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Further briefing for
Strasbourg.

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PRIME MINISTER

THE EUROPEAN MONETARY SYSTEM (EMS)

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

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

EMS - Present Position

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



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

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

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



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

Parliament

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

The Principal Issues

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

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



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

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

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

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



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

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

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

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



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

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

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

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



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

Political considerations

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

Immediate Issues

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

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

Conclusion

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

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

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

G.H.

(G.H.)

20 June, 1979