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Prime Minister to see

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PRIME MINISTER

We had a word on 14 September, and again on 16 September about EMS, and I undertook to let you have a note on the current Treasury view. As I mentioned, I have throughout ensured that we keep under regular review the balance of advantage between joining and remaining outside the exchange rate mechanism. This assessment takes account of the most recent developments.

2. The background is that after a year and a half of appreciation of the dollar against the DM, markets are expecting a recovery of the DM: this has indeed begun. They foresee the American current account moving into deficit while the German deficit falls substantially. While Poland still counts against the DM, the decline in dollar oil prices helps the German currency. It looks as if this market view could be broadly right, though political developments (eg in Poland) could upset it. The counter inflationary determination of governments, in the United States and Germany as in the UK, will also continue to influence currencies.

3. Against that background one can consider UK membership of the EMS under two headings. First, would membership keep sterling stronger and the exchange rate more stable? Secondly, could it be both operated and presented as a continuation and extension of our present counter inflation policies?

Sterling: Stronger and more stable?

4. On the first question, you are familiar with the risk that, if we entered the system while sterling was falling, the market

might not accept the entry rate or regard the decision to join as an adequate substitute for policy steps. Under more normal circumstances however we could expect some initial benefit in the market from the determination to defend the rate which entry would imply. That part of British industry which trades with Europe would get an exchange rate which fluctuated within narrower margins and changed from time to time in steps rather than experiencing more continuous change. In the longer term successful defence of the exchange rate, in the EMS as out of it, would depend on policies which convince markets. In the wrong circumstances defence of a fixed exchange rate could increase the strains rather than reduce them.

5. Whether on average sterling would be stronger inside the EMS in the next 2 years would therefore depend on the future of the DM and our ability to keep up with it. Keeping up with it might well mean increasing our effective rate if the dollar fell as the DM rose. But the scale and nature of policy measures we would have to take to secure a generally appreciating currency would be much the same inside the EMS or out of it. Those now in the EMS have had to take policy measures to maintain their parities, eg the French had to increase interest rates to 22 per cent, and introduce new exchange controls, following their elections.

6. You and I have discussed the complication of the petro-currency status of sterling, which remains important. Given the international status of sterling, it pulls our currency in the opposite direction from those of our main Community partners, eg the DM or the French franc. We have declined against the EMS currencies in recent weeks because of the oil factor, just as we rose against them earlier for the same reason. This factor, though not necessarily decisive, could oblige us to accept more frequent realignments in the EMS, and it could also demand more frequent policy action to steady our rate.

7. The conclusion must be that EMS membership could produce a higher average exchange rate if the DM rose and if we took policy steps to keep up with it. Such policy steps might in any case be intrinsically right, whether or not we were members, but they would be domestically unpopular, and this unpopularity might well be enhanced if they carried a Community label. Provided we took them, membership should produce more stability in sterling rates against the currencies of our major European trading partners - though not against the dollar.

Continuation of, or conflict with, current policies?

8. Turning to the second question, I am sure that we could present EMS membership as an extension of present policy, but the continued credibility of that would depend on events. We have said we would join in due course. We have made progress on inflation. We have taken increasing account of the exchange rate in interest rate decisions. The present constellation of exchange rates against sterling is probably not wildly unacceptable to industry and could improve further in coming months (though if we joined and we went up against the dollar with a rapidly improving DM there would no doubt be protests).

9. Accepting and defending an exchange rate link (or any public exchange rate target) is however very different from taking account in one's policies of the exchange rate position, as we do now. There would also have to be clear acceptance within the Government that if steps were needed to prevent the exchange rate falling, policy action would have to be taken promptly, including action on public expenditure as well as on interest rates or taxes. Delay in the EMS means intervention. Rates of $1 billion a day are not unknown. In practice that would tend to mean additions to external indebtedness in reversal of present policies. If entry to the EMS became an easy option in this way it would indeed be a reversal of present counter inflation policy.

10. As we know, there could be conflicts between policies needed to hold the exchange rate and those needed to meet a monetary target. We have already seen this conflict when the exchange rate was high and rising but on monetary grounds we needed to raise interest rates to meet the target. This could happen again. We can balance these conflicting situations outside the EMS; it would be more difficult inside it. The Germans and Swiss have had the same problems - and in extreme situations have sacrificed their monetary targets to their exchange rate targets, in the knowledge that their absolute inflation rates were then low. We have to remember too that the most important exchange rate link for the Germans (and for the international system) is the DM-Dollar rate, which is outside the EMS. Their position as masters of the key currency of the system is different from (and stronger than) the position of other members.

11. It is possible to argue that EMS membership would not make major differences to our overall policy stance because we could always realign our way out of unforeseen developments. To the extent that we could rely on shocks in the oil market as an excuse there could be some truth in that. But clearly we could not in practice go beyond a certain point without making our membership meaningless. And we should not want to do that. If we went in, we would have to accept the rules of the game.

12. Opponents of our monetary policy would obviously seek to interpret joining the EMS as moving away from monetary targets and the MTFS. It would in fact be essential to retain the MTFS; and the taunt that we were not in practice doing so would not stick if our counter inflation policy succeeded, with the exchange rate playing a part. But that comes back again to the question of what policy measures we were prepared to adopt.

Relations with the Community

13. I of course have in mind the possibility that UK entry might bring wider political dividends within the Community. We ought at some stage to examine in detail what they might be.

I myself am inclined to doubt whether it would be realistic to think in terms of any direct quid pro quo e.g. in the Budget context: our partners would reasonably argue, if we decide to go in, that our decision, like our previous decision to stay out, was based entirely on our assessment of our best interest, and that they owed us no favours. On the other hand, UK entry would be generally seen in political terms as a positive step, consistent with the widespread wish to inject a new momentum into the Community's development: it would certainly bring at least the benefit of an improvement in the atmosphere of Community discussion, e.g. on the Budget problem.

Conclusion

14. To sum up, my view is that - as I said to you earlier in the week - the case for joining is now probably stronger than it was last year, not least because of the deceleration of inflation and, more important than that, the much lower level of the exchange rate. But our petro-currency status still differentiates us from our partners. The key point is that EMS membership would not of itself provide an additional buttress to our counter-inflationary policies: the success of which would still depend on policy action. Certainly the case for policy decisions could be reinforced by the wish to avoid a realignment within the grid. But it might become politically harder to take the necessary action in what the public would see as a more European context. There would be new constraints on our decisions, which would sometimes conflict with the monetary constraints we have already accepted, and we would have a more direct responsibility for exchange rate levels and movements. In short, entry would not be a soft option. But neither of us would wish to join it for that reason. On the contrary.

15. For the present, I am not yet convinced that the political benefits of joining, and the likely benefit to UK business from greater stability vis a vis the European currencies, and the possible strengthening of our counter-inflation policy, outweigh

the risks and disadvantages. But the balance has shifted and may shift further. Nigel Lawson is close to taking the opposite view. But Leon Brittan - like Sam - remains against a decision to enter.

16. This is the basis on which we might like to arrange a further talk in a few weeks' time, when we both return from our travels.

17. I am sending a copy of this minute to the Governor of the Bank of England.

(G.H.)
18 September, 1981