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EMS

You asked (Mr Wiggins' minute to Mr Riley of 1 September) for any further comments on the EMS. I am not unduly impressed by the arguments against our joining the EMS as recorded in the note of the meeting you held (in my absence) on 4 September.

2. It was argued that what matters to British industry is stability in relation to the dollar, and that linking the £ to the DM could make the existing £/\$ instability worse. I accept neither the premise nor the conclusion. In the first place, the IMF weighting for the \$ in the effective rate for sterling is a little under 25% compared with a little over 45% for the EMS currencies. (Direct trade with the US is of course even smaller, at some 16% of UK imports). In the second place, there is no evidence to support, nor reason to believe, the thesis that £/\$ instability would be increased by our joining the EMS. As for the view that there might be greater instability in the sterling effective rate (trade weighted) if we were to join the EMS, this is (a) unproven (it may of course be true from time to time, but false at other times) and (b) of little help to UK exporters, whose concern is with specific exchange rates in the real world rather than abstract averages.

3. It is impossible to say what the 'right' £/DM exchange rate is. But the £ is now clearly within the 'reasonable' band of DM4-4.50, and

we should join at the going market rate.

4. It might be argued that joining would be inconsistent with previous protestations that we cannot control - and therefore could not reduce - the exchange rate. I do not accept this. In the first place, by joining the EMS we would not be controlling the exchange rate tout court: the £ rate, for example, would continue to fluctuate. But we have never said, for example, that we could not depress the nominal exchange rate (eg by announcing our conversion to inflationary policies): what we have maintained is that there was no sensible way in which we could bring down the exchange rate and that, even if we did do so by foolish means, this would be unlikely to reduce the real exchange rate, which is what matters for price competitiveness. Thus I see no presentational problem in this regard.

5. The positive reasons why we should now join the EMS were set out in my original minute of 15 June. Since then the case has become if anything stronger - and not merely because of the change in the £/DM rate and the fear of inflating expectations being triggered by any further fall in the exchange rate generally. We have also received, from the economists, increasing evidence of the weakness of £M3 as a reliable proxy for underlying monetary conditions, without any greater confidence being able to be attached to any of the other monetary aggregates. This clearly strengthens the case for moving over to an exchange rate discipline.

6. Curiously enough - since he is not (yet) on this side of the argument - the case was rather well ^{set} /out by Samuel Brittan in a piece he wrote (not in the FT) shortly before the present Government took office: I attach a copy of the relevant passage.

7. Finally, there are international (as well as domestic) political gains to be secured from joining the EMS. While these must not be exaggerated, they must not be ignored; and it would be helpful to examine how these might best be maximised. This links up with what Ortolini was saying to you the other night, but clearly Schmidt is the key figure in this context.

NL

NIGEL LAWSON

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