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PRIME MINISTEREuropean Monetary System

Chancellor Schmidt has more than once emphasised to you the importance he attaches to our joining the exchange rate arrangements of the European Monetary System. There is negotiating currency there, if we are able to use it, which could be useful when you see him at the end of the month and in the European Council.

2. The Chancellor of the Exchequer has sent you a Treasury paper on this, which concludes with a list of options, descending from joining soon to saying that we cannot do so yet but still intend to join when conditions permit.

3. In theory a commitment to a fixed exchange rate would not be consistent with a strategy which gives overriding primacy to a target for growth of money stock: the measures required to counteract upward pressures on the rate tend to increase the money supply, and the measures required to counteract downward pressures on the rate tend to diminish the money supply.

4. But there are elasticities in the EMS exchange rate arrangements which would significantly mitigate those rigidities. There is first the margin: $2\frac{1}{4}$ per cent for most of the currencies, 6 per cent for the Italian Lira. And there is secondly the ability by agreement to change the parity.

5. As I read what Chancellor Schmidt said to you last time you met him, he was saying that you do not need to worry that joining the exchange rate system will be a straitjacket on your ability to maintain monetary control, because:-

(a) joining the system will itself make the movements of sterling less volatile (this appears to have happened so far with the French Franc and the Italian Lira);

(b) || the partners will not put difficulties in the way of your changing ||
|| the parity of sterling if and when you need to do so. ||

6. The Treasury's Option iii. is that we should secure a formal understanding that they would be ready to agree without difficulty to changes in our central rate. The objection to that is that it looks like another British demand for special treatment; this would reduce the value of that Option in terms of negotiating currency.



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7. We should substantially minimise the risk of substantial intervention to hold the rate if we went in to the arrangements on the wider, 6 per cent, margin. If we had joined last September, for instance, we might just have stayed within that margin in spite of the strong upward movement of the pound.

8. Predicting movements in the exchange rate is a hazardous business. But it makes sense to try to foresee the most likely trend. There is general agreement that our present exchange rate is really too high for our own competitiveness - though we should not welcome the effects of a substantial depreciation in the rate of inflation. So long as our inflation rate remains higher than that of our competitors, the exchange rate should have a tendency to decline. On the other hand it will tend to be sustained by the high level of interest rates accompanying the monetary strategy, and by the position of sterling as a petro-currency. There will be times when threats to Middle East oil supply will push the sterling rate up; otherwise the balance of forces seems to point to a declining trend.

9. If that view is accepted, and if we were to go into the exchange rate arrangements with a 6 per cent margin, and if we can accept Chancellor Schmidt's implicit assurance that we should in practice be able to change the central rate if we needed to, the conclusion could be that joining the exchange rate arrangements of the EMS need not in practice significantly inhibit the pursuit or effectiveness of the monetary strategy.

10. There are two caveats to that. First, it would be more credible if we joined at a central rate which was generally regarded as more real than our present rate. What that might be is not a matter of mathematical certainty, but I would suggest it would be a rate 5 to 10 per cent below the present rate: say, about 65 to 68 (compared with 72) for the effective Smithsonian rate, and 2.00 to 2.10 \$/£. Secondly, our joining would be more credible at a time when the monetary strategy was seen to be working.

11. On this basis, a position you might take with Chancellor Schmidt and at the European Council on 31st March might be that the Government had taken a definite decision of principle to join the exchange rate arrangements with a 6 per cent margin (at any rate in the first instance), as soon as possible; and



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that we should like to discuss the timing with our partners but should be inclined to suggest that, in their interests as well as ours, it would be sensible to enter the arrangements at a central rate rather lower - say 5 to 10 per cent lower - than our present rate, and therefore at a time when the current spot rate had fallen by that sort of amount; and at a time when there was clear evidence that the monetary strategy was being effective.

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(Robert Armstrong)

17th March 1980