17.10.79.

10 DOWNING STREET

From the Private Secretary

Copies to the Deputy Gov^r
Mr Fforde
Mr McMahon
Mr Dow
Mr Balfour
The Chief Cashier
Mr Dawkins

17 October 1979

Dear Tony,

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

EMS

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

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

SECRET

/ Summing up

MJB 23/10

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

Exchange Controls

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

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

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

/ Commenting on

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

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

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

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

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

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

Yours ever,

T. Lankester