,
(c) Measures of domestic monetary policy,
(d) Other measures of economic policy.

As a result of such actions it is assumed that the divergent currency will move back within its divergence limits, which may (if the option of a change in a currency's central rate was chosen as one of the policy responses) be newly-defined limits. One problem with the indicator is that the EMS rules state that such policy responses are not mandatory.

Intervention Arrangements

The rules of the EMS state that intervention should be:

i) effected, in principle, in participants' currencies,
ii) compulsory without limit at the bilateral intervention points,
iii) optional when a member currency crosses its threshold of divergence and
iv) subject to prior consultation among all participants in the case of intra-marginal operations.

The new elements of these arrangements, compared to those in the previous snake scheme, are the intervention arrangements linked to the divergence indicator. However, as noted above, intervention, or any other policy response, is not mandatory when the divergence indicator is crossed.

In practice, the history of the EMS has seen significantly greater interventions than would have been dictated by the positions of individual currencies relative to their bilateral limits and divergence indicators. Further, despite an increase in interventions in EMS currencies, there have been significant gross interventions in dollars. At times, these have been in opposite directions, with different central banks buying and selling dollars simultaneously. For the EMS intervention rules to be followed, the need for dollar interventions must be removed. This could be done by the adoption by EMS members of a common dollar policy, involving a joint float of the EMS bloc against the dollar. In this case, intervention in EMS currencies to maintain the EMS parities would be needed, with the dollar rate of the bloc of currencies left to market forces. While a common European policy for the dollar, involving, for example, a target $/ECU rate, would be helpful to the cohesion of the EMS, it would not remove the need for dollar interventions.

European Monetary Fund

An important institutional element of the EMS was the proposed translation, within two years, of the European Monetary Co-operation Fund (EMCF) into the European Monetary Fund (EMF). In the event, due to the worsening economic climate and argument over the appropriate route to this institutional reform, this phase has not yet been completed. Notwithstanding this, the EMCF did receive (in April 1979) 20% of the value of each member's gold and foreign exchange reserves and in return each member was credited with a corresponding amount of ECUs. These transactions were completed in the form of three-month revolving 'swaps' with final transfer of the funds to the EMCF to be made when the transitional phase was completed and the EMF in operation. These swaps were valued on the basis of certain formulae related to dollar and gold market values and at the beginning of the EMS stood at ECU 23 billion.

With these funds, the EMCF administers three separate types of credit mechanism. The very short-term financing facility (for forty-five days) operational under the snake has been continued; in principle, the volume of such short-term resources callable by individual members is unlimited. In addition, a further ECU 25 billion has been made available in both short-term monetary support (ECU 14 billion), with a maturity of nine months, and medium-term financial assistance (ECU 11 billion), which is drawable for periods of between two and five years.

12 OCT 1984

1. Andrew Turnbull
To read section on EMS, which I find persuasive
2. File EMS

Mr. Robin Butler

Here are the final chapters IX and XI of my M/S for your vetting. Would you also forward them to Peter Middleton for his review? Done /

The Prime Minister may like to look at parts of it. But she will not have the time to read it, so perhaps you could summarize the salient points for her, if you think it worthwhile. At least it may be useful for speech material.

I gather that the Governor has expressed some enthusiasm for Britain's joining the EMS. I examined the arguments and evidence afresh in my chapter on exchange rates, etc. I am quite convinced that all the evidence suggests that it would be a most retrogressive step. If the issue is a lively one, I would like the Prime Minister to see my critique - it is marked MP33-48D.

AWS

Sept 10th 1984

Monetary Policy and the EMS

There have long been aspirations to form some monetary union of the European Community, which would correspond to the trade and fiscal harmonization implicit in the Treaty of Rome. The breakdown of the Bretton Woods system of more or less fixed exchange rates and the erosion of confidence in the stability of the dollar, added to the European view that there should be some substitute for the role of reserve currency. The initial "snake", introduced in early 1972, was modelled on the late lamented Bretton Woods, with exchange rates "fixed but adjustable".[1/] The EMS was introduced in early 1979 and included all the major currencies of Europe except sterling.

The essence of the EMS consists of agreeing central rates with respect to the European Currency Unit which obtain until the next "realignment". The member countries then use policies of intervention and monetary control in order to keep their rates within a band ± 2-1/2 percent, except Italy where the band is ± 6 percent. In practice, however, the rates are usually maintained fairly close to the central value. Although the system has many of the features of a mini-Bretton Woods, there is no systematic relationship of any currency, including the D mark, to the U.S. dollar. The most important exchange rate in the trading world, the D mark/dollar rate, was excluded from the EMS.

1/ The snake had a checkered history, with the early defection of three of the four major currencies, leaving only the German mark and its satellite currencies. However, by the time of the introduction of the EMS, the snake had become bloated and very permissive indeed and had few pretentions to be a fixed rate system; adjustments were large and frequent.

In assessing the effect on monetary policy of membership of the EMS one must initially draw a sharp but essential distinction between the ideal system and the real system. First the ideal. If the objectives meant anything, then they required the exchange rates to be virtually fixed with respect to one another for a specific period (say one year) before the next realignment. If this is the case, and assuming there are no oscilations around the central values, the markets can expect periods of up to one year when the exchange rate between the Italian lira and the D mark are fixed.

But if the exchange rate is fixed for an average of six months, then this will imply that the rates of interest on financial assets with those maturities will be roughly the same. If, after six months, I can exchange my lira for D marks at the same rate at which I bought them, I will find it proftable to switch into lira deposits if the interest rate in Italy is a tithe above that in Frankfurt. Thus nominal interest rates for those maturities must be approximately equal; portfolio arbitrage will ensure the outcome.[1/] It follows that by joining the EMS, as in any fixed exchange rate system, Britain would have to forego a substantial degree of sovereignty over her monetary policy.[2/]

[1/] There will be some transmission of this effect to other maturities so the level of the yield curve will be largely determined by this arbitrage, but we leave that aside for this argument.

[2/] The government would have a number of other monetary instruments -- such as reserve ratios and varying the maturity structure of public debt -- which could be used, but there is no doubt that interest rate policy is the primary weapon.

This interest rate equality illustrates one of the main difficulties -- an inherent contradiction no less -- with the EMS. One of the objectives of the EMS was to produce "convergence" of the rates of inflation of member countries -- and in these terms it meant converging on the inflation rate of Germany. Thus it was hoped that Italy, with an inflation rate of about 15 percent, would eventually converge to the German inflation rate of about 3 percent. But the requirement that, under a fixed exchange rate, Germany and Italy have the same nominal interest rate -- say 9 percent -- means that the real interest rate in Germany is high and positive (6 percent) whereas the real rate in Italy is negative at minus 6 percent. If the monetary authorities operate an interest rate regime in controlling their domestic money supply, there will be a great pressure to expand money and credit in Italy, whereas in Germany there will be a substantial financial squeeze.

This is precisely the opposite monetary policy to that which would move towards "convergence". Monetary policy has not been merely neutralized by the fixed exchange rate system, it has been made perverse. If countries still seek convergence, then this must be achieved mainly through fiscal policy, and indeed fiscal policy will have to offset the malignant effects of the EMS monetary policy. It is often claimed that the EMS has had a substantial effect in inducing member countries to take stringent fiscal action which they would not have entertained had they not been members of the EMS. This is true. But it is odd to credit the EMS with discipline that arises from its distortions.[1/]

[1/] Am I alone in finding it odd that exchange rate fixity and the concomitant equality of interest rates is described as "closer monetary cooperation

. . . in Europe"? ("Five years of Monetary Cooperation in Europe", EEC, COM (84) 125 final, March 1984.) Fixing exchange rates and interest rates will produce divergent monetary policies.

In reality, however, the EMS diverges substantially from the fixed exchange rates with free capital markets that we have outlined above. First, there are substantial restraints on the free flow of capital -- particularly by France and Italy -- so that arbitrage is nowhere near perfect. Indeed, in the case of France and to a lesser extent in the case of Italy the capital constraints have become considerably more stringent since France has been a member of the EMS. One must be wary of post hoc, ergo propter hoc, but this evidence is not inconsistent with the fact that France would not have needed such controls if she had not been constrained by the psuedo fixity of exchange rates. Willy nilly, regulation of capital flows has enabled considerable deviations in interest rates between member countries, so the countries have been able to pursue more appropriate monetary policies than those which were implied by a strict EMS.

Secondly, even over quite short time horizons, the exchange rates have not been fixed. This is partly because of the width of the band within which currencies can move -- up to 5 percent for all except Italy which can move as much as 12 percent.[1/] But the main reason is that changes in the

[1/] It must be noted that the practice of countries was to attempt to keep their exchange rate on the average close to the central value and not to bump against ceilings and floors.

have been frequent and sometimes quite sudden. The average percentage change (ignoring sign) from month to month (end) in the exchange rate of the French franc and the Italian lira from 1979 to 1983 was 0.8 percent.[1]

[1] See Five Years of Monetary Cooperation in Europe, Table 1.

If the movement is all one way, as it was substantially in the case of Italy, this represents about a 10 percent depreciation of the lira during a year. Although currencies outside the EMS exhibited greater month to month variability, on this measure, there were many more negatives cancelling out positives, rather than the more-or-less steady downward drift of Italy and France.

The forward markets reflect all these uncertainties about future rates of exchange. And it is noticeable that the forward discounts for France and Italy in the EMS group, with respect to the D mark, were and are usually larger than the ones pertaining to the United Kingdom.[2] Being inside the

[2] Thus on March 27, 1984 three month forward dollars commanded a 5 percent premium in D marks, and a 6 percent discount in the lira. This corresponds to the annual 10 percent draft of the lira against the D mark in 1983. Sterling, however, was at a premium of only 1.74 percent. And, of course, three month ~~in the bank~~ inter-bank rates reflected these at 5.85 in Germany, 17.4 in Italy, and 9 in London.

EMS did not seem to reduce the insurance premium one had to pay to avoid exchange rate risk. On the contrary, insuring against exchange risk cost more if you were in Italy, France or Eire than if you were outside/in the

United Kingdom or the United States. Although the EMS has removed some of the short-term, month-by-month unsystematic "random" variations in exchange rates, it has not reduced significantly the systematic variation which can be forecast by the market.[1/] This variation in EMS exchange

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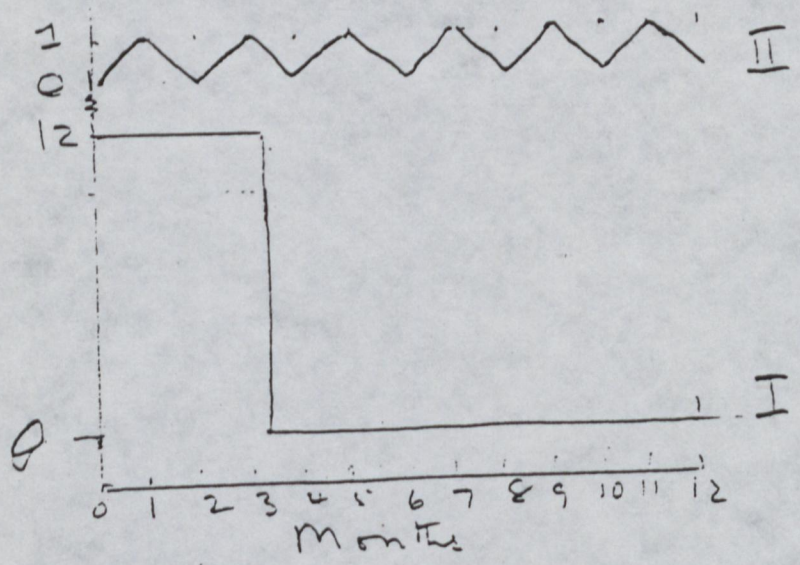
[1/] The ECE Study, "Five Years of Monetary Cooperation in Europe", measures exchange rate instability by the size of the average monthly absolute change in percentage terms. It is worth noting therefore that the same measure of variability (i.e., 1 percent a month) would apply to the following two series. In series I there is one big 12 percent fall (not

Figure No.



atypical of the EMS realignments), whereas in the other series II there is a plus one minus one pattern for each month. Additional unemployment in series I arises from the fact that no one known when the big fall will take place. Thus, the same measured result masks a very distinct and different reality.

rates together with capital controls has enabled the countries to pursue monetary policies, as manifest in their interest rates, which were not entirely counterproductive in inducing "convergence". The basic inconistency between fixed exchange rates and convergence remains.

In the rather messy EMS system, there has been no evidence of convergence. As the ECE paper admits, the mean absolute deviation between annual price inflation increased slightly from 4.2 percent in 1979 to 4.4 percent in 1983, although as always great things are expected for the years to come. The record on convergence so far is rather dismal, but more important is the fact that the EMS has butressed the latent argument for greater capital controls and reductions in the degree of convertibility. It has also provided a rationalization for trade restrictions.

The EMS was also presented as a step in the grand process of monetary integration of Europe -- perhaps ultimately towards one central bank, one currency, and one economic policy. If one entertains such ultimate goals, then the EMS seems to me to be a step backwards. Fixing prices (like exchange rates or, indeed, agricultural prices) creates centrefugal forces and divergence, not centrepetal forces and convergence. The road to convergence is to harmonize the great quantity determinants of monetary conditions -- namely, the rate of growth of money, and the budget deficit. If the members each pursued policies of similar low monetary growth then there would be the basis for eventual convergence. A medium term financial strategy is the right approach.

It has been claimed that the EMS is one way in which member states will accept the fiscal and monetary discipline required for convergence. The policies of France in the period of the socialist government 1981-1984 are presented as an example of such discipline. And it is true that the expansionary program of the Mitterrand government from the assumption of

power in 1981 ran only until March 1983. Then after successive devaluations in October 1981, June 1982, and March 1983, the government instituted an austerity program, aimed at reducing the budget deficit to 3 percent of GNP and monetary growth to 9 percent. Of course one cannot be sure what policy the French government would have pursued if they had not been members of the EMS. But we do know that the behavior of the British Labour government in the period 1974-1976 was quite similar.[1/] Unbridled expansionism

[1/] The main exception is that Britain did not devalue until 1977.

in 1974-1975 was followed by substantial squeeze in 1976. Ironically, in spite of the fact that Britain was not in the snake, the exchange rate against the dollar was pegged over this period! Thus protestations that the French government were largely or even significantly induced to the austerity of 1983 by membership of the EMS must be viewed with skepticism. It is entirely understandable that the supporters of the EMS should claim such credit as falls their way.

The conclusion is that it is difficult to see what the United Kingdom would gain from joining the EMS. Certainly under the Thatcher government, and conceivably under alternative governments, there is no need to bolster the anti-inflationary policies with psuedo fixed parities of the kind practiced in the EMS. At most the EMS might reduce the very short-term weekly, or monthly, variations in the exchange rate against the EMS currencies. But research suggests that because of thick and almost perfect forward markets such short-term movements have little if any effect in inhibiting

trade.[1/] On the other hand, those who seek eventual monetary union of

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[1/] A survey of firms by the British North American Association showed little concern with the short-term variability of exchange rates, and firms were apparently well versed in buying forward cover. Under floating conditions the firms could either buy certainty in the forward market or take their chances on the spot market. With a real fixed rate system that choice is denied them. For a contrary view, however, see M. A. Akhtar and R. Spence Hilton, "Effects of Exchange Rate Uncertainty on German-U.S. Trade", Federal Reserve Bank of New York, Quarterly Review 9, 1 Spring 1984, p. 7-16.

Europe had best pursue it through quantitative convergence rather than exchange rate fixity. Britain will best serve monetary union in Europe by urging the right policies rather than embracing the wrong ones.

Finally, the EMS failed, indeed it was bound to fail, in insulating policies from politics. One of the great attractions of fixed parities of the past, such as the gold standard, is that the rules determined policy. If, for example, there was a run on the gold stock, then no one doubted that a monetary squeeze was on the cards, as manifest in the Horsley-Palmer rule. The room for political discretion and dissembling was small.

It would be nice if the great nations of Europe periodically discussed the existence and rationale for the fundamental disequilibria in exchange markets, and then proceeded to a rational conclusion. Such ideals are far from reality. In the EMS the periodic realignments are grand political events which present many opportunities for horse-trading, threats, counterthreats, bluff, etc. Quid-pro-quos are extracted for any "concession" on exchange rate parities. And exchange rates become another pawn in the grand game of Europe. Indeed, it would be naive to expect anything else. (The same characteristics emerged in the Bretton Woods system, and eventually led to its demise.) At the very least one may claim that it is not clear that the psuedo-fixed rates and other policies that emerge from this political bargaining process are "superior" to the free market solutions.

An Exchange Rate Target

Of course it would have been possible for the government to pursue an exchange rate target without joining the EMS.[1/] The set of possible exchange rate targets is virtually infinite. However, if one is seeking stability, not merely in terms of ~~the~~ foreign currency but also in terms of domestic monetary-fiscal policy, one should choose that currency, or a combination of currencies, together with an appropriate rules of reaction, which is thought likely to give rise to such stability. If we restrict our search, for the time being, to particular currencies -- suppose it is the U.S. dollar -- then the targetting is an act of faith in the greater likelihood of the United States pursuing suitable stable policies.[2/]

[1/] Logically it could have pegged at a central rate with respect to the EMS currencies and behaved as if it were in the EMS, without the political hassle of the realignments, etc.

[2/] The experience of pegging to the United States in effect through gold in 1925-1931 and in the Bretton Woods system after World War II to 1971 is not reassuring. In the period from 1947 to the 1960s it was complained that the United States was exporting deflation, whereas from the mid 1960s onwards, they were said to be exporting inflation. In the 1970s under the dirty floats they were said to be exporting both. And in 1984 few would claim that the United States is a paragon of financial prudence and stability.

The choice of the EMS is essentially a decision that the German economy is, in the future, likely to be managed in monetary terms so that it is a suitable model for the United Kingdom. Perhaps it will. The post-war years have certainly seen Germany pursue the most stable of monetary and fiscal policies. But things may change, especially with the transformation of the SPD and the emergence of persistent unemployment.

If there was a desire, however irrational and misplaced, for more stable exchange rates in the United Kingdom, then it would have been more sensible and consistent with the objectives if the exchange rate target had been expressed in terms of the effective rate rather than the EMS/ECU package.[1/] This takes the exchange rates and weighs them according to the composition of trade of the United Kingdom. Thus, targetting an effective rate, compared with the EMS regime, would enable us to avoid slavishly following the D mark as it depreciates (or appreciates) with respect to the dollar, and so, by stabilizing with respect to the D mark, introducing greater instability with respect to the dollar.

In the long run an effective exchange rate target would ensure that the United Kingdom inflated, with respect to the prices of traded goods, at roughly the same rate as her trading partners, whereas an EMS target that did not suffer periodically large one-way "realignments" in respect to the D mark would ensure that we inflated at the same rate as Germany.

Interpreting Exchange Rate Movements

One of the main criticisms of adopting either a fixed exchange rate, or an exchange rate target, is that the value of a currency reacts -- sometimes dramatically -- to many factors besides monetary behavior. The exchange rate is the relative price of liquid financial assets. Although the stocks and changes in the stocks of such assets are important determinants of the relative price, they are only part of the story. The exchange rate is much affected by anticipations, expectations and uncertainties, which are in turn affected by political events, rumor and report. In effect the exchange rate has many of the characteristics of the price of an ordinary share of a corporation. One must expect a fair degree of volatility in free markets for the foreign currencies.

Consider, for example, the effects of targetting an exchange rate during the periods of particularly large political uncertainty such as the run up to the general election. A conservative government committed to a policy of sound finance will find the exchange rate coming under increasing downward pressure. The markets will take a view of the likelihood of Labour government and the consequential fall in sterling (or combination of exchange controls and regulations). Provided there is a high enough probability of a Labour government being relected, the markets will anticipate the event.[1/]

[1/] In the 1983 general election the chances of a Labour government, as reflected in the polls, was virtually zero.

The higher the likelihood of a Labour government being elected, and the greater the differences between the expected monetary and fiscal policies

of the two parties, the greater the depressing effect on the exchange rates in the year or months before the date of the election.

Suppose the authorities were pursuing an exchange rate target for monetary policy. Then in the year before the election the authorities would increase interest rates and induce a monetary squeeze in order to maintain the parity. This is likely to result in a decline in real growth, and perhaps a decline in real output, together with other effects such as an increase in enemployment -- hardly the sort of policy which any government would wish to impose during the election year. Furthermore, the greater the difference between the parties -- the Conservative "sound policy" and the Labour "profligate policy" -- the tighter the squeeze. Worst of all, the greater the likelihood of a Labour government, the higher must interest rates go to deliver the exchange rate target, and so the policy will increase still further the probability of a Labour government being elected. Thus a good chance of a Labour government may be turned into a sure thing.[1/]

[1/] The bias induced by this policy to elect profligate governments is still present in the case where the existing government pursues an inflationist policy. If the alternative Conservative government were believed to be in favor of sound finance, then if they had a good chance of being elected, this would have a favorable effect on the exchange rate of the Labour government and so enable them more easily to pursue an appropriate expansionist policy in the run-up to the election.

Clearly the exchange rate target for monetary policy is bad political economy.[1/] But even if it were not, there are strong objections to a monetary policy that routinely reflects all the alarms and excursions that affect exchange rates. If, for example, the United States, in order to contain the inflationary impact of the large Federal deficit, induces a very tight monetary squeeze so that the dollar-sterling rate comes under great pressure, why should the United Kingdom respond in a like manner, in order to defend the parity? It may well be that the domestic monetary conditions in the United Kingdom are entirely satisfactory and do not call for any such squeeze. The exchange rate target will induce artificial oscillations and additional instability in monetary conditions in order to preserve stability of exchange rates.

Granted that it is undesirable to make monetary policy a consequence of the vagueries of exchange rate movements, it is worthwhile considering whether the movements in exchange rates can be used to interpret and get useful assessment of prevailing monetary conditions. If, for example, a high exchange rate meant that monetary conditions were "tight" and a low exchange rate implied that monetary conditions were "loose", then the

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[1/] It is, of course, conceivable that an exchange rate target may be proposed precisely to offset the normal temptations of governments to expand and inflate during the run-up to the general election. But, according to the argument in the previous footnote, it would have the opposite effect on an incumbent profligate government, making it yet more inflationary on the approach to the election. It will restrain only the government that pursues, relatively speaking, a sound monetary policy.

exchange rate could rank along with interest rates, both nominal and real, as a measure worthy of close attention but not targetting. The exchange rate could provide corroborating evidence for our main targets, the monetary aggregates.

The difficulty with this subsidiary role for exchange rates is one of interpretation. One would need to identify the causes of movements in the exchange rate before it could be used safely for monetary analysis. One would need to filter out those movements which are due to political factors, changes in the policies or prospects of our trading partners, accidents and the vaguries of nature, market "confidence", etc., which account for a substantial fraction of the variation of the exchange values. This is difficult. There is no repetitive historical record so that one can isolate such effects.

Exchange rate movements must, therefore, be considered as generally rather dubious indicators of monetary conditions. There are exceptional circumstances where very large exchange rate movements, combined with other evidence may be used as a clinching argument. (I shall argue that this was the case in the winter of 1980-1981.) But one whould not look to exchange rates for any subtle interpretation of monetary conditions.

Although the authorities may decide to eschew exchange rate targets and to concentrate on delivering a target for monetary growth, it will be difficult to ignore the exchange rate effect if the market still believes that the authorities will react to exchange rate changes. The authorities will be driven by the market. Again one finds that the critical element in the policy is its "credibility."

Consider for example conditions which, as we shall see, broadly apply to the United Kingdom. The authorities announce that the level of short-term interest rates will depend primarily on the assessement of the movements in the monetary aggregates. The exchange rate is to be the object of benign neglect. However the markets are not convinced that the politicians and central bankers can so readily jettison their concern for the level of the exchange rate. (There are many in the Bank of England who have made no secret of the fact that they believe it would be appropriate to pay much more, not less, attention to the exchange rate). The question will be put: "Can ministers stand idly by as the exchange rate sinks (or rises) with all that that will entail?"

Whatever the reasons for the markets distsrust, portfolio managers will act on the basis of these beliefs. Thus suppose that there is a rise in the United States dollar brought about by some draconian tightening of monetary conditions in the United States. The authorities, surveying domestic monetary conditions, observe no surge of monetary growth and broadly believe that monetary conditions are 'right'. The market however sees sterling

sinking against the dollar and anticipates that there is a good chance that the authorities will be driven to raise interest rates to stop the precipitous fall. The expectation of the authorities increasing interest rates substantially will be enough to generate falls in the price of financial assests. Portfolio managers will be induced to sell gilts in the expectation that they will be able to buy in later at a lower price. Similarly the discount market will reduce the price that it offers for new bills. Thus there will be all the appearances of a 'gilt strike'!

Broadly speaking the authorities have two choices. First they could stick to their announced policy and not ratify the market moves, or secondly they could follow the lead of the market and behave as if they were defending the parity of sterling. The first path is a difficult one. Changing ingrained expectations is a harrowing business. The authorities would have to sit out the funding strike and use other sources of funds - such as running down foreign assets or borrowing from foreigners.1/

It would be wise to avoid monetizing any of the borrowing requirement and so inflating the monetary aggregates, but as a temporary measure this might be a last resort. The dangers of such a policy choice - the possibility of inciting inflationary expectations, and indeed the fact that the authorities may lose the confrontation - are clear and present.

1/ The implications for the exchange rate are clear and need not be elaborated here.

The second choice seems to avoid all such risks. If the authorities raise interest rates so that there is no risk of them going up further, then the funding strike is over and the flood begins; and sterling will return to the range at which there are no market fears of authority reaction. The temptation to follow this seemingly obvious path is clear.

But this will simply validate the markets expectations that there is an exchange rate target. The next time the rate comes under pressure, the authorities will be locked ever more closely into the exchange rate target by the more certain expectations of the market. Believing it is so makes it so. All that is needed for an exchange rate target is the belief, however acquired, in the market thta the authorities just could not tolerate substantial depreciation of sterling. Then the authorities can argue that they cannot fight market pressure - or at least it would be foolhardy to do so. Thus does rumour beget policy.

In one sense the second alternative of capitulation to the market has many attractions for governments and monetary managers. The markets and foreigners can be blamed for the painful oscillations in interest rates as well as the instability of exchange rates. It avoids eyeball to eyeball confrontation of the authorities and the market, and the government is unlikely to get a bad press if it does what is expected. The older heads in the corridors of Whiehall and the City will recall that in battles between the authorities and the city (not to mention the gnomes, etc.) it is the latter that always wins.

But the markets may take the view that some pressures on the exchange rate cannot be countered effectively by feasible movements in interest rates. Portfolio managers may be convinced that, on fundamental grounds of purchasing power parity, the exchange rate must move. Their guess about the intentions of the authorities is reciprocated by the authorities trying to adduce what the market foresees or wants, and so on... As in all game-theoretic strategies, such behaviour defies any neat analysis. The extent to which the authorities were driven unwillingly by market expectations cannot easily be assessed from overt behaviour. The attempts to attribute causation in the following pages are tentative. The subject deserves more analysis and reflection.

FROM: Sir C Tickell

DATE: 13 February 1984

PS/PUS

cc Sir J Bullard
Sir P Cradock
Sir W Harding
Sir J Leahy
Mr Wright
Mr Hannay
Mr Hayes
Mr Jenkins
Planning Staff
Research Dept
ECD(I)
ECD(E)
ESID

Sir M Butler, UKREP Brussels

THIS COPY FOR

EMS AND ECU

1. As requested in Mr Jay's minute of 19 January, I submit papers prepared with ECD(I) and ESID on the related themes of the European Monetary System (EMS) and the private use of the European Currency Unit (ECU) for consideration by DUSs at their meeting on 24 February. It would, I think, be right for DUSs to consider these questions at the same time.

EMS

2. The purpose of the EMS paper is to bring out the arguments for and against our joining the Exchange Rate Mechanism (ERM) of the EMS. Personally I believe that it may slightly understate the damage which instability in the currency markets has done to Western economies since the break-up of the Bretton Woods system in 1971. Uncertainty is the enemy of investment.

3. The fundamental political argument for full British membership of the EMS with participation in the ERM is similar to that which caused us to join the European Community itself: in short that it profoundly affects us; that it is better to have a guiding hand from within rather than try to influence it from without; and that we should play a full part in an institution whose future could determine the growth of the Community as a whole. At present we are in a kind of half-way house. Already now, and more in the future when the Community is again enlarged, there is a tendency for members to form operational groups for functional purposes. In such circumstances we would not want to find ourselves anywhere but in the central group - in effect the Germans and the French - on the key questions comprised in the development of the EMS, which could eventually evolve towards some form of economic and monetary union.

4. It will not be easy to choose the right moment to join the EMS if Ministers so decide. As we found when we eventually joined the Community itself, moving buses are hazardous to catch. Once we had failed to join the EMS at the beginning, there were always arguments to suggest that the time had not come. Sometimes sterling has been too strong, sometimes it has been too weak. We now confront the likelihood, discussed in the paper, that the Deutschmark will appreciate against sterling as well as the US dollar, and that if we were to join tomorrow, we might all too soon have to change whatever

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peg we chose for sterling and anyway introduce instability into the system. This is something which will obviously need very careful discussion. At all events we want to be ready to move forward if and when the time looks right. I suspect that whatever the circumstances we shall have to accept some measure of risk.

5. At the DUSs's meeting we shall need to consider how next to proceed. I think myself that once we agree on the two papers, they should be submitted to the Secretary of State with a recommendation that he should talk to the Chancellor of the Exchequer as soon as possible after the Budget. You will recall that FCO Ministers meeting at Chevening in December agreed that this would be desirable. My own discussions with Treasury officials suggest that the Chancellor is keenly interested in the whole problem. There is also plenty of interest in Brussels and elsewhere. The Commission is already in touch with the Treasury on the subject. The annex to the paper on EMS suggests some of the points which require further study. The main burden of such studies would of course fall on the Treasury and the Bank of England, but I hope that the FCO could be involved.

ECU

6. The Secretary of State has asked about the advantages and disadvantages of our pursuing a more positive line than that encapsulated in the nihil obstat which describes the present position of the Bank of England. The second paper brings out the arguments clearly. The fact is that there are no obstacles to the use of the ECU for private transactions in Britain where there are no exchange controls. Were there similar freedom in other member states, the use of the ECU would probably grow faster than it already has. If the market has developed in a more leisurely way in London than in one or two other Community capitals, this mainly reflects special factors (for example exchange control in France and Italy) and the judgement of the market in London. Little can be done about this. Here you will wish to see the conclusions of the paper.

13 February 1984

Crispin Tickell

THE EUROPEAN MONETARY SYSTEM

Introduction

1. The purpose of this paper is first to examine the advantages and disadvantages of possible British membership of the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) in the light of recent developments: and secondly to consider the implications for future British policy.

Historical Background

2. The EMS was set up in March 1979 with the aim of creating a "zone of monetary stability in Europe". The essential components of the EMS are:

(a) a European currency unit (ECU);
(b) an Exchange Rate and Intervention Mechanism;
(c) a credit mechanism
(d) measures designed to strengthen the economies of the less prosperous States in the EMS.

3. EMS was envisaged as the first step towards European Economic and Monetary Union (EMU). But the pre-conditions for EMU - the total elimination of internal barriers against trade and services, mobility of capital and labour, a Community-wide system of taxes, harmonisation on a Community basis of aids to industry etc - do not exist and are not likely to do so in the forseeable future, and the move to the second stage of EMS - the consolidation of the system through the establishment of a European Monetary Fund and the development of the ECU as a reserve asset - which was to have taken place two years after its setting up, has been indefinitely deferred.

4. The numeraire (denominator) of the existing system is the ECU, a composite monetary unit containing fixed quantities of each EC currency (except the drachma). Each currency participating in the ERM has a central rate against the ECU and, deriving from it, against other currencies. Central banks are obliged to intervene to keep their currencies within 2.25% (6% for Italy) of their

central rate against the ECU and against the other ERM currencies. The system implies fixed exchange rates but periodic adjustments have been made. The latest of these was on 21 March 1983 when the French franc was devalued and the DM revalued. These readjustments have been agreed by Finance Ministers meeting in a format similar to that of an ECOFIN Council; ie, under the Chairmanship of the Minister whose country holds the Presidency at that time.

5. HMG is formally a member of the EMS but decided in 1979 not to participate in the ERM. The change of government which took place soon afterwards did not affect this decision. The new government opposed full participation in the exchange and intervention mechanism on the grounds that it would have kept the pound sterling at an artificially high rate, hindering economic activity and requiring intervention at a rate that conflicted with the tight monetary policy being pursued by the British Government.

6. Nevertheless, the United Kingdom does play a part in the EMS. Sterling is assigned a notional central rate and this is adjusted to reflect its value at every realignment of the EMS. If of significant size, this adjustment can affect the central rates of all other ECU currencies. On occasions, due to sterling's wide fluctuations since 1979, the impact has been considerable. However, since sterling's central rate remains unchanged between realignments, these fluctuations have no implications for the intervention obligations of ERM members.

7. Sterling's detachment from the system has enabled the Chancellor to play an important role at realignment meetings. For example, Sir Geoffrey Howe presided over the meeting on 21 February 1982 during the Belgian Presidency when the Belgians were seeking a large devaluation of the FB and there was a need for impartial chairmanship.

8. The Government has kept the question of sterling's participation in the ERM under review and has stated publicly that

it would join when the time was right, both for Britain and for the system as a whole.

Recent Developments

9. There have been a number of developments relevant to the debate about British membership of the ERM since the subject was considered at a special meeting chaired by the Prime Minister's meeting on 22 January 1982 and at which the Chancellor, the Secretary of State and the Governor of the Bank of England participated. The EMS has demonstrated its durability and flexibility. Sterling is less obviously over-valued in relation to other EMS currencies than in previous years. Oil prices (to which sterling has been sensitive) are relatively stable. The British inflation rate has fallen below the Community average and to within two percentage points of the FRG's. The potential incompatibility of our monetary objectives with adherence to an exchange rate target within an essentially DM-denominated system is consequently less than hitherto. Indeed, in his Mansion House speech in November 1983, the Chancellor confirmed that the exchange rate had a role as an indicator of monetary conditions. It may be that full membership of the EMS could now begin to have attractions as a possible anti-inflationary discipline.

10. The House of Lords Select Committee on the EMS chaired by Lord O'Brien which reported in July 1983 concluded that the balance of advantage lay in early, though not necessarily immediate, British participation in the ERM. Professor Jim Ball of the London Business School also came down in favour of British membership in his recent report (with Michael Albert) to the European Parliament on economic recovery in the 1980s. Also in September 1983 a Commission paper on the Other Policies chapter of the post-Stuttgart negotiation (COM(83)578 Final) recommended that steps should be taken to promote the role of the ECU and that the ERM should be extended to all Member States. During his visit to London in November, M Ortoli raised the issue briefly and said that he would wish to come back to it with the Chancellor in 1984. A senior Commission official visited the Treasury in late January

1984 to follow up and discussions are now engaged.

11. The rise in the value of the dollar in recent months and the widespread expectation that this movement will sooner or later be reversed has led to growing interest in a co-ordinated European response. It is relevant to observe that the two major steps by which the EMS reached its present stage of development occurred at times of considerable turbulence in international markets. The seminal Werner Report was published in 1970 following the early signs of disintegration of the Bretton Woods system. The Jenkins/Schmidt initiative in 1977-8 which led to the establishment of EMS as we know it was in response to the international recession associated with the first oil price shock; to the growing belief that more monetary stability was desirable; and the feeling that the Community should take steps to ensure that Member States' economies were not adversely affected by a world monetary system dominated by a currency, the dollar, over whose management we had no control. A new bout of currency instability resulting from a rapid fall in the value of the dollar could conceivably lead to calls for the enhancement of the role of the EMS.

<u>The Political Case for Joining the ERM</u>

12. The main political factors in favour of joining are:

(a) The United Kingdom ought to be party to all activities regarding the development of the Community. We should never repeat our mistakes which led to our self-exclusion from the process which led to the signature of the Treaty of Rome. Other things being equal it is desirable that we should participate fully in the EMS. This would give us the chance to steer it in a direction consistent with British interests.

(b) So long as we are not in the ERM we strengthen the argument that we are not committed members of the Community. To join would be a telling demonstration of that commitment. This would have particular value in the post-Stuttgart negotiations which are designed to set the Community on a new

course.

(c) Our line that we shall join when the time is right is less and less convincing to our partners. The longer we absent ourselves, the more difficult it will be to join as habits harden in other moulds.

13. But the political case cannot be assumed to be beyond question. Our entry could cause problems for the other members, and if the system were subsequently to collapse, whether or not as a result, we might attract the blame. More significant is the possible domestic political impact: if, as is quite possible, maintaining an EMS rate involved unpopular policy measures such as higher interest rates, this would scarcely enhance enthusiasm for Community membership. Indeed, its present unpopularity might reduce the effectiveness of a constraint expressed as a European obligation (by contrast with France, where the need to maintain the EMS parity is seen as reinforcing the case for tough measures).

14. On balance however, the political arguments in favour of British participation are persuasive. As economic circumstances become more favourable to our joining the political considerations could assume greater importance.

The economic case for joining the ERM

15. This can usefully be evaluated in terms of the effects on:-

(a) British economic policy;
(b) European integration
(c) external constraints on European economies; and
(d) development of the international monetary and exchange system.

These aspects are, of course, closely related. The policy debate in Whitehall has hitherto concentrated on various aspects of (a),

but points (b) - (d) are also important, both in their own right and also because they impinge on (a).

British Economic Policy

16. The case in terms of British economic policy for joining boils down to the following:-

(a) provided we enter at a reasonably competitive rate, stability with regard to our main trading partners is desirable in its own right, primarily in reducing business uncertainty;

(b) large fluctuations ('overshooting') might be reduced by affecting expectations (because there is a presumption of action by the authorities both in Britain and in other EMS countries to limit them) and because of the practical provisions of the system (additional intervention resources etc);

(c) the link with what is, in effect, a DM zone reinforces anti-inflation policy;

(d) while there remains a possiblility of conflict between monetary and ERM objectives, the danger is much less than previously because British performance is now closer to that of the FRG. In practice monetary and ERM objectives may be mutually reinforcing; if conflict persists, there is always the option of realignment.

(e) joining the ERM at an early stage might complement the tighter domestic policies which would be necessary to combat the inflationary effect of any depreciation in the value of sterling consequent upon a realignment of the dollar.

17. At a technical level the issue would be now to reconcile a new exchange rate priority with our existing priority on monetary aggregation.

European Integration

18. Even if the theoretical importance of joining the ERM as a step which would lead towards EMU can be ignored (there is for the time being no impetus to move even towards stage two of the EMS), the more modest reality of the ERM could be helpful in promoting mutually profitable integration. The habit of consultation required inter alia by realignments has grown, and may help to promote consistency of policies. The operation of the CAP, and agreement on price restraint, might be easier if exchange rates were more stable. Inter-Community trade problems are more likely to be manageable in such circumstances.

External Constraints

19. One of the most pressing bones of international contention is the effect of US interest rates on the rest of the world. European governments complain that high US interest rates (generally attributed to the size and apparent persistence of the US Government's budget deficit) face them with the choice between keeping up their own interest rates to avoid currency depreciation and allowing their exchange rates to fall as the price of more acceptable real interest rates. The former inhibits recovery, while the latter increases inflationary pressures.

20. The latter course might be less damaging, and the dilemma less acute, if all the European currencies moved together. The increasing interdependence of EC trade (including Britain's) means that externally generated price pressures for any individual country would then be less significant, and recovery might be hastened at less inflationary cost. Moreover, the pressures on the US to put its house in order might be increased (although there is the hazard that it could be resolved by increased trade protection).

The International Monetary and Exchange Rate System

21. The recent strength of the dollar is but the latest of a series of sharp fluctuations in exchange rates since floating began in 1971. It is widely agreed that there have been severe

damaging misalignments ("overshooting"), and that efforts should be made to reduce them. There is also little dispute that the main ingredients for reducing these problems are policy consistency among countries and convergence of economic performance. This is not, however, inconsistent with measures aimed explicitly at exchange rates. These can take the form both of arrangements for intervention and on margins such as the ERM and of more general commitments by Governments to align policies in such a way as to keep exchange rates within broad target zones.

Expectations in the market can be influenced by measures of the latter type, although the effects are likely to be stronger if they are complemented by relevant practical measures.

22. These questions, as well as wider issues of development of the international monetary system, are likely to be a major item on the agenda of the London economic summit. US reluctance to contemplate interference in the exchange markets may limit progress, although there have been signs that attitudes are changing. The point may be approaching at which these matters will at last be seriously examined; the influence of the European voice in such discussion will depend largely upon the coherence of the European monetary authorities and of their positions. This might be stronger after a period of British membership to the ERM. Moreover, our part in determining European positions may also be stronger in such circumstances.

Economic arguments against Membership

23. A reversal of the recent strength of the dollar is widely perceived as likely, if not imminent. Were this to happen the DM would almost certainly strengthen against sterling. The size and strength of the German economy would make it the major refuge for funds coming out of the dollar, driving the DM up also against EMS currencies and sterling. Because the mechanisms of the ERM would tend to dampen the former movement, sterling would probably fall relatively further. If this were the case it could be argued that HMG should wait to joint the ERM until at least some of this realignment had recurred. If sterling were to join earlier and

then be forced to devalue, this would be damaging for public opinion in Britain and perhaps for the system itself.

24. A second reason for caution is sterling's petro-currency role; although oil prices are unlikely to show as much instability as in the 1979-83 period, prospects remain uncertain. It is also worth asking whether membership of the ERM might not change expectations and hence the degree of coincidence between oil price movements and the sterling parity.

25. There are also domestic economic arguments against joining:

(a) although precautions can be taken to minimize the danger of inconsistency, there will always be the possibility of conflict between monetary and exchange rate targets, particularly in the face of unforeseen shocks. Manifestly, those most closely involved judge that we should give priority to monetary objectives in such circumstances. Committed membership of the ERM would require interest rate policy to be linked to exchange rate objectives with the possibility that monetary aggregates could be relegated to secondary importance.

(b) Understandably, those who would have to execute a policy which contained the possibility of inconsistency do not relish the idea of blame for failing on one count or the other: hitting one target is difficult enough.

(c) The possibility of holding a fixed exchange rate in the face of powerful market movements is questioned. Taking the strain partly on the exchange rate and only partly through intervention has long been preferred.

(d) There is a strong aversion among some of those most closely involved to fixed rates, the EMS, and to interference in markets.

26. To these arguments might be added suspicion of proposals which involve sharing with outsiders decisions affecting management of the British economy.

Conclusions

27. A decision on Britain's adherence to the ERM must continue to rest primarily on the economic arguments. Although in recent months the economic arguments for an against membership have become more balanced; the expectation of a significant fall in the value of the Dollar remains a powerful argument to suggest that the time is still not right. Considerations of competitiveness and the difficult of managing entry when exchange rate relativities are changing rapidly mean that the arguments for joining would be stronger once this expected readjustment (which seems likely to involve the relative parities of DM and sterling) had taken place. On the other hand those who give primacy to price stability could argue that entry ahead of any thoroughgoing realignment would assist in maintaining the current policy stance.

28. The interest of the Foreign and Commonwealth Office is to ensure that the political case for joining, and particularly the need to ensure that we are not left out of important EC developments, is never lost to view. We also need to guard against the possibility that we might miss a chance to join at a propitious moment because the essential preparatory work had not been done. This is an argument for a study of the technical issues both within Whitehall and with the Commission. (The annex to this paper suggests some points for study.) This could lead to a more open debate on the fundamental issues and might convince our partners of our sincerity when we say, as we are bound to go on doing if we are not to be thought to be going backwards, that we will join when the time is right. These studies could also lead us to adopt a more collaborative and European approach to the problems of establishing a greater degree of exchange rate stability which could be threatened in the not too distant future by the fate of the dollar.

Annex

POSSIBLE PREPARATORY STUDIES ON UK MEMBERSHIP OF THE ERM

1. We need to consider the implications for the ERM of British adherence. Strains could rapidly reappear within the system if sentiment turned against the dollar and capital flowed towards the DM. Could the ERM cope with a DM and a £ which tended to diverge?

2. If this were to happen, the burden of adjustment would not fall upon the United Kingdom alone. We need to consider the consequences for both the United Kingdom and the Federal Republic of a serious effort to hold their rates together.

3. In the longer term we need to have a clearer picture of what we are trying to achieve. Do we wish to see target zones for exchange rates? Do we wish to see practical measure to introduce 'viscosity' into exchange rate movements? Do we regard decoupling Europe from the influence of US interest rates as a desirable or practical

4. The issue of how best to bring about permanent parity changes. A "market-determined crawling peg" in which central rates change gradually and mechanically in response to past divergences from the central rate is a possible alternative to large step changes.

5. A separate though related question concerns the role of the ecu. We need to consider whether there is anything which can legitimately be done without interference in the market to influence or encourage the use of the ecu, which is increasing of its own volition.

(See separate paper)

THE PRIVATE USE OF THE ECU

1. The growing private use of the European Currency Unit (ECU) is perhaps one of the surprises of the European Monetary System (EMS) experience. In terms of an eventual Economic and Monetary Union (EMU) the development of a parallel European currency is a long term goal. But the European Commission has always been keen to encourage private use of the ECU in the meantime, and originally believed that such would follow from greater official use of the ECU. Instead private use now seems to be ahead of official use, involving a number of non Community agents and in spite of capital and currency controls across the Community.

2. These developments have taken the form of accelerating growth of Eurocurrency markets based on the ECU. In the main these have been bond markets but during 1983 bank and official medium term credits began to catch up. During the first ten months of 1983 total bonds and credits issued amounted to 3.3bECU which compared with 2.1bECU in 1982, 500mECU in 1981 and 20mECU in 1980. The main countries involved in these markets are Italy and France, but Ireland, Denmark, Greece, Belgium and the United Kingdom (via an issue by Rank Xerox) have also been the source of smaller issues. Outside the Community, American, Canadian, Japanese, Spanish and Scandinavian institutions have also issued bonds or credits. Nonetheless the ECU market share remains small, amounting to only 4% of total Euro bond markets.

3. There is also evidence that the ECU is being increasingly used to invoice foreign trade within the Community and by some traders outside it.

/4.

4. The underlying reason for lenders, borrowers and traders using the ECU or any currency bundle is risk avoidance. Any transaction must offer both sides some advantage in terms of expected stability of value or level of interest rate over dealing in domestic currency or other foreign currencies (including the constituents of the ECU basket).

5. The relative fixity of exchange rates of the currencies within the ERM gives the ECU some of its attraction but in principle the same considerations apply to the individual currencies as well as the basket. Another advantage at least for citizens of member states is that their domestic currency forms some proportion of the basket and hence bears no exchange risk; but again in principle the difference in interest rates obtainable on domestic and ECU instruments ought to compensate for any expected change in exchange rates. The reality is that exchange rate changes can be sudden and particularly in high inflation countries interest rate differentials may be difficult to interpret and fears of a sudden collapse of the currency greater than reflected in foreign exchange markets. It is certainly suggestive that the main growth in the market has been in high inflation, weak currency countries, Italy and France in particular.

6. There may also be specific institutional reasons. Italian firms felt themselves over exposed to dollar risks and hence began to borrow in ECU. Italian investors, because of a relaxation of currency laws in favour of the ECU, had the opportunity to lend in ECU, thus hedging against Italian inflation. Both sides were in effect setting up a domestic bond market which did not previously exist. Non-EC institutions probably raised money in ECU simply to diversify the exchange risk on their debt, or to allow themselves to borrow currencies such as French Francs which they were otherwise not allowed to hold.

/The private

The private use of the ECU in Britain

7. The United Kingdom has taken a relatively small part in the market, with only one bond issue originating here. Lloyds Bank International is one of the major European banks taking deposits in ECUs, which are second only to their US dollar holdings. Nonetheless, and in spite of rapid growth, by the end of September 1983 British Bank ECU liabilities were only one quarter of one percent of British dollar claims, and 2% of British deutschmark liabilities.

8. There have been, subsequent to the abolition of exchange controls in 1979, no obstacles to British citizens or institutions holding ECU or carrying out any transactions they wish in ECU. This is the basis of the Bank of England declared policy of Nihil Obstat. It needs to be recognised that the absence of exchange controls by itself is a more positive policy than in other member states where exchange controls or, in Germany's case, domestic currency laws may prevent nationals holding ECUs. It is also worth noting that the Treasury is willing to accept loans from the EIB denominated in ECU.

9. So why has development been slow in Britain? Ignorance must certainly be a factor. But the underlying reasons are probably in the current balance of payments/exchange rate position.

10. First, the strong balance of payments has meant that Britain has been a net capital exporter in recent years; a feature emphasised by the portfolio adjustment which took place after the abolition of exchange controls. Second, the decline in both inflation and the public sector borrowing account may have increased demand for sterling assets while reducing supply. Thus there has been no need of official financing in ECU or indeed other foreign currencies, as there

/was

was for instance in the late 1970s when the budget deficit and the balance of payments deficit were both large.

11. British absence from the Exchange Rate Mechanism (ERM) of the EMS has meant that potentially the ECU rate fluctuates more against sterling than against other member currencies, thus negating some of the apparant advantages to traders of invoicing in ECU. In any case for private individuals and firms, the strength of sterling against European currencies in recent years has probably argued against the ECU as a currency hedge of any importance in trade.

Outlook for future use of the ECU

12. In general, a bout of dollar weakness might prove helpful to the future development of ECU based Euromarkets but the main structural improvements would come from a general dismantling of barriers to capital movements within the Community, and in particular a change in attitude by the German central bank towards the ECU. Currently it prevents German citizens holding ECUs. Against these, the possible entry of Greece, Spain and Portugal will reduce the attractiveness of the currency basket to traders in particular.

13. There is also need for a general clearing mechanism for ECUs. Currently banks with small deposits are forced to split them up into constituent currencies at the end of each trading day. Such a mechanism is under active consideration.

14. In Britain a shift from a surplus on the current balance to a deficit would increase demand for loans in foreign currencies. The fact that around 14% of the ECU is in sterling and that there are weak as well as strong currencies in the basket would reduce the exchange risk on ECU denominated borrowings and hence make them more attractive. A weakening of sterling might also increase the demand by exporters to

/Britain

Britain for ECU invoicing and hence for ECU accounts.

15. The Commission is currently looking for three positive steps to improve the use of the ECU - none of which provide any substantive difficulty for Britain:-

a) that all member states recognise the ECU as a foreign currency. Effectively this is aimed at the Federal Republic;

b) that the ECU is officially defined and copyrighted;

c) that ECU issues are open to EC citizens wherever they reside, thus giving ECU an advantage particularly where exchange controls operate.

(a) and (c) are already operational in Britain, and (b) is dependant on (a) happening in other member states.

A more positive British policy

16. British membership of the ERM might encourage the use of ECU in Britain particularly if sterling were expected to be among the weaker members. Short of membership of ERM there are a number of possible policy initiatives HMG could undertake to increase use of the ECU:-

a) instruct the Bank of England to use the ECU among its reserve assets and to intervene in the market for it;

b) issue Government borrowing instruments in ECUs;

c) encourage local authorities and nationalised industries to make foreign borrowing in ECUs, particularly loans protected by the Public Sector Exchange Cover Scheme;

/(d)

d) publicise the ECU as a monetary asset for trade and investment purposes to raise consciousness of the ECU in Britain.

17. On (a), at present the market would probably be very thin and such a facility would do little good by itself. In any case in circumstances where there was the possibility of differential movements against EMS currencies (eg the DM and the French Franc) it would probably be more efficient to trade direct. Only the Italian Central Bank is currently doing this, against a background of 10% of trade invoiced in ECU and a substantial domestic credit market denominated in ECU. Starting with the Central Bank hardly seems sensible for the United Kingdom.

18. On (b) the issue of government borrowing instruments in ECU would probably be strongly resisted by the Treasury and the Bank of England. There is currently no problem in funding Government borrowing on the Gilt Edged market and some sterling bonds are bought by foreigners. Nor is there any need to finance a balance of payments deficit. Hence the issue of a foreign currency bond could be interpreted as HMG signalling a wish or an expectation that sterling should fall.

19. On (c) there might be less resistance to other Public Sector bodies, who are in any case borrowing overseas, directing their borrowing to ECU. This would give an extra hedge to the Exchequer for those loans insured against exchange rate movements under the Public Sector Exchange Cover Scheme. But even this route would not be very attractive unless there is a substantial risk that sterling would depreciate less against the ECU than - say - the US dollar.

/20.

20. On (d) it would hardly be for HMG directly to undertake publicity to promote the private use of the ECU, although it might let it be known that it had a benevolent attitude towards it. The Eurocurrency markets are largely based in London and the operators on them are sophisticated. It is unlikely that there is anything that HMG could tell them that they do not already know. With private individuals, government advice to hold ECUs might be seen as encouragement to speculate against the currency or at least an indication that British inflation was likely to rise above the EC average. It is possible that the Commission might wish to undertake a Community-wide publicity campaign, aimed at traders in particular but also perhaps covering private individuals, to encourage the use of the ECU. As HMG has no exchange controls this would do no more than recommend what is already allowed. Any campaign would probably founder on German opposition.

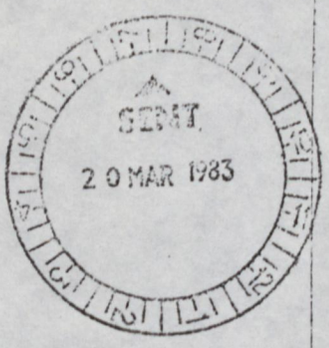
21. The European Parliament has suggested the issue of a one ECU coin as publicity and to give substance to the ECU. Given that no prices are set in ECU (beyond the CAP) and that Banks are reluctant to accept even high value coins in foreign exchange dealings, this would look like a gimmick and in the short term could be counter productive. Any commercial initiative to issue ECU travellers cheques is much more realistic. It is possible that such papers as the Economist may be launching campaigns of their own to propagate the use of the ECU as something the City might exploit in order to develop its role as the main European financial centre.

Conclusion

22. HMG has placed no barriers against the private use of the ECU, and has preferred to leave its development to market forces. It would be hard actually to promote it without raising doubts about the governments intentions, but in

/certain

certain circumstances HMG might look favourably on ECU denominated borrowings under the Public Sector Exchange Cover Scheme. Publicity from whatever quarter might alert dealers and traders to the opportunities for greater use of the ECU, but the responsibility for such use and the advantages it might bring to the City must be for the judgment of those concerned.



As requested I gave the original to the PM last night-

Mollie Dungell
20/3.

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R.C.

E.M.S. REALIGNMENT CONFERENCE

SUMMARY

1. MINISTERIAL MEETING ADJOURNED THIS AFTERNOON WITHOUT AGREEMENT. WILL RESUME AT 9 AM TOMORROW IN HOPE OF REACHING AGREEMENT BEFORE EUROPEAN COUNCIL IN LIGHT OF OVERNIGHT CONSULTATIONS. CENTRAL BANK GOVERNORS HAVE AGREED THAT WHEN MARKETS OPEN TOMORROW, THE OFFICIAL INTERVENTION RATES WILL BE DECLARED TEMPORARILY SUSPENDED AS ALSO THE OFFICIAL DAILY FIXING IN THOSE COUNTRIES WHERE THAT APPLIES. KEY ISSUE IN DISPUTE IS EXTENT AND DISTRIBUTION OF SPREAD BETWEEN FRENCH FRANC (FF) AND DEUTSCHE MARK (DM).

DETAILED REPORT

2. MONETARY COMMITTEE YESTERDAY MORNING IDENTIFIED FOLLOWING MAIN ISSUES FOR DECISION BY MINISTERS:-

(I) EXTENT OF SPREAD BETWEEN FF AND DM CONSENSUS WAS FOR 7 - 9 PER CENT:

(II) POSITIONS OF INDIVIDUAL COUNTRIES. GERMANS WERE PREPARED TO MOVE UPWARDS MORE THAN HALFWAY BUT FRENCH RESISTED ANY DOWNWARD MOVEMENT OF FF AT ALL. OTHER MEMBERS IN GENERAL PREPARED TO SLOT IN (BELGIUM, LUXEMBOURG AND DENMARK FOLLOWING DM IN PART: ITALY AND IRELAND MOVING TO BOTTOM OF SPREAD: AND DUTCH PROBABLY FOLLOWING DM):

(III) BACK UP MEASURES TO MAKE REALIGNMENT CREDIBLE. NO SPECIFIC PROPOSALS EMERGED BUT FRENCH HINTED AT FURTHER MEASURES TO REDUCE DEMAND:

(IV) WIDENING OF INTERVENTION MARGINS. NOT FAVOURED BUT OFFERED FOR CONSIDERATION AS TEMPORARY MEASURE (SAY, TO 4 PER CENT) TO SECURE LAST DITCH SOLUTION.

3. AT SERIES OF MINISTERAL MEETINGS YESTERDAY (WITH STOLTENBURG IN CHAIR) FRENCH (DELORS) REFUSED ANY CONCESSION AND THREATENED TO WITHDRAW FROM E.M.S. UNLESS GERMANS WILLING TO BEAR COMPLETE

3. AT SERIES OF MINISTERAL MEETINGS YESTERDAY (WITH STOLTENBURG IN CHAIR) FRENCH (DELORS) REFUSED ANY CONCESSION AND THREATENED TO WITHDRAW FROM E.M.S. UNLESS GERMANS WILLING TO BEAR COMPLETE BURDEN OF AT LEAST 8 PER CENT ADJUSTMENT. CORE OF ARGUMENT WAS THAT FOLLOWING JUNE 1982 REALIGNMENT FRANCE HAD TAKEN SERIES OF MEASURES TO RESTORE CONTROL OVER ECONOMY: THESE WOULD TAKE TIME TO WORK AND THERE WOULD STILL BE SUBSTANTIAL GAP BETWEEN FRENCH AND GERMAN INFLATION AT END 1983. FRANCE COULD NOT BE EXPECTED TO MAKE FURTHER SACRIFICES WHICH WOULD JEOPARDISE ATTEMPTS TO MASTER INFLATION. GERMANY MUST THEREFORE TAKE RESPONSIBILITY FOR ADJUSTMENT BY REVALUING DM. IF FRANCE LEFT E.M.S. PROTECTIONIST POLICIES WOULD ALSO BE INTRODUCED. DELORS MADE MUCH OF CURRENT CRITICISM OF E.M.S. AND COMMUNITY GENERALLY IN FRANCE, AND PRODUCED LIST OF UNRESOLVED GRIEVANCES, WHICH HE EVEN ARGUED IN HIS OPENING STATEMENT, WOULD HAVE TO BE RESOLVED AS A PRIOR CONDITION FOR CONTINUED FRENCH MEMBERSHIP OF THE EXCHANGE RATE MECHANISM. THIS WAS SEVERLY CRITICISED BY THE ITALIANS (GORIA).

4. GERMANS OFFERED TO GO MORE THAN HALF WAY BUT ARGUED STRONGLY THAT EXCESSIVE REVALUATION OF DM WOULD THREATEN INCIPIENT GERMAN ECONOMIC RECOVERY. RECENT INTEREST RATE REDUCTION HAD MADE SIGNIFICANT CONTRIBUTION TO EASING PRESSURE ON FF: AND MONEY SUPPLY HAD BEEN INCREASING AT EXCESSIVE RATE.

5. AFTER OVERNIGHT CONSULTATIONS DELORS CONFIRMED IN PLENARY THAT FRANCE INSISTED ON 8 PER CENT SPREAD AND GAVE SIGNS OF BEING WILLING TO ACCEPT SOME DOWNWARD MOVEMENT OF FF, POSSIBLY WITHIN WIDENING OF MARGINS FROM TWO AND A QUARTER PER CENT TO 3 PER CENT. HE ALSO GAVE NOTICE OF FRENCH REQUEST FOR 4 - 5 BILLION DOLLAR CREDIT FACILITY FROM 1981 COMMUNITY LOAN MECHANISM AND INDICATED THAT FRENCH GOVERNMENT WOULD ANNOUNCE TOMORROW OR TUESDAY NEW MEASURES TO RESTRAIN DOMESTIC DEMAND, WITH A VIEW TO ELIMINATING THE TRADE DEFICIT BY END 1984.

6. DISCUSSIONS THEN CENTRED ON SERIES OF NEGOTIATIONS ON POSSIBLE ALLOCATION OF 8 PER CENT SPREAD. (THESE WERE UNREAL IN AN ECONOMIC SENSE, BECAUSE THERE WAS NO FIXED REFERENCE POINT AGAINST WHICH THE VARIOUS COMBINATIONS WERE OR COULD BE MEASURED: BUT THEY ASSUMED ENORMOUS POLITICAL IMPORTANCE). CURRENT POSITION IS THAT GERMANS ARE UNWILLING TO INCREASE DM BY MORE THAN 5 PER CENT, AND FRENCH TO REDUCE FF BY MORE THAN 2 PER CENT, ALTHOUGH AT ONE TIME FRENCH SEEMED WILLING TO CONTEMPLATE 2.5 PER CENT. ALL ATTEMPTS TO COMPROMISE HAVE SO FAR FAILED (EG CHANCELLOR SUGGESTED DM 4.75 PER CENT AND FF - 2.75 PER CENT) AND DELORS HAS ACCORDINGLY RETURNED TO PARIS TO CONSULT PRESIDENT.

7. IF AGREEMENT CAN BE REACHED BETWEEN FRENCH AND GERMANS, OTHERS SHOULD FIT IN FAIRLY EASILY. POSSIBLE REALIGNEMNT ON BASIS OF DM + 5 PER CENT AND FF - 2.5 OR 3 PER CENT WOULD BE:-

DUTCH GUILDER + 3 PER CENT
BELGIAN FRANC, LUXEMBOURG FRANC AND DANISH KRONE + 1 PER CENT
ITALIAN LIRA WITH FF
IRISH PUNT - 4 PER CENT

8. IN VIEW OF MARKET REPERCUSSIONS CENTRAL BANK GOVERNORS (WITH GREAT RELUCTANCE AND APPREHENSION) AGREED THAT FROM OPENING TOMORROW AUTHORITIES WOULD TEMPORARILY SUSPEND THEIR OBLIGATORY BUYING AND SELLING RATES FOR THEIR PARTNERS' CURRENCIES (THOUGH RETAINING THE RIGHT, IF THEY WISHED, TO INTERVENE AT RATES OF THEIR CHOOSING) AND, WHERE APPLICABLE, CANCEL THE OFFICIAL FIXING IN THEIR MARKET. THIS MAY BE WRONGLY DESCRIBED AS 'CLOSING MARKETS', BUT COMMERCIAL TRANSACTION WILL, OF COURSE, CONTINUE.

9. MINISTERS AGREED THAT STOLTENBERG SHOULD INFORM PRESS BRIEFLY, WITHOUT MENTIONING ANY FIGURES, OF ADJOUCNEMENT OF DISCUSSION. BUT SEVERAL MINISTERS (NOTABLY DELORS) HAVE SPOKEN TO PRESS AND

9. MINISTERS AGREED THAT STOLTENBERG SHOULD INFORM PRESS BRIEFLY, WITHOUT MENTIONING ANY FIGURES, OF ADJOUCNEMENT OF DISCUSSION. BUT SEVERAL MINISTERS (NOTABLY DELORS) HAVE SPOKEN TO PRESS AND MAIN FIGURES SEEM WELL KNOWN.

COMMENT

10. PROSPECTS FOR EARLY AGREEMENT TOMORROW DIFFICULT TO ASSESS. DELORS PERSONALLY SEEMS TO WANT TO REACH AGREEMENT AND HAS MADE CONCESSIONS FROM OPENING POSITION BUT HAS SO FAR BEEN UNABLE TO GET NECESSARY BACKING TO CLINCH DEAL. REPORTS OF IMPENDING FRENCH GOVERNMENT RESHUFFLE COULD LEUD TO STRENGTHENING OF HIS HAND, BUT TIME IS SHORT IF DEAL TO BE STRUCK WITH GERMANS DEFORE TOMORROW MORNING. IF DELORS UNABLE TO GET BACKING OVERNIGHT, AGREEMENT BY FURTHER NEGOTIATION IN PCESENT MINISTERIAL GROUP TOMORROW MORNING SEEMS UNLIKELY AND BUCK MAY WELL THEREFORE HAVE TO BE PASSED TO EUROPEAN COUNCIL. NEGOTIATIONS HAVE NOT BEEN HELPED BY POOR CHAIRMANSHIP BY STOLTENBERG WHO, DESPITE DIFFICULTIES, COULD IN OUR VIEW HAVE MADE GREATER EFFORTS TO BRIDGE SMALL FINAL GAP.

11. CHANCELLOR WILL REMAIN IN BRUSSELS FOR RESUMED MEETING TOMORROW (BUT WILL HAVE TO LEAVE BY LATE MORNING IN VIEW OF COMMONS BUDGET DEBATE). FINANCIAL SECRETARY WILL, AS PREVIOUSLY PLANNED, ATTEND ECOFIN (WHICH IS DUE TO FOPLOW RESUMED MEETING). UNWIN WILL STAY ON IN BRUSSELS TO BRIEF EUROPEAN COUNCIL DELEGATION.

FCO ADVANCE TO:
FCO - PS/SOS: EVANS: HANNAY
CAB - PS/ARMSTRONG: HANCOCK
MAFF - HAYES: ANDREWS
TSY - LITTLER: HEDLEY-MILLER: MONCK: PERETZ
BANK - PS/GOVERNOR: GILL

NO.10 - DUTY OFFICER (DESKBY 202000Z)

BUTLER

NNNN

Mrgaxed to Chequers
11.30pm 18/3.
BPC

PRIME MINISTER

REALIGNMENT OF EMS

The Germans have agreed to a request from a number of countries (characteristically not including France!) for a conference tomorrow on a realignment of the EMS in view of the strains now on the various currencies.

The Germans have agreed to call a conference which will start at 5.00 p.m. tomorrow in Brussels. The Chancellor is going. There will be a meeting of officials at 1215 attended by the Governor, and Mr. Unwin and Mrs. Hedley-Miller from the Treasury.

The Germans have hinted that if it becomes difficult for them to retain the Chair because they are an interested party, the Chancellor may be asked to take the Chair as "a neutral judge".

FERB

18 March 1983

(4)

Prime Minister.

A.V.C. 25/10

EUROPEAN MONETARY UNION - WHY NOT?

BY PIERRE WERNER, PRIME MINISTER OF LUXEMBOURG

26 OCTOBER 1982

THE TOPIC ON WHICH I AM SUPPOSED TO TALK TO YOU HAS THE SPECIAL FEATURE OF UNTIMELINESS. I MEAN THAT WHENEVER I HAPPENED TO SPEAK ABOUT OR TO LECTURE ON WHAT HAS BECOME OVER THE YEARS NEARLY A STANDING PRACTICE OF MINE, TURNED OUT SO VERY OFTEN IN THE MIND OF MY HEARERS TO BE CONSIDERED AS UNSEASONABLE. AND WHEN I TRIED TO CONVINCE THEM TO LET ACTION FOLLOW ACQUIRED INTELLECTUAL CONVICTION, I GOT REPEATEDLY THE SOBERING ANSWER, THAT THIS WAS NOT THE RIGHT MOMENT, THAT THINGS HAD NOT MATURED.

AT THE RISK OF RAISING IN YOUR MIND THE SAME QUESTIONING AND DOUBTS, I ACCEPTED ONCE MORE THE THEME OF MY SPEECH TO BE MONETARY INTEGRATION. IT MIGHT SEEM PRESUMPTUOUS! BUT I FEEL THAT FROM TIME TO TIME, IT IS APPROPRIATE TO TEST THE IDEA WITH RESPECT TO THE UNDERLYING CURRENT ECONOMIC AND POLITICAL REALITIES.

ESPECIALLY IN A PERIOD OF STRAIN AND TURBULENCE IN THE MARKETS WE ARE BOUND TO MEASURE THE EUROPEAN INFLUENCE ON THE EVENTS AND TO SCRUTINIZE EVERY POSSIBILITY OF USING WITH A STABILIZING PURPOSE THE POTENTIAL ECONOMIC STRENGTH OF EUROPE.

THE WAY OF SETTING THE ACCENT ON EITHER OF THE TWO WORDS IN MY INTERROGATIVE TITLE, AFFORDS A NATURAL DIVISION OF MY SPEECH IN TWO PARTS.

I SHALL FIRST EXAMINE THE "WHY NOT". I MEAN BY THAT THE REASONS OF THE INHERENT DIFFICULTIES OF THE PROBLEM.

AFTER THIS AND SWITCHING THE ACCENT ON THE "NOT", THE "WHY NOT" QUESTION APPEARS AS A KIND OF CHALLENGE TO OVERCOME THESE DIFFICULTIES IN VIEW OF A FINAL BETTER ORDER OF THINGS.

SOME 13 YEARS AGO SPEAKING OF CLOSER MONETARY TIES INSIDE THE E.E.C. HAD BECOME OF ACTUAL INTEREST. SUDDENLY THE GOVERNMENTS OF THE SIX BECAME AWARE OF THE INSUFFICIENT FORESIGHT AND PROVISIONS OF THE TREATY OF ROME IN MONETARY MATTERS. THIS INSUFFICIENCY WAS IN SHARP CONTRAST WITH THE AMBITIONS AND FAR-REACHING GOALS OF THE TREATY AS FAR AS THE LIFTING OF TRADE RESTRICTIONS BETWEEN THE MEMBER-STATES, THE COMMON TRADE POLICY TOWARDS THIRD COUNTRIES, THE HARMONIZATION OF ECONOMIC AND FISCAL POLICIES WERE CONCERNED, NOT TO SPEAK OF THE CONSTRAINTS OF THE UNIFIED PRICE SYSTEM FOR AGRICULTURAL GOODS.

SO FAR THIS WEAKNESS OF THE COMMUNITY POLICY HAD NOT SERIOUSLY EMERGED, BECAUSE THE REIGN OF THE BRETTON WOODS SYSTEM OF FIXED PARITIES SUPPORTED ALSO BY THE "EUROPEAN PAYMENTS UNION" DRAWN FROM THE MARSHALL PLAN, AFFORDED A DECENT STABILITY OF INTERNATIONAL MONETARY RELATIONS.

BUT THE PEACE OF BRETTON WOODS WAS DRAWING TO ITS END AND THE RULINGS OF THE INTERNATIONAL MONETARY FUND, WHICH WERE SUPPOSED TO MAINTAIN ORDERLY EXCHANGE RELATIONS ON A WORLDWIDE LEVEL WERE MORE AND MORE QUESTIONED.

SINCE 1967 THE CALM ON THE MONETARY FRONT WAS DISTURBED.

THE GOVERNMENTS OF THE SIX FELT THAT THE GROWING INFATUATION FOR FLOATING EXCHANGE SYSTEMS, COULD JEOPARDIZE THEIR CONTINUOUS EFFORTS TO FIGHT

DISCRIMINATORY PRACTICES AND FAIR DEALINGS BETWEEN THE NATIONAL ECONOMIC SYSTEMS, WHICH WERE WIDELY LIBERALIZED.

OF COURSE THE TREATY OF ROME HAD NOT COMPLETELY IGNORED THE EVENTUALITY OF MONETARY DISTURBANCES AND CRUMBLING NATIONAL EXCHANGE SYSTEMS. BUT ITS PROVISIONS ACTUALLY INTENDED MORE TO SHIELD INDIVIDUAL MEMBER-COUNTRIES AGAINST THE DIRECT IMPACT OF DISTORTING MONETARY PRACTICES, RATHER THAN TO ACTIVELY RESTORE SOUND RELATIONSHIPS, THUS FALLING BACK FROM THE FUNDAMENTAL LIBERALIZING PHILOSOPHY OF THE COMMON MARKET.

IT IS IMPORTANT HOWEVER TO STRESS THAT ARTICLE 107 OF THE TREATY HAD PRACTICALLY RECOGNIZED THE EXISTENCE OF A PROPER COMMUNITY INTEREST TO BE OBSERVED IN SHAPING MONETARY POLICY.

AS A MATTER OF FACT, THE ARTICLE READS THAT "EVERY MEMBER-STATE HANDLES ITS EXCHANGE - RATE POLICY AS A PROBLEM OF COMMON INTEREST." THE NATIONAL INTEREST OUGHT NOT TO EXERT AN ABSOLUTE RULE.

IN DECEMBER 1969, THE HEADS OF STATE OR GOVERNMENTS, MEETING IN THE HAGUE ASKED THE COUNCIL OF MINISTERS TO WORK OUT IN COOPERATION WITH THE COMMISSION A SCHEME IN VIEW OF THE CREATION BY STAGES OF AN ECONOMIC AND MONETARY UNION WITHIN THE COMMUNITY. ON MARCH 6TH, 1970, THE COUNCIL OF MINISTERS SET UP A SPECIAL STUDY GROUP. AS PRIME MINISTER AND MINISTER OF FINANCE OF LUXEMBOURG, WHO HAD ALREADY SINCE YEARS ADVOCATED MONETARY UNION, I WAS ASKED BY THE COUNCIL TO PRESIDE OVER THESE STUDIES GIVING THEM BY THIS WAY THE DESIRABLE POLITICAL TOUCH.

MY INTENTION IS NOT TO RECALL TO YOU THE WHOLE STORY OF THE REPORT TO WHICH MY NAME HAS BEEN LINKED. LET ME ONLY SAY THAT AFTER SIX MONTHS OF THOROUGH INVESTIGATIONS AND CROSS EXAMINATIONS DURING WHICH THE

MONETARIST AND ECONOMIST APPROACH WERE OFTEN AT GRIPS, WE ISSUED A REPORT RESPONDING ACCURATELY TO THE MANDATE GIVEN BY THE HAGUE SUMMIT MEETING.

THE PURPOSE OF THE GOVERNMENTS HAD BEEN TO GIVE THE COMMUNITY A NEW START BY A LOGICAL AND GRADUAL DEVELOPMENT OF ITS AIMS AND POLICIES THROUGH THE STRUCTURING AND COORDINATING POWER OF COMMON MONETARY POLICIES AND, IN THE FINAL STAGE, OF A COMMON EUROPEAN CURRENCY SYSTEM.

HAILED BY THE FERVENT MILITANTS FOR EUROPEAN INTEGRATION FOR ITS UNFALTERING DESCRIPTION OF THE INSTITUTIONAL ASPECTS OF A FULLY COMPLETED ECONOMIC AND MONETARY UNION, THE SAME ASPECT MADE A LOT OF POLITICIANS RAISE EYEBROWS ON WHAT THEY CONSIDERED AS TO BOLD A SUPRANATIONAL THRUST.

NEVERTHELESS IN 1971 AND 1972 THE COUNCIL OF MINISTERS DECIDED TO GO AHEAD FOR A FIRST STAGE WITH A BALANCED ECONOMIC AND MONETARY PROGRAM. ON THE MONETARY SIDE, IT INITIATED A MECHANISM KEEPING THE FLUCTUATIONS OF THE CURRENCIES OF THE MEMBER-STATES WITHIN NARROWER MARGINS THAN THOSE APPLICABLE ACCORDING TO THE ARTICLES OF AGREEMENT OF THE IMF WITH THIRD CURRENCIES AND ESPECIALLY THE US $ 51. THIS IS THE BIRTH OF THE SO-CALLED MONETARY SNAKE, WICH IN SPITE OF ITS AGITATED AND VARIABLE FATE HAS HAD ENOUGH VITALITY TO LEND STILL ITS MODEL TO THE PRESENT EUROPEAN MONETARY SYSTEM.

THE FIRST STAGE OF THE SCHEME LARGELY CONSIDERED AS AN EXPERIMENTAL THREE YEAR PHASE WITHOUT FUNDAMENTAL INSTITUTIONAL CHANGES, WAS SUPPOSED TO END IN DECEMBER 1973. IT TOOK A RATHER JOLTING COURSE AFTER THE FIRST SIX MONTHS. THE YEAR 1971 IS MARKED AS A MATTER OF FACT BY DEEP GOING COMMOTIONS IN THE INTERNATIONAL MONETARY SYSTEM DUE TO THE PROGRESSIVE

WEAKENING OF THE DOLLAR.

IN MAY 1971 THE DEUTSCHMARK AND THE DUTCH GUILDER BEGAN TO FLOAT AGAINST THE DOLLAR, ON AUGUST 15TH, PRESIDENT NIXON SUSPENDED THE CONVERTIBILITY IN GOLD OF THE AMERICAN CURRENCY, IN DECEMBER THE SMITHSONIAN AGREEMENT DEVALUED THE DOLLAR BY 7,89 %. THESE AND OTHER EVENTS DID NOT OFFER THE CALM BACKGROUND NEEDED FOR THE FIRST STEPS OF THE SIX ON THE ROAD TO MONETARY INTEGRATION, ALTHOUGH, AS MY CONVICTION WAS, THEY MIGHT HAVE ACTED AS A CHALLENGE AND PROVOKED A JUMP IN THE REACTION OF THE MEMBER-COUNTRIES.

THIS LEADS ME TO THE FIRST "WHY"!

WHAT ARE, PUTTING ASIDE THE CITED EPISODES, THE INHERENT DIFFICULTIES OF MONETARY INTEGRATION.

THE FIRST OF COURSE IS THE STRONG ATTACHMENT NOT ONLY OF THE STATESMEN BUT ALSO OF THE MEN IN THE STREET TO THE SOVEREIGN RIGHT OF ISSUING COINS AND OTHER LEGAL TENDERS UNDER A NATIONAL AUTHORITY.

AS FAR AS THE SYMBOLIC VALUE OF NATIONAL COINS AND BANKNOTES IS CONCERNED, A MONETARY UNION DOES NOT NECESSARILY MEAN THEIR ABOLITION.

WHAT IS MORE FUNDAMENTAL IS THE HANDLING OF THE NATIONAL CURRENCY SYSTEM AS A WHOLE, THE PULSATION OF THE CREDIT OPERATIONS PILED UPON IT, THE MOVEMENTS OF THE MONEY-STOCK IN ALL ITS SHAPES.

THE MODERN STATE HAS THE MEANS OF CREATING, DESTROYING OR REDUCING PURCHASE POWER ACCORDING TO VARIABLE METHODS.

WITHOUT ANY DOUBT, A COMPLETE MONETARY UNION ENTAILS A COMMON CONTROL OF THE QUANTITY OF MONEY. IT IMPLIES ESPECIALLY A COMMON APPROACH TO THE FIGHT AGAINST INFLATION.

THESE TWO REQUIREMENTS AT FIRST SIGHT CUT DEEPLY INTO NATIONAL POLICIES. ON THE OTHER HAND BUDGETARY AND GENERALLY FISCAL POLICIES ARE LARGELY INFLUENCED BY THE MANAGEMENT OF THE NATIONAL CURRENCY SYSTEM. A CERTAIN CONSENSUS ON THE WAY BUDGETARY DEFICITS OUGHT TO BE FINANCED WOULD BE NECESSARY. AS A MATTER OF FACT, IF FINANCE MINISTERS WITH THE HELP OF THE COMMISSION, COULD BE INDUCED TO AGREE ON GENERAL GUIDELINES ABOUT THE APPROPRIATE MEANS OF BALANCING NATIONAL BUDGETS AND SETTING LIMITS TO MERE MONETARY EXPANSION FOR BUDGETARY REASONS, HARMONIZATION OF POLICIES WOULD HAVE MADE A MAJOR PROGRESS.

HARMONIZATION OF ECONOMIC POLICIES MEANS ALSO ACHIEVING A COMPROMISE BETWEEN THE ECONOMIST APPROACH, WHICH EXCLUDES A MONETARY SET-UP BEFORE THE RESULTS OF A LARGE COHESION ON POLICIES HAVE BECOME CONSPICUOUS AND THE MONETARIST APPROACH, WHICH IS CONVINCED THAT THE ACHIEVEMENT OF COMMON POLICIES DEPENDS LARGELY ON MONETARY INCENTIVES. MAY I RECALL IN THIS RESPECT THE SLOGAN MISTER JACQUES RUEFF HAD FORGED ALREADY IN 1949 SAYING : "L'EUROPE SE FERA PAR LA MONNAIE OU NE SE FERA PAS," WHICH MIGHT BE TRANSLATED INTO SHAKESPEARIAN TERMS : "TO BE OR NOT TO BE FOR EUROPE MEANS TO ENGAGE IN OR TO ABSTAIN FROM MONETARY UNION."

INFLATION AND EMPLOYMENT ARE NOWADAYS THE TWO MAIN MATTERS OF CONCERN AND ANGUISH FOR GOVERNMENTS AND CITIZENS. THEIR MUTUAL INTERACTION IS A MATTER OF HOT CONTROVERSY BETWEEN ECONOMISTS. CAN THIS DOUBLE FIGHT BE WAGED AT THE SAME TIME WITH POSITIVE RESULTS. THAT IS ONE OF THE GREAT THEMES OF INTERNATIONAL DISCUSSION GOING ON.

MAY I QUOTE IN THIS CONNECTION THE OPINION OF A BRITISH ECONOMIST MISTER DAVID T. LLEWELLYN, WHO ADVOCATES IN PRINCIPLE MONETARY UNION. HE SAYS : "THE DURABILITY OF ANY FIXED EXCHANGE RATE WILL BE DETERMINED, IN NO SMALL PART, BY THE WILLINGNESS OF HIGH INFLATION COUNTRIES TO ACCEPT THE SHORT RUN EMPLOYMENT COSTS OF THE NECESSARY MONETARY ADJUSTMENT." THE LONG RUN RESULTS WILL BE THE MORE ASSURED.

THIS IS OF COURSE A MATTER OF STRONG POLITICAL WILL, INSPIRED BY AN ENLIGHTENED UNDERSTANDING OF THE MODERN WORLD'S UNITY OF FATE.

SOME INSTITUTIONAL ASPECTS PROPOSED BY THE 1970 REPORT OF ECONOMIC AND MONETARY UNION, HAVE RAISED MUCH DUST AT THAT TIME. IT HAD BEEN UNDERLINED IN THE REPORT THAT MONETARY UNION INVOLVES EFFICIENT CENTERS OF DECISION-MAKING ON OVERALL ECONOMIC AND MONETARY POLICY. LATER ON THE INTELLECTUAL CONTENT OF THIS CLAIM WAS DROWNED SOMEWHAT IN THE CONCEPT OF EUROPEAN UNION.

THIS ASPECT RAISES THE WHOLE PROBLEM OF THE ADEQUACY AND EFFICIENCY OF THE COMMUNITY INSTITUTIONS, ESPECIALLY IF WE TAKE INTO ACCOUNT A FURTHER ENLARGEMENT OF THE MEMBERSHIP.

SO MANY HANDICAPS CAN THEY BE OVERCOME? IS THERE ANY FUTURE IN MONETARY UNION?

EXPERIENCE SHOWS THAT THE LOGIC BEHIND THE AIM OF A MONETARY ORDER INSIDE A COMMON MARKET, IS SO STRONG, THAT IT CANNOT CONSTANTLY BE ELUDED.

THIS WAS RECOGNIZED BY THE EUROPEAN COUNCIL MEETING AT BREMEN ON JULY 7TH, 1978, WHEN THE HEADS OF GOVERNMENTS DECIDED TO LAUNCH A NEW EUROPEAN MONETARY SYSTEM. SINCE MARCH 1979, THIS SYSTEM IS WORKING AMONG A CERTAIN NUMBER OF MEMBER-COUNTRIES AND IN SPITE OF HEAVY DOUBTS AT THE OUTSET,

IT HAS BEEN ABLE TO CONTRIBUTE TO THE STABILITY OF THE ECONOMIES OF THIS GROUP OF COUNTRIES. BASED ALSO FUNDAMENTALLY ON A PERMISSIBLE MARGIN OF FLUCTUATIONS BETWEEN EXCHANGE-RATES, IT SHOWS SOME IMPROVEMENTS WITH RESPECT TO THE FORMER "SNAKE", PUTS THE ECU AT THE CENTER OF THE SYSTEM AND AFFORDS CONSIDERABLE LARGER CREDIT FACILITIES WITHIN IT.

IT IS NOT MY PURPOSE TO DESCRIBE THIS SYSTEM WHICH AS SUCH CONSTITUTES A FIRST STAGE IN A MORE AMBITIOUS SCHEME, LEADING TO A EUROPEAN MONETARY FUND WITH LARGE POWERS IN MONETARY POLICY.

IT SHOWS THAT THE "WHY NOT" HAS ALREADY RECEIVED A LIMITED RESPONSE.

THE RECRUDESCENCE OF A MONETARY DESIGN WAS CERTAINLY DUE TO A SHIFT OF THINKING FLOWING FROM ACTUAL EXPERIENCE.

THE INCRIMINATED LOSS OF SOVEREIGNTY INFERRED BY COMMON ACTION IS NO LONGER CONSIDERED AS STANDING IN THE WAY.

THE INTERDEPENDANCE OF THE ECONOMIES RESULTING FROM A NON-DISCRIMINATORY TRADE RELATIONSHIP, REINFORCED BY COMMON POLICIES, LEADS TO A CORRESPONDING INTERDEPENDANCE OF MONETARY POLICIES. AS EVENTS SHOW, THE VALUE OF A CURRENCY, THOUGH DETERMINED BY THE ECONOMIC PERFORMANCE OF THE NATIONAL ECONOMY, IS LARGELY DEPENDENT ON THE POLICY AND BEHAVIOUR NOT ONLY OF THE NEIGHBOUR, BUT ON THE WHOLE INTERNATIONAL ENVIRONMENT.

MONETARY SOVEREIGNTY IS NO LONGER ABSOLUTE, BECAUSE THE FREE WILL OF AUTHORITIES IS PERMANENTLY OVERRUN BY INDOMITABLE EVENTS. TAKE FOR INSTANCE THE CONTESTED INFLUENCE OF HIGH INTEREST RATES IN THE U.S.A. ON THE GROWTH OF THE EUROPEAN ECONOMIES.

THE POOLING OF SOVEREIGN RIGHTS IN CURRENCY MATTERS IS CERTAINLY NOT EQUIVALENT TO THEIR LOSS. COLLECTIVE ACTION IS ON THE CONTRARY ABLE TO RESTORE A GREAT PART OF IT FOR EVERY ONE.

ON THE OTHER HAND, THE INFLATION ISSUE HAS ALSO PROVOKED NEW INSIGHTS. THE SO-CALLED STAGFLATION, WHICH PREVAILED FOR SEVERAL YEARS, SHOWS THAT STAGNATION AND INFLATION CAN COEXIST, AND THAT THE LATTER DOES NOT NECESSARILY BEGET FULL EMPLOYMENT.

HARMONIZATION OF ECONOMIC AND BUDGETARY POLICIES, THOUGH STILL NOT EASY, HAS MADE SOME INVOLUNTARY PROGRESS, AS FACTS ARE STRONGER THAN GOVERNMENTS. IF YOU LOOK AROUND EUROPE, YOU WILL NOTICE THAT RECENTLY PRACTICALLY ALL THE GOVERNMENTS HAVE DRAWN THEIR CONCLUSIONS FROM THE CONTINUED CRISIS SITUATION AND ARE PRACTICING OR TRYING TO PRACTICE MORE RIGOROUS POLICIES. THE RESULT IS THAT INFLATION RATES HAVE DROPPED. THE GENERAL AIM SEEMS TO GET AT LEAST BELOW 10 %. ON THE OTHER HAND THE EUROPEAN MONETARY SYSTEM CAN TOLERATE SOME DISCREPANCY BETWEEN INFLATION RATES (PERHAPS 4-5 %), AS THE EXCHANGE RATE IS INFLUENCED ALSO BY OTHER ECONOMICAL AS WELL AS POLITICAL FACTORS.

THE FEELING IS INCREASING THAT A NEW PATTERN OF GROWTH, AFTER THE CURRENT ADJUSTMENTS CAN ONLY SUCCEED IF, AS WELL ON A WORLDWIDE LEVEL AS ON THE EUROPEAN FRONT, A GREATER STABILITY AND CONFIDENCE CLIMATE CAN BE DEVELOPED.

IN THIS RESPECT WE MUST ADMIT THAT THE EUROPEAN COMMUNITY HAS NOT REACHED SUFFICIENT COHESION ENABLING IT TO SUPPLY A DECISIVE CONTRIBUTION TO A BETTER WORLDWIDE ECONOMIC AND MONETARY ORDER.

AS SUCH THE COMMUNITY IS STRONG ENOUGH TO CREATE A EUROPEAN CURRENCY

SYSTEM CAPABLE OF TAKING UPON ITSELF PART OF THE BURDEN OF THE PREVAILING RESERVE CURRENCY, THE U.S.A. DOLLAR. THE COMPETITION BETWEEN TWO STRONG CURRENCY SYSTEMS, WILL COMPEL THE UNITED STATES AS WELL AS EUROPE TO MANAGE THEIR CURRENCIES ON STRICTER AND MORE COORDINATED LINES, EXTERNALLY AND INTERNALLY, CREATING ALTERNATIVES OF STABILITY FAVOURABLE TO ECONOMIC EXPANSION THROUGHOUT THE WORLD. THE REAL VALUE OF THE DOLLAR WOULD NOT SUFFER FROM IT. ON THE CONTRARY, PRESENTLY THE RATHER UNPARALLELED RESERVE CURRENCY, TENDS TO BE RATED TO MUCH ON POLITICAL AND SPECULATIVE GROUNDS.

ON THE WHOLE THE EUROPEAN COUNTRIES BY STRENGTHENING THEIR COMMON MONETARY SYSTEM CAN FREE THEMSELVES FROM DISTURBING OUTER INFLUENCES AND AT THE SAME TIME CONSOLIDATE WHAT HAS BEEN SO FAR THE ACQUIRED ACHIEVEMENTS OF THE COMMON MARKET.

IT IS OF COURSE FUNDAMENTALLY A PROBLEM OF POLITICAL INSIGHT AND WILL.

I AM AWARE NOW THAT I AM PLEADING AGAIN, LEAVING MY NEUTRAL APPROACH.

IT MAY STILL BE A LONG WAY TO ECONOMIC AND MONETARY UNION.

IT IS THEREFORE THE MORE IMPORTANT TO STRENGTHEN AND COMPLETE THE EXISTING EMS.

SEVERAL LINES OF PROGRESS HAVE BEEN ADVOCATED AND SHOULD BE FOLLOWED.

IN THE SHORT RUN WE SHOULD:

- IMPROVE THE POLICY COORDINATION TOWARDS THE DOLLAR BY SETTING UP A FECOM - FED (FONDS EUROPÉEN DE COOPÉRATION MONÉTAIRE - FEDERAL RESERVE

SYSTEM) SWAP CREDIT LINE, GIVING MORE STABILITY TO THE DOLLAR VIS-À-VIS THE EUROPEAN CURRENCIES.

- ENLARGE THE ROLE OF THE ECU (EUROPEAN CURRENCY UNIT) BY DROPPING THE EXISTING ACCEPTABILITY LIMITS ON ITS USE BETWEEN CENTRAL BANKS AND BY ENCOURAGING ITS PRIVATE USE. THE PRIVATE USE HAS ALREADY BEEN DEVELOPED IN RECENT MONTHS IN FUND RAISING AND BANK ACCOUNTS.

THE BELGIAN GOVERNMENT HAS PROPOSED ON ITS SIDE TO SECURE A BETTER CONVERGENCE AMONG MEMBER COUNTRIES' ECONOMIC PERFORMANCES, IN PARTICULAR BY DEVISING AND USING A "DIVERGENCE INDICATOR" FOR INFLATION RATES, WHICH WOULD INDICATE WHEN INFLATION OUGHT TO BE HALTED BY APPROPRIATE POLICIES.

IN THE LONGER RUN THE FECOM CREATED IN 1973 SHOULD BE CONVERTED INTO A EUROPEAN MONETARY FUND.

WHEN DISCUSSING THE STRENGTHENING OF THE EMS, ONE CANNOT ESCAPE THE PROBLEM OF THE POUND STERLING.

MAY I RECALL THAT THE UNITED KINGDOM HAS APPROVED IN 1978 THE FOUNDATION OF THE EMS. THE POUND STERLING IS ONE OF THE CURRENCIES OF THE BASKET FORMING THE ECU. BUT THE BRITISH GOVERNMENT DID NOT CONSIDER IN 1978 THAT THE ECONOMIC CONDITIONS IN THE COUNTRY WERE SUCH THAT IT COULD IMMEDIATELY JOIN THE INTERVENTION MECHANISM.

NOW, MANY THINGS HAVE CHANGED SINCE 1978. FOR INSTANCE, THE REDUCTION OF THE INFLATION RATE HAS BEEN SPECTACULAR SINCE THEN.

MUCH OF WHAT HAS BEEN SAID OF THE ADVANTAGES OF MONETARY COOPERATION APPLIES OF COURSE ALSO TO GREAT BRITAIN.

I KNOW VERY WELL THAT JOINING THE EMS MEANS SOLVING DELICATE PROBLEMS OF APPROPRIATE CONDITIONS AND SETTING THE RATE.

BUT I CAN ONLY EXPRESS THE WISH THAT STERLING JOIN THE SYSTEM AS SOON AS POSSIBLE UNDER APPROPRIATE CONDITIONS. MUCH OF WHICH I SAID OF THE POSSIBLE PRESTIGE OF A EUROPEAN CURRENCY SYSTEM, DEPENDS ON THIS IMPORTANT STEP.

PERHAPS SOME OF YOU WILL CONSIDER THAT ALSO THIS PROPOSAL IS UNTIMELY AS OTHER DESIRABLE STEPS MENTIONED IN MY SPEECH.

BUT WHY SHOULD WE NOT THINK ABOUT THE WHOLE AND PONDER HOW AND UNDER WHAT CONDITIONS THE UNTIMELY COULD BE MADE TIMELY.

I MUST REPEAT HOWEVER THAT THE FULL BENEFIT OF MONETARY UNION CAN ONLY BE EXPECTED IF THE COMMUNITY ON THE WHOLE TAKES CONSCIENCE OF THE PRESENT DANGERS CONSISTING OF A RETURN TO PROTECTIONISM AND ADULTERATION OF THE COMMUN MARKET'S GOALS AND PRINCIPLES.

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MY TELNO 650, PARAGRAPH 7: EUROPEAN MONETARY SYSTEM

1. IN CONVERSATION WITH MINISTER (ECONOMIC) YESTERDAY FISCHER, FOREIGN MINISTRY, TOOK AN OPPURTUNITY TO MAKE A STRONG PITCH FOR BRITISH MEMBERSHIP OF THE EMS. HE SAID THAT IN PRIVATE CONVERSATION WITH GERMAN OFFICIALS WITHIN THE LAST FORTNIGHT THE FEDERAL CHANCELLOR HAD REITERATED IN A VERY CONSIDERED WAY THAT THE BEST THING THE BRITISH COULD DO FOR THEMSELVES AND THE COMMUNITY WAS TO JOIN THE EMS. THE FEDERAL CHANCELLOR, SAID FISCHER, FELT VERY STRONGLY ABOUT THIS. HE IMPLIED THAT HERR SCHMIDT FELT THAT OUR REASONS FOR STAYING OUT WERE FLIMSY AND THAT, MORE POSITIVELY, THE BEST WAY WE COULD SCOTCH TALK ABOUT SECOND-CLASS MEMBERSHIP OF A TWO-SPEED COMMUNITY WAS TO JOIN.

2. UNWIN ASKED FISCHER IF HE COULD REPORT HIS REMARKS AS A FORMAL, IF PERSONAL, DEMARCHE. FISCHER SAID THAT HE COULD. THEY STRIKE ME AS INTERESTING IN PUTTING THE FOREIGN MINISTRY FIRMLY IN LINE WITH A CONCERN OF THE FEDERAL CHANCELLOR'S WHICH WE HAVE SOMETIMES FELT TO BE PERSONAL, IF PERSISTENT AND STRONGLY HELD.

TAYLOR

STANDARD
WED
ECD
SAMD
NAD
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CABINET OFFICE

COPIES TO:
PS | Chancellor
Mrs Hedley-Miller } TSY
PS | Mr Rickett }

THIS TELEGRAM WAS NOT ADVANCED

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MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Parliament Street
London
SW1P 3AG

30 March 1982

AGRICULTURE COUNCIL: 31 MARCH

Thank you for your minute of the 26 March concerning the position of the green pound.

We have as you know agreed to discuss this and I note your views that there should be a re-valuation if there is an increase in excess of 9 per cent in common prices.

You will, of course, understand that we cannot make any firm decisions until the final settlement is known. To take an exaggerated view, if there was a settlement of 14 per cent on average, but with only a 6 per cent increase for cereals and milk, a 5 per cent re-valuation would be totally disastrous for British agriculture.

I would suspect that by the end of the week we will have some clearer vision of the type of package that is likely to emerge after agreement has been reached on the budget; and naturally, before final decisions, as previously requested, I will discuss this with colleagues.

One further feature which has of course emerged since we last discussed this, is the very large number of countries which are now going to enjoy increases above the final settlement. France, Belgium, Luxembourg, Denmark, Italy, Greece and Ireland are, in my view, all likely to have farm price increases above the average settlement. I think it would therefore be politically very damaging if, with an 11 per cent rate of inflation, and the past fall in farm incomes, we were seen to be doing very much worse than most of Europe.

I am sending copies of this to the Prime Minister, to OD(E) Colleagues, and to Sir Robert Armstrong.

PETER WALKER

original copy filed on Cano file 149 (2)
Reference CAP

Anne Nicholls

A.S.C. 30.3

MINISTER'S MEETING WITH CHAIRMAN OF THE COUNCIL OF MINISTERS (AGRICULTURE): 27 MARCH 1982

Present:

Mr de Keersmaeker - Belgian Minister of Agriculture and European Affairs		Minister
		Mr Andrews
Mr Van der Moortel Mr Dobbelaere	- Ministry of Agriculture	
Mr Fricchionne - Council Secretariat		

1. Although this was the last stop on Mr de Keersmaeker's tour of Community capitals, he gave virtually no indication of the positions of other Member States. Nor did he give any indication, except in the most general terms, of the kind of price fixing package which he envisaged as being ultimately negotiable. He said that he thought that the price settlement would need to be at a level "moderately" higher than what the Commission were proposing, and that the package would need to go some way to meet the special demands made by several Member States, particularly the Greeks; the problem was to ensure that this special treatment was as limited as possible.

2. The Minister agreed to hand over the list of UK requirements which had already been passed to Mr Dalsager; I gave copies to Mr Van der Moortel and Mr Fricchionne after the meeting. As regards areas of particular concern to the Minister, the following points emerged.

    1. The Minister stressed that it was impossible to agree on a price settlement before it was known how it would be financed. Nor was it possible for him to accept the Commission's proposal for re-valuation of the green pound, which would leave UK farmers with a price increase substantially lower than the average, especially when so many other Member States were in a position to benefit from recent or imminent currency movements. He pointed out that it had never been the UK that had in the past resisted Member States' freedom to exploit the re-alignment of green currencies towards a neutral position.

    2. The Minister was particularly worried about proposals to give help to small dairy farmers through the co-responsibility system. He was ready to consider the case for a special aid, and a compromise settlement could involve agreement that funds should be made available but not through a market mechanism. Mr de Keersmaeker said no more in response and that he felt that the dairy problem was negotiable.

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3. Mr de Keersmaeker said that he recognised the existence of the link between the price fixing and the Community budget. As regards the Mediterranean acquis, he said that there was no scope for an agreement on the whole of this problem because of the absence of proposals on olive oil. He took the Minister's point that it was unreasonable to expect Member States to agree to particular items in the Mediterranean package that would benefit certain Member States while ignoring others, but pointed out that the problem of the acquis was not institutionally related to the price fixing. Nevertheless something probably needed to be done in this area, perhaps by means of general guidelines which could be fleshed out later. The Minister said there were only two possible ways of handling the Mediterranean problem if it were to be linked with the price fixing. Either the whole package could be agreed so that a balance could be struck between the interests of the Member States, or a financial limit could be adopted as a framework for future agreement on those areas not finalised.

4. The Minister then had a short private discussion alone with Mr de Keersmaeker. I understand that Mr de Keersmaeker made it clear that he fully understood the UK's problem on the Community budget, but said that he regarded it as his duty to work towards agreement on an agricultural package at this week's Council meeting. The Minister said that, as he did the last time that the budget was at issue, he would have to reserve on the whole of the agricultural package pending a solution. Some of his reserves would be purely tactical, but others would be on points of real substance, which he had stressed at the meeting and which were described in our note. Nevertheless, he felt that if the meeting was carefully handled, it would not be impossible for agreement to be in sight by the end of this week. As regards the budget issue itself, the Minister stressed that an agreement would only be possible once the UK could see what it would mean in financial terms.

5. Neither the Minister nor Mr de Keersmaeker took seriously the threat of a majority vote on the agricultural package; this was not in the wider interest of the French, nor was it likely to be acceptable to several other Member States. The Minister said that he did not like the idea that the Agriculture Ministers should remain in session until the Foreign Ministers had concluded their meeting; in the event that an agreement was reached on the budget and good progress had been made on an agricultural package, there would be no problem about re-convening the Agriculture Ministers to finalise a settlement quickly If there had not been good progress on the price fixing, then a couple of weeks breathing space would be necessary in any case.

Robert Lowson

Mr Redfern + 1

R LOWSON
29 March 1982

cc
Ms Nason
Mr Clements
Mr Lebrecht
Mr Robbs
Mr Andrews
Mr Stapleton — Mr Pooley - UK Rep Brussels
Mr Dixon — Mr Coles - 10 Downing Street
Mr Parkhouse — Mr Richards - PS/SOS/FCO
Mr Myers — Mr Kerr - PS/Chancellor of the Exchequer
Mr Dawes — Mr Byrne - UK Embassy Brussels

Original copy filed on Euro Bdg CAP Prime Minister To me.

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MINISTER OF AGRICULTURE, FISHERIES & FOOD

AGRICULTURE COUNCIL: 31 MARCH

We have discussed next week's Agriculture Council, and the difficult hand you will then have to play. You know my views on the main CAP price issues, and the importance of maintaining the line agreed in OD(E), ie that there should be no increases beyond the Commission's original proposals, and lower increases for certain cereals prices, milk, sugar, oil seeds and Mediterranean products. The purpose of this minute is to add a point about the green pound.

2. If at the end of the day we were obliged to consider price increases beyond the Commission's original proposals, we should need, in my view, to offset any excess above a 9% average by a one-for-one revaluation of the green pound. I quite see that you may be concerned at the risk that such a revaluation could be followed by a further EMS realignment, and a consequential devaluation of the green franc. But the essential criterion which should govern our own decision is that the level of the green pound must strike the right balance between the needs of consumers and of producers. I hope you won't mind my writing at this late stage to put on record once again my firm belief that a revaluation of the green pound to prevent any excess above a 9% increase in common prices will be sufficient to protect the position of producers, while enabling us to ensure that the impact on prices in the shops is kept within defensible limits.

3. I am sending copies of this minute to the Prime Minister, to OD(E) colleagues, and to Sir Robert Armstrong.

Approved by the Chancellor and signed in his absence. (G.H.)
26 March 1982

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Europol CAP Pt 9

original copy filed on Europol 149 CAP

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

Prime Minister

A.J.C. 26/3

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The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

26 March 1982

Dear Sir Geoffrey

POSSIBLE FURTHER EMS REALIGNMENT: AGRI-MONETARY CONSEQUENCES

I thought it might be helpful if I followed up our discussion at the Prime Minister's briefing meeting on 24 March about the line we should take in the event of a French franc devaluation before the conclusion of the negotiations on the CAP price-fixing.

We agreed that, provided support was forthcoming from Germany and Netherlands at a realignment conference, you would seek to maintain the agreement reached at the February meeting that no green rate devaluations would be sought or proposed until the conclusion of the price-fixing negotiations. Although this cuts across our traditional position on negative MCAs - of which we obtained Council endorsement in May 1980 - we should justify this in the light of this year's particular circumstances.

If, on the other hand, the Germans and Dutch offer no support at the realignment conference, you will clearly not be in a position to insist on adherence to the February agreement. The countries interested in getting Green Rate devaluations through may indeed seek to have the previous agreement set aside. If so, we agreed at the Prime Minister's meeting that you would seek to get it on record that, if others are free to devalue when it suits them, we must be free not to revalue unless and until it suits us.

/I attach ...

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... I attach a possible form of words which could be included in the draft communique. The proviso about the Agreement of eight Member States of 6 March 1979 (the so-called Gentlemen's Agreement) has to be made, otherwise it would be claimed that we were trying to override it. But the point that we want to make is a valid one both for revaluations greater than those required by the Gentlemen's Agreement (including the Commission's current proposals for Germany and the Netherlands) and for revaluations for countries not party to the Gentlemen's Agreement. We should not, of course, want to agree to the first half of the proposed form of words without the second half.

If the weak currency countries do not ask for any reference to the question of Green Rate devaluations and if there is no support from Germany and Netherlands for a specific reference to maintaining the previous agreement, then you may prefer not to poke this issue up at any realignment conference. I would then rely on the February agreement to block the devaluations in the Agriculture Council, so long as the Germans and Dutch would support us.

I am sending copies of this letter to the Prime Minister, the Foreign and Commonwealth Secretary and Sir Robert Armstrong.

Yours ever

Robert Lord

for PETER WALKER
(Approved by the Minister and signed in his absence)

POSSIBLE EMS REALIGNMENT CONFERENCE
DRAFT PASSAGE ON MCAS FOR COMMUNIQUE

It was agreed that, notwithstanding the agreements reached at the meeting of Ministers and Central Bank Governors on 21 February 1982, Member States with negative monetary compensatory amounts may at any time ask the Commission to propose changes in representative rates leading to the reduction or elimination of these amounts; and that correspondingly, without prejudice to the Agreement of eight Member States of 6 March 1979, Member States with positive monetary compensatory amounts may reject any proposal for changes in representative rates leading to the reduction or elimination of these amounts.

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10 DOWNING STREET

From the Private Secretary

25 March 1982

Possible EMS Realignment: Green Rate Changes

At the Prime Minister's briefing meeting for the European Council on 24 March, the Chancellor of the Exchequer raised the question of green rate changes following any new EMS realignment.

The Chancellor explained that at the last EMS realignment conference it had been agreed that consequential green rate changes should not be made at once because the annual price fixing was being negotiated. There had been a dispute between those who wanted to postpone the consequential green rate changes until 1 April and those who wanted them postponed until the new prices were agreed, whenever that was. If the French now asked for a new realignment, it was probable that a number of other countries would take advantage of the opportunity to devalue their central rates as well so that they could then secure greater price increases for their farmers. The Community could thus be faced with potential devaluations of green rates by France, Belgium, Denmark, Italy and Ireland. The Chancellor therefore needed agreement on a line to take if the question of the timing of consequential green rate changes was discussed at a new realignment conference (which might be called at very short notice).

In discussion it was pointed out that our policy in the past had always been that a Member State was free to adjust its green rate in line with a change in its central rate if it wished so that, if others wanted to change their green rates immediately after a new realignment, it would be extremely difficult for the United Kingdom to resist on its own. If the green rate change were made at once, our price fixing lever would to some extent be weakened. On the other hand, we would be able to exploit the opportunity to get the others to agree that no Member State should be forced to adjust its green rate if it did not wish to do so.

Summing up the discussion, the Prime Minister said that the Chancellor should try to get agreement that green rate changes should not be made during price fixing negotiations. But we should not stand on this position on our own. If isolated, we

/ should

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should instead try to secure agreement that no Member State should be forced to adjust its own green rate if it did not want to do so. Outside the price fixing season, our existing policy should be maintained - namely that the United Kingdom should be free to adjust its green rate when it chose.

I am sending copies of this letter to Francis Richards (Foreign and Commonwealth Office), Robert Lowson (Ministry of Agriculture Fisheries and Food) and David Wright (Cabinet Office).

A. J. COLES

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

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Please type letter

A.J.C. 25/3

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Qz.02518

MR COLES

POSSIBLE EMS REALIGNMENT: GREEN RATE CHANGES

As I mentioned to you on the telephone, I think Departments will need a record of the decision taken at the Prime Minister's briefing meeting yesterday morning.

2. I attach a draft letter for your consideration.

D.H.

D J S HANCOCK

25 March 1982

Draft letter from Mr Coles

To: Private Secretary to the Chancellor of the Exchequer

cc: Private Secretaries to Foreign and Commonwealth Secretary, Minister of Agriculture, Sir Robert Armstrong

POSSIBLE EMS REALIGNMENT: GREEN RATE CHANGES

At the Prime Minister's briefing meeting for the European Council on 24 March, the Chancellor of the Exchequer raised the question of green rate changes following any new EMS realignment.

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4. Summing up the discussion, the Prime Minister said that the Chancellor should try to get agreement that green rate changes should not be made during price fixing negotiations. But we should not stand on this position on our own. If isolated, we should instead try to secure agreement that no Member State should be forced to adjust its own green rate if it did not want to do so. Outside the price fixing season, ~~the~~ our existing policy should be ~~preserved~~ maintained - namely that ~~Member States~~ the U.K. should be ~~were~~ free to adjust ~~their~~ its green rates when ~~they~~ it chose.

5. I am sending copies of this letter to [as above].

25/3

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Prime Minister (2)

Thurs 4/3

Foreign and Commonwealth Office
London SW1

3 March 1982

Dear Geoffrey.

EMS DEVALUATIONS: 21 FEBRUARY

In Peter Carrington's absence abroad I am writing to thank you for your letter of 24 February and the illuminating account of what was obviously a very difficult meeting. I hope that you will indeed be able to avoid chairing another for some time; I fear that you have made something of a reputation for carrying out this task!

Not the least interesting of the implications of these events are those for CAP prices and the Mandate. It would suit our book if the Belgians/Danes/Luxembourgers got their devaluations agreed as soon as possible after 31 March. It is unlikely that prices will have been settled by then and devaluation will reduce their need for a high price settlement and thus support in the Council for the French position; this should in turn help to avoid a 9:1 split emerging too soon. Alternatively, if the French, as they may well do, continue to block devaluations at the 31 March/1 April Council, then we should be able to ensure that they receive some of the odium which might otherwise be directed at us.

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

Yours ever

Humphrey

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

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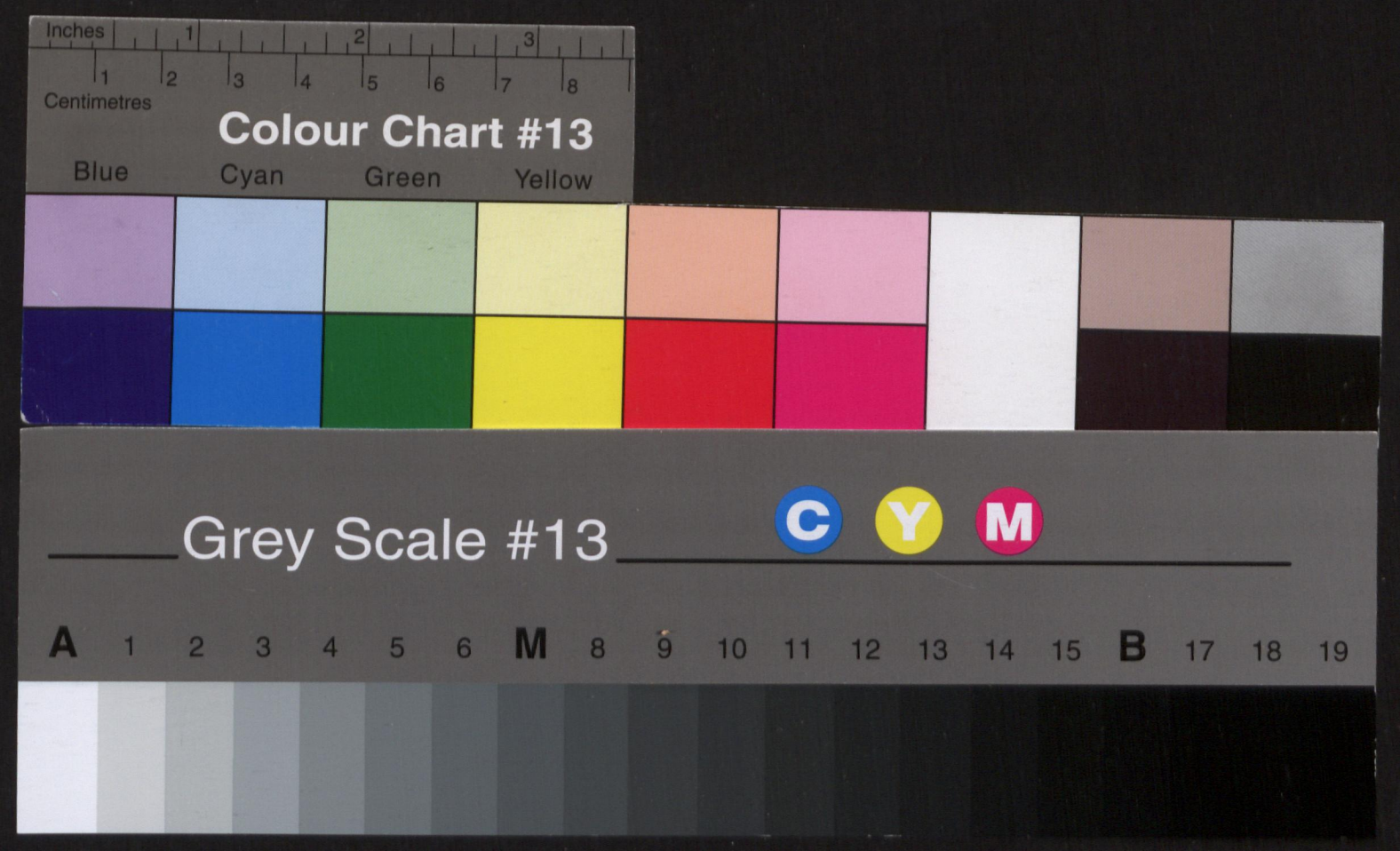
4 MAR 1982

PART 1 ends:-

CC (82) 7th Item 3 - 25.2.82

PART 2 begins:-

LPS to Ch/Ex 3.3.82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