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EUROPEAN COUNCIL, LUXEMBOURG

27/28 APRIL 1980

EUROPEAN MONETARY SYSTEM

Brief by HM Treasury

OBJECTIVE

1. To give no commitment, but to be ready to explain our position in a positive way to avoid prejudicing the budget negotiations.

POINTS TO MAKE

2. A suggested statement to be drawn on is attached at Annex A.

BACKGROUND

3. Chancellor Schmidt raised this issue privately with the Prime Minister. It is uncertain whether it will be raised formally at the European Council. Chancellor Schmidt may get support from the Dutch, Belgians, Danes and Italians (who have all told us recently that a "positive" statement

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on EMS would have a favourable impact) in urging us to make some commitment - though not necessarily to early entry. The Prime Minister should present our position in a positive and "communautaire" light without giving any commitment.

Experience of EMS

4. Began 13 March 1979. Progress reports by Community bodies indicate broad satisfaction with the system by participants.

So far two realignments :-

- i) 23 September 1979. DM revalued 2%; Danish Kroner devalued 3%. Heavy intervention put upward pressure on German money supply ahead of difficult realignment conference.
- ii) 30 November 1979. Danish Kroner devalued by 5% as part of policy package. Agreed without a realignment, but the Kroner has only small weight.

5. The weak currencies in the EMS have proved to be the Danish Kroner and the Belgian Franc. The DM has tended until recently to be a strong currency, reinforced by relatively high German interest rates (which have been a source of friction between the EMS countries).

Sterling

6. If we had joined at the outset in March 1979, we would almost certainly have had to request a very early realignment. Since the first realignment in September 1979 sterling has been through contrasting periods of downward and upward pressure. It is virtually certain that if we had joined in September within the 2 $\frac{1}{4}$ % margins regime we would have had to intervene to keep sterling up in November and again (very heavily) since January to keep it down. We should probably have been forced to ask for a realignment in January. Of course if we had been in the exchange rate mechanism, the fluctuations could have been less sharp, but that would depend on the markets being convinced that we could and would hold sterling at its intervention points, despite the conflict with monetary policy. If they were not convinced, UK experience shows that speculation would be intensified by the very commitment to intervene at set points.

7. If we had joined in September 1979 within the 6% margins regime (currently used only by Italy), the position would have been easier, though we would have been up against our 6% ceiling in February and would probably have had to increase our market intervention to "smooth off" the rise in sterling and keep within our margin. But we would probably not have had to ask for a realignment.

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8. Membership would certainly have influenced our interest rate policy over this period, ^{and} the Government's ability to carry out its monetary policy. For example, in June 1979 it would have been difficult for us to increase interest rates in the way demanded at that time by monetary policy, at a time when sterling would clearly have been very strong within the system.

International Environment

9. Sterling differs from the other European currencies in being subject to risks of large exchange rate movements in both directions. This is borne out by recent experience.

10. The unsettled international political and oil environment has put pressures on sterling different from those on other countries. There is evidence of sterling being used as a haven. Our exchange rate is higher than can readily be explained by the tightness of our monetary policy relative to that of other countries. This might continue : the Government's firm monetary policy, the existence of relatively high nominal interest rates, our possession of both oil and a prime financial market, combine to make the UK exposed to potential upward pressure. Conversely the weakness of the UK economy, industrial performance, inflation rate and a weak current account, combine to make us exposed to potential downward pressure, and an easing in the oil market could reduce sterling's attractiveness. Abolition

of exchange controls (in compliance with our Community obligations) has increased sterling's exposure to downward pressure.

Monetary Policy

11. The Government's overriding commitment to monetary targets was emphasised in the UK Budget on 26 March. Our declared intention is to adjust other policies as necessary to keep the money supply on target. The Government is determined to pursue this strategy. But it will take time to turn round the upward trend of our inflation rate. Membership of the EMS exchange rate regime would be difficult to reconcile with subordination of other policies to monetary policy, because it would require us to adopt an exchange rate objective - and hence an exchange rate policy - as a matter of international obligation.

Circumstances in Which we Could Join

12. Much would depend on whether we decided to join with 2½% or 6% margins (the French might try to resist the latter but would have no legal basis on which to do so before March 1981 if ever). The overriding condition would need to be for the UK to have reached a state where in practice there is a reasonable possibility of successfully reconciling a rigorous and paramount monetary policy with the exchange rate obligations of the EMS. For this to come about, the following are the principal conditions that would probably need to be fulfilled :

- i) The Government's policies would need to have achieved success in reasserting control of our monetary conditions and in reducing our inflation rate to the level of most of our partners.
- ii) The level of sterling at which we joined would need to be a sustainable one, taking due account of our industrial competitiveness.
- iii) We would have to be at a stage where our interest rate policy could be managed so as to permit sterling to remain within its margins.
- iv) The oil market would need to be in a state where it was having no marked effect on sterling in either direction.

We could explain these points to our partners as necessary.

"Join in 18 months"

13. A commitment to a particular date would be a hostage to fortune. Our firm intention is to join when conditions permit. Any definite timetable would necessarily be subject to very heavy caveats which would deprive it of political value.

Community Aspects

14. It is very much in the interests of the Community that we should succeed in reducing inflation. We have to make monetary policy paramount; we are obliged to be single-minded and avoid all conflict with it. Moreover sterling is at a high level and has moved a good deal. We have the impression that while our partners want us to join, many think that this would not be the right moment. We have no desire to create problems for the system. Our position is based on a coherent general policy which is serving the Community's objectives of economic "convergence". There is no question of a "psychological block" on EMS (as Schmidt has argued).

HM Treasury
16 April 1980

STATEMENT ON EMS

The United Kingdom Government fully supports closer monetary co-operation in the Community in the interests of the fight against inflation; and fully supports also the European Monetary System both as a major step forward for monetary co-operation in the Community and as a Community instrument for resisting inflation.

The United Kingdom is participating fully in the discussions on the setting up of the European Monetary Fund and intends to bring sterling into the exchange rate mechanism of the EMS when conditions permit. The Government wish to do this in circumstances and at a time which are best for the Community and for the System, as well as right for our own economy.

We are giving first priority to gaining control of our own monetary conditions, achieving our monetary targets and bringing our rate of inflation nearer to that in most other Community countries. In those conditions we would have more room to reconcile monetary and exchange rate objectives, and the stability of our exchange rate would be reinforced to the advantage of the System. We shall also have to continue to have regard to the differential impact which oil developments can have on sterling and on other Community currencies. All these complex issues are relevant to a decision on joining the exchange rate mechanism and we are very willing to discuss them in the appropriate Community fora.

The March Budget represents an important stage in reasserting control of the United Kingdom money supply, public borrowing and inflation - objectives which the Government believes have the support of their Community partners. The Government look forward to the time when the success of these efforts will enable the United Kingdom to join the exchange rate mechanism of the EMS.