R.

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EMS

I have read your Private Secretary's minute of 15 June on this subject. While you will clearly not want to indicate any change of policy on Wednesday, I do feel that we should seriously consider taking the occasion of our presidency of the EEC to join the EMS.

This is in many ways a second best course. Financial discipline is essential for the conquest of inflation; and there are two forms which financial discipline can take. It can be a self-imposed explicit monetary discipline, or a partly externally-imposed exchange rate discipline. (Normally, of course, the two can co-exist; but from time to time there can be conflicts and the question then arises as to which dimension takes precedence.)

I have no doubt that, ideally, a straight monetary discipline is superior. But we are now getting into that phase, which will become increasingly evident as the election approaches, when the political pressures for a relaxation of monetary discipline will start to mount. This raises the question of whether, in practice, we may not be able to enforce and maintain a greater degree of effective financial discipline if we were to embrace the exchange rate discipline, for all its imperfections. This is particularly apposite given that those of our colleagues who are most likely to be pressing for a relaxation of monetary discipline (in practice, if not in terms) are those who are keenest on the UK joining the EMS. In other words, we turn their own sword against them. Essentially, what this would mean is tying the £ to the DM. One gamble is whether this would in practice be a sufficient discipline. It would certainly not have been over the past two years. But now the £ is (still) relatively high and the DM by general consent unnaturally low: and this opportunist consideration, coupled with the long-term anti-inflationary conduct of the German economy, makes it a gamble in which the odds are surely heavily in its favour.

This links up with Mr Burns' minute of 12 June on Inflation. We have undoubtedly gained more than we have lost from the strong £ over the past two years, and a substantial fall in the £ from now on would be highly damaging to our inflation prospects. As for industry, a link with the DM at the present exchange rate might appear rather rough (although it is some 10% below the peak reached earlier this year): but there is no way we can tolerate a weak £ and the EMS would have to be sold to industry as a form of exchange rate stability. Despite the dollar switchback, this might not be too difficult to do.

Ostensibly, the timing of such a move might be justified along the following lines. For a long time, the foreign exchange markets totally ignored our possession of North Sea oil. Then - perhaps in 1977 - they suddenly became aware of it, and of its significance, and a major adjustment in the external value of the £ necessarily took place. That adjustment has now, in our judgement, been completed, and from now on there is no reason why the £ and the non-petrocurrenci of the rest of the EEC should not march in harness at the new parity.

It might look odd to join the EMS when some observers think it is about to fall apart through the weakness of the franc under Mitterranc socialism - not to mention his lack of Giscard's personal commitment to the EMS. But in fact probably the greatest political benefits to be had from the UK joining the EMS would be derived if we were, as it were, to occupy France's empty chair.

You will not be suprised to know that I have very mixed feelings about the course I have sketched out above. At the end of the day, the argument rests heavily on political judgement. But at the very least it seems to me to warrant urgent examination.

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NIGEL LAWSON
15 June 1981