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Prime Minister

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

7th March, 1980

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Dear Tim,

EMS

In response to the request in Michael Alexander's letter of 26th February I now attach a paper which the Treasury has prepared in consultation with the FCO, Cabinet Office, Departments of Trade and Industry and Bank of England.

I am copying this letter and enclosure to the Private Secretaries to the Secretaries of State for Foreign Affairs, Trade and Industry, to the Governor of the Bank of England and to Sir Robert Armstrong.

Yours
John

(A.J. WIGGINS)

T.P. Lankester, Esq.,
Private Secretary,
10, Downing Street

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## THE EUROPEAN MONETARY SYSTEM

This paper re-examines in the light of subsequent developments the analysis contained in the paper circulated by the Chancellor on 24 September.

[illegible] of last meeting on EMS.

2. The September paper had 3 main sections. It examined the history of the EMS, the main issues for consideration by Ministers in reaching their view on whether sterling should become part of the exchange rate arrangements, and the questions for decision. The paper was considered at a restricted meeting of Ministers on 17 October. Summing up the discussion the Prime Minister concluded that the time was not yet ripe to join the exchange rate regime. She said that she was particularly concerned about the potential conflict between the Government's monetary targets and the EMS interim 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.

3. This paper considers developments since the autumn under the same main headings as the earlier paper.

### History of the EMS and present UK position

4. The September paper described the current UK position of membership on aspects of the EMS other than the exchange rate arrangements. There has been no change in this. The Dublin Council communiques reaffirmed March 1981 as the latest date for the establishment of the European Monetary Fund
It is not now clear whether the French or the Germans intend to adhere to this objective.

5. The EMS itself has experienced two realignments since the September paper was written though there has been only one major change - the change on 23rd September which

involved a deutschemark revaluation of about 2% and a Danish Kroner devaluation of about 3%. The market pressure leading up to this realignment were reasonably heavy. Total purchases of foreign currency by the German authorities amounted to about $350 million in the 2 weeks prior to the realignment, and total sales of foreign currency by the Belgian and Danish authorities amounted to over $1.6 billion, much of which would have tended to expand the German money supply. The Ministerial meeting to determine the new pattern of exchange rates was a lengthy affair, lasting until the early hours of 24 September. The Belgians sought a 4% devaluation against most other Community currencies but had to be content with a 2% revaluation of the Mark.

6. The second realignment involved a further 5% devaluation of the Danish Kroner on 30 November in the context of a package of economic measures to protect the Danish balance of payments. No other currency changed, and no realignment conference was held.

7. The Danish devaluation was accepted by the other members of the EMS (including ourselves) without the need for a meeting partly because the devaluation was part of an economic package, part ly because there had been a recent general realignment and no other currency was under strain, and partly because the weight of the Kroner in the ECU basket is so small that the agri-monetary consequences of the devaluation were minimal. The last point would certainly not apply to sterling which has a weight of 14%, and it would not necessarily be the case that the other two factors would apply. These seem unlikely to be repeated even for a small country like Denmark.

8. The consequences of EMS exchange rate changes for agricultural prices are becoming increasingly important in realignments. The French in particular have a strong interest in reducing price competition by German farmers, whose positive MCAs are now the

most important example of a "green rate" in the Community. They extracted from the Germans agreement to accept a 1% farm price reduction (but no more) on the occasion of any DM up-valuation in the EMS. This is liable to complicate realignments. The 2% revaluation of the DM which emerged from the difficult realignment of September 1979 produced a 0.9% reduction in German farm prices. If we joined the EMS we would be bound by the rule which applies to the Germans if a sterling revaluation created positive MCA's.

The International Environment

9. The international environment has been particularly unsettled over the last year and for the reasons advanced in the September pape sterling remains more exposed to it than all other EMS currencies except the Mark. Since September we have abolished our remaining exchange controls. This has increased sterling's exposure to downward pressure. The doubling in the price of the oil, the consequential massive increase in OPEC's financial surplus, and the US freeze of Iranian assets have all been major influences in the market, as, perhaps, has also the general worsening of the international political environment following the Soviet invasion of Afghanistan. These factors have been reflected most dramatically in the price of gold, but they have probably also contributed to sterling's attractiveness (as a haven for funds relatively protected by North Sea oil) in relation to EMS currencies and the dollar.

10. The increase in the gold price has not affected the EMS as such, but has led to more ECUs being issued against the gold swapped by EMS members (including ourselves). Weaker countries who have gold in their reserves are enabled to defend their rates for longer. As stronger countries accumulate ECUs they may be forced to revalue faster to reduce inflows.

Future Prospects and the outlook for Sterling

11. The future remains unsettled. Interest rates in other currencies are now rising, and if relative interest rates move against sterling then its attractiveness will be reduced.

The OPEC surplus and the longer-term implications for OPEC investors of the freeze of Iranian assets will continue to affect the market, not necessarily in predictable ways. If an easier oil market were to develop later this year and our relative inflation continued high the foreign exchange market might shift its attention to other factors and tend to give less weight to the benefits for sterling of North Sea oil. A new Middle East crisis could have the reverse effect.

12. International perception of domestic economic policies is another major uncertainty affecting the future prospects for sterling. Confidence is likely to depend primarily on the credibility of the Government's monetary policy. But even assuming that tight monetary control is maintained, the risk of a sharp reassessment of sterling cannot be ruled out. The exchange rate i s currently very high in relation to domestic costs; the market could be unsettled by a combination of continuing high inflation rates, poor competitiveness and current account deficits. For all these reasons we would expect sterling to continue to fluctuate sharply in relation to EMS currencies even if we can be less sure of the direction of movement.

## Relationship to Domestic Economic Policy

13. To the extent that the various factors affecting sterling have been working in the recent past they are reflected in the movements in the exchange rate as shown in the annexed chart. This shows how sterling has fluctuated against the weakest member of the EMS - the Belgian franc - since last September. If we had been in the system sterling might have been more stable because the market accepted our commitment to defend a named rate and judged we could hold it. But if the market became convinced that we could not hold the rate, speculation would be intensified by our commitment to intervene at a particular point, as has often happened in the past. We might have experienced both effects at different times, depending on the circumstances.

What seems virtually certain is that if we had entered in September at the then prevailing rate with a 2¼% margin we would have had to intervene last November to support sterling, and, very heavily indeed, since January to hold the rate down.

14. The Government's overriding commitment to monetary targets will be reaffirmed in the Budget and may be underlined by the simultaneous publication of a statement outlining the Government's medium-term financial strategy. This will emphasise, in general terms, that other policies will be adjusted as necessary to keep the money supply on target. On a more technical plane, any decision that the Government may take on new methods of monetary control could have a bearing on our ability to hold sterling within the EMS.

15. If sterling had to be defended at its lower intervention point, industrial interests would be likely to advocate a step change downwards in its central rate in order to offset some of the loss of competitiveness that has occurred in recent years. The direct effect of purchases of sterling from the foreign exchange market is to reduce £M3 so that intervention to prevent sterling from falling does not create a conflict between exchange rate policy and the monetary targets unless it is sustained on a massive scale to defend a rate that has lost credibility. In that case the monetary consequences would be likely to be destabilising for the reasons explained in paragraph 33 of the September paper.

16. Repeated attempts to defend sterling would progressively impair the Government's ability to discharge the commitment to reduce the outstanding quantity of external official debt substantially during the life of this Parliament.

17. It is highly unlikely that large scale and sustained intervention to prevent sterling rising above its upper intervention point would be compatible with the Government's monetary targets. The monetary position for the next 6-12 months is likely to remain very tight.

If Ministers decided on entry, the announcement of the decision would have to reconcile it with Government's central economic policy. If Ministers decided against immediate entry, one possible approach would be to say that the right time for sterling to join would be when basic economic conditions in the United Kingdom were compatible with those elsewhere in the Community and especially when our inflation rate had been reduced towards the Community average. In the meantime the approach most consistent with the Community objective of economic convergence would be to leave the UK free to give absolute priority to getting our inflation rate down.

Rate of Entry

18. A very important question on entry to the EMS would be the rate at which sterling joined the system. The chosen rate would affect inflows and outflows, and therefore influence the monetary aggregates and the course of interest rates; it would have direct effects on inflation and interest rates; and it would affect MCA's. Discussion of these effects would bring out the point that the Government were assuming much more direct responsibility for the exchange rate.

19. The presumption would be that we would enter at the market rate, which is what the 8 present members did in 1979. If the sterling rate were regarded at the time by our partners as very high relative to underly ing factors like domestic inflation and the balance of payments, it is possible that they might agree to a step devaluation on entry. There is no guarantee that the market would accept the new rate. In any event, it would be a very important step for the Government to announce that it had sought a devaluation, and to accept the monetary/inflationary effects. It could say however that the devaluation improved the immediate competitiveness of industry. On the other hand if entry were at a market rate regarded as high, industry would be unhappy about entrenching such a rate by a policy commitment to defend it in the EMS.

Relations with the Community

20. The absence of sterling from the EMS exchange rate arrangements causes minor technical difficulties both in the operation of the divergence indicator and in the procedures to be followed when a realignment takes place. But ways have been found of overcoming these, and there has been no pressure at a technical level for sterling to join the exchange rate arrangements to eliminate the difficulties. Indeed there has been considerable understanding of our position, and the other Member States and the Commission have recently been very keen to strengthen consultations with the UK authorities to avoid the technical problems posed by sterling's absence from the exchange rate arrangements.

21. At a political level, our absence from the exchange rate arrangements does not appear to have been a factor in the discussions at the Dublin European Council. Recently, however, Chancellor Schmidt has shown considerable interest in the question of UK membership of the exchange rate arrangements, and has linked it indirectly with the negotiations over our contribution to the EEC budget, saying that sterling's membership would improve the atmosphere in the Community and thus help to bring about a settlement. Herr Genscher has said that such a step "would have a great impact". Schmidt's desire to see us full members of the EMS is not new: he advocated it strongly last autumn. What is new is the fact that he has linked it, albeit tenuously, with a satisfactory outcome of our negotiations over the budget.

22. Entry would probably enable us to get some interest rate subsidies like the Italians and Irish. (The Italians now get about £85 million a year). More generally, entry would not ensure us a better deal on the Budget but it would improve the atmosphere in which the Budget issue was discussed.

23. The next European Council will receive a report on the technical problems of establishing a European Monetary Fund (EMF) but there is unlikely to be any substantive discussion. The UK is taking an

active part in these discussions. For electoral reasons, the French and the Germans seem to have agreed to make haste slowly on the EMF. If they try to blame us for the delay, the rest of the Community will know that it is nonsense.

24. Summarising, the main change in the international and domestic economic scene since Ministers last considered the matter in September has been the abolition of exchange controls. This remains a factor, though sterling has so far not suffered from it. The political aspects have developed as in paragraphs 21 and 22.

Possible Courses of Action

25. There is no chance of persuading the rest of the Community to change the formal arrangements of the existing scheme. The main possible courses of action are summarised below. They are arranged in descending order of obligation and degree of conflict with the monetary objectives:

i. join soon with a $2\frac{1}{4}$% margin; this entails a high risk of substantial intervention;

ii. join soon with a 6% margin; experience suggests that we would stand a much better chance of avoiding sustained intervention;

iii. say we wish to join soon, with either a $2\frac{1}{4}$% or 6% margin, but wish first to seek an understanding from our partners that, as sterling is unusually exposed, they would agree to movements in our central rate imposed by that characteristic. Developments in the oil market would be one example but not the only one. Some degree of formality for this understanding would be necessary. We cannot say whether it would be negotiable: or whether it would be criticised as another British attempt to gain special treatment;

iv. say we would "travel alongside" the system for a few months, with a view to joining at the end of the trial period. France did this in the first weeks of 1979 and Chancellor Schmidt suggested it to the Prime Minister in Strasbourg. However, the September paper advised that this option had few advantages except for a short period;

v. say we intend to join within 12-18 months (Genscher formula). We could link the timing with the announced intention (which the French and Germans may or may not intend to honour) to move to a new stage on the European Monetary Fund by March 1981. This is however a hostage to fortune;

vi. repeat, perhaps more formally, the statement that we intend to join when conditions permit, elaborate more on "conditions permit" and invite the Community to join us in studying the problem of combining control of inflation through a strict monetary policy with membership of the exchange rate arrangement;

vii. say that after a very careful review of the situation we cannot yet join the EMS exchange rate arrangements but that we still intend to join when "conditions permit": we are struggling through our monetary policy to converge towards lower Community inflation rates.

26. Ministers may not wish to complicate the problems of monetary management by joining immediately. If so, they will wish to concentrate on the later options in the above list. These are intended either

i. to avoid a clear commitment to join at an early date but to display a more positive attitude than now to the idea of eventual entry; or

ii. to confirm our present policy but to explain it as tactfully as possible.

H M TREASURY
6 March 1980

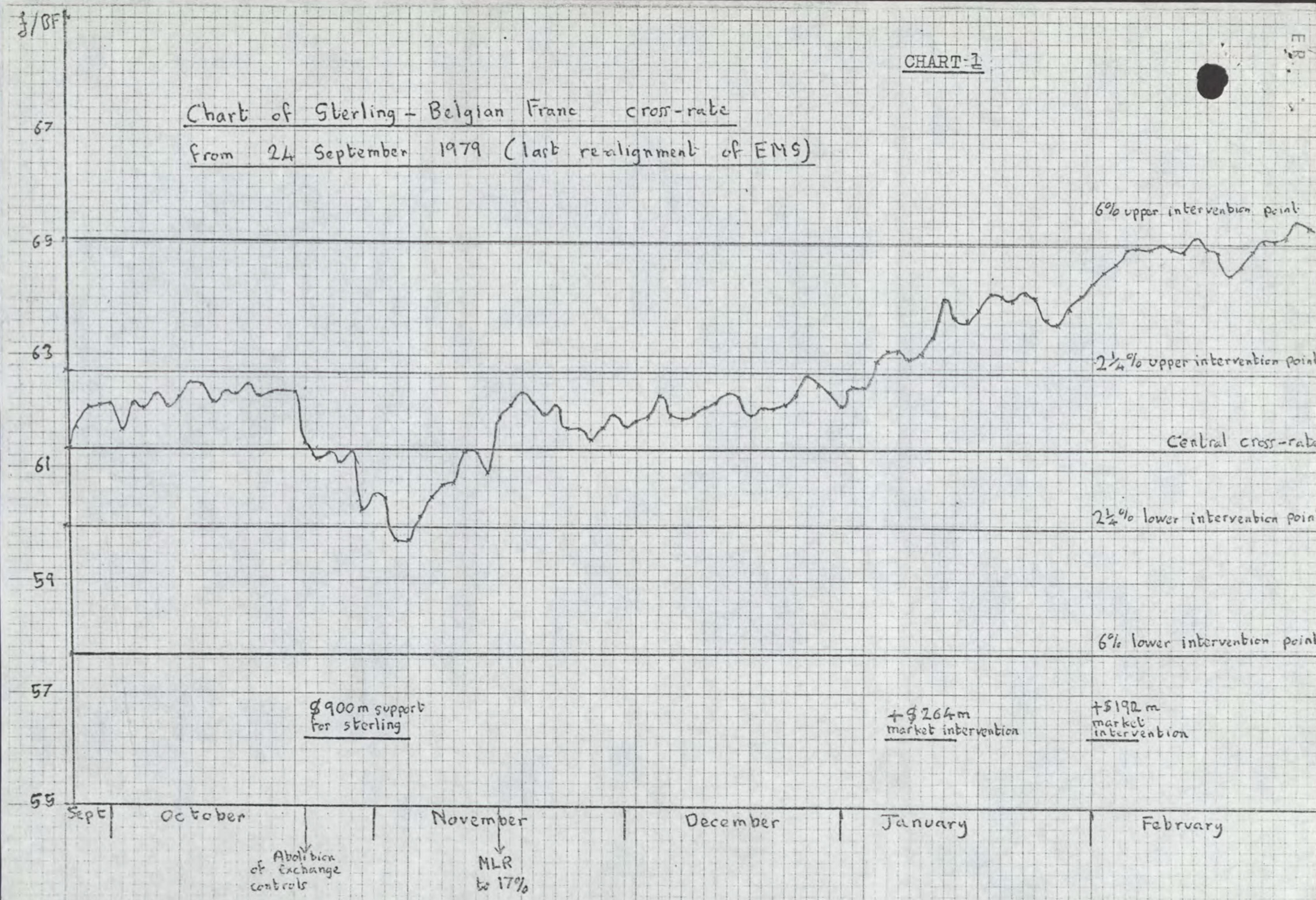

CHART-1
Chart of Sterling - Belgian Franc cross-rate
from 24 September 1979 (last realignment of EMS)
£/BF
67
65
63
61
59
57
55
6% upper intervention point
2¼% upper intervention point
Central cross-rate
2¼% lower intervention point
6% lower intervention point
$900m support for sterling
+$264m market intervention
+$192m market intervention
Sept
October
November
December
January
February
Abolition of exchange controls
MLR to 17%

Sterling ↓

Banks buying sterling

contracts M3