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PRIME MINISTER

European Monetary System

In the run up to the Budget Ministers will need to review the case for and against the United Kingdom joining the exchange rate mechanism of the European Monetary System (EMS). This rests at present on a minute which the Chancellor of the Exchequer sent you on 18 September 1981, in which he argued against joining at that time, but thought that the balance of the argument might change in favour of joining later on.

2. When the EMS was first negotiated in 1979, the previous Government elected not to join the exchange rate mechanism, giving as its public reasons the special characteristics of sterling and of the United Kingdom economy. The position of this Government, as stated by you and the Chancellor on a number of occasions, has been that we intended to join when the Government judged that the conditions were right. The issues for discussion are therefore whether the time has now come to go in; if so, under what conditions; and if not, whether and how we can plausibly continue to argue that there will be some time in the future when conditions will be right for full United Kingdom membership of the EMS. In considering these issues, the Government will be primarily concerned to assess where the United Kingdom's economic interests lie, but there are also wider implications for our membership of the Community.

3. A short note summarising the EMS and the objectives is at Annex A. Basically its purpose is to encourage economic convergence and to bring about a zone of monetary stability in Europe. EMS cannot of itself change the underlying economic forces which make for convergence or divergence or impose greater exchange rate stability than those forces will support. Nor can it alone direct the policies of individual member Governments into a convergent path. When exchange rates threaten to diverge beyond the limits provided in the EMS, countries have to be prepared first to try and steady their exchange rates by intervention in the markets, then to take policy measures affecting their own economies, and finally to seek a realignment. The four realignments which have taken place since March 1979,

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together with the 6 per cent band adopted for the Italian lira, reflect the fact that little progress has so far been made towards greater economic convergence: among EMS members inflation rates are both higher and further apart than in 1979. At the same time it could equally be argued that the system has so far withstood the strains of conflicting national policies and pressures reasonably well, and that the four realignments are a measure of the system's ability to respond flexibly to changing circumstances within a disciplined and relatively stable framework. That at least seems to be the view of its existing members. And over a period of time the discipline of having to keep within the EMS could tend to steer Governments in the direction of convergence.

The Economic Case

4. Two main arguments have been advanced for the view that full membership of the EMS would benefit the United Kingdom economy:

- (a) At any time when sterling would otherwise be tending to move down against other European currencies, it would reinforce counter-inflationary policies; sterling would be linked to the Deutschmark (DM), which might be expected to appreciate, and United Kingdom policy would be forced to converge with that of West Germany, a low inflation country with a strong economy.
- (b) The CBI and others believe that full membership might, by giving more stability to sterling in relation to European currencies, assist the 40 per cent of our exports which now go to other EC members: this argument would be valid only so long as sterling was at a competitive rate in relation to other European currencies and above all to the DM.

5. Whether joining the EMS would over time contribute or run counter to the medium term financial strategy (or indeed more generally to a counter-inflation policy) would depend on the way that sterling moved. If sterling was tending to move downwards against European currencies, intervention to hold it in the EMS would make it easier to meet the requirements of the strategy (in terms of £M3); if sterling moved up again strongly against the ECU intervention would make it more difficult to meet these requirements. Intervention to keep the sterling/ECU rate up would require some use of our foreign currency reserves, but (so long as we were dealing with containable movements) less than if we were not in the EMS,

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because other member states would also have to intervene in support. The Government is, of course, already free to take (as it did last year) action to prevent the exchange rate from falling too far. Outside the EMS its judgment whether, when and how to act in that way and what degree of priority to give to the exchange rate objective (however defined) in relation to other policy objectives is unfettered. Inside the EMS it would be constrained by the obligation to keep the rate within the band, but the very fact of being in the EMS would be likely to make it easier, and over time less costly to our own reserves, to defend the rate against anything short of a major speculative attack.

6. It would therefore be important to the judgment of the economic case to take a view on whether the sterling/ECU rate (and more especially the sterling/Deutschemark rate) had currently reached a band below which we should not wish it to fall, and above which we would not expect it to rise; and to take a view on whether the rate was more likely to fall or to rise in future. If we judged that it had reached a level below which we should not wish it to fall, and which we should therefore wish to defend; and if we judged that it was more likely to fall than to rise in the future, there would be an economic case for going in. Indeed, if we were in any case intending to defend a rate - if, in other words, we had an exchange rate objective at least to the extent of being prepared to take action rather than see the rate fall below a certain level, and we had reason to expect such a fall - the defence of the rate could (in conditions that fell short of a major speculative attack) cost us less (in terms of expenditure of our own reserves and in terms of accompanying measures like increasing interest rates) if we were in the EMS than if we were not.

7. If we faced a major speculative attack on sterling but not on other European currencies, we should be less free in the EMS than outside it to respond by allowing the sterling/ECU rate to fall. We should no doubt start by intervening, and we should have the benefit of the EMS support facilities - others would also be intervening in our support. But, if intervention was clearly failing to stem the attack, we should have to seek a realignment. We might need to move fast. In the circumstances our partners could probably be expected to cooperate in moving fast; but it would be for consideration whether we should before joining seek to obtain assurances from our partners of readiness to move fast if the need

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arose.

8. If we were expecting the sterling/ECU rate to rise back to the levels of a year ago, it could be argued that we should do better to stay outside: if our expectations were fulfilled and we were in the EMS, we should have to sell sterling to keep the rate down, to the disadvantage of our monetary and counter-inflation objectives - unless and until we could persuade our partners to agree to a realignment. This might not in practice be too difficult, since the realignment would ex hypothesi improve their competitive position. But there would probably have had to be a period of trying to keep the rate within the band first: an EMS realignment would obviously be "stickier" than a float outside the EMS.

9. It is dangerous to hazard predictions about the movement of exchange rates. But I would incline to the view that for the next year or two the chances of the sterling/ECU rate falling are greater than those of it rising. The main factor which might cause it to rise is the oil market. But OPEC have pegged their prices to the end of 1982, and presumably Saudi Arabia will use its muscle to keep that peg in. Thanks to the reduction in demand for oil, as a result of recession, energy conservation and diversification away from oil, the oil market has been slack, and is expected to remain so. Unless therefore there is some political disaster in the Middle East affecting oil supplies, this factor is not likely to be pushing sterling up during the next year. The main factor tending to push it down is likely to be our relative inflation rate as compared with the Federal Republic of Germany; this is of course much less bad than it has been, but the assumption must be that it is likely to continue to be unfavourable for the next two years.

10. So much for the factors one can foresee. If that analysis is accepted, it could be argued that the conjuncture is at present more favourable than it has seemed in the past to the case for our joining the EMS. I would only add that, if during the next two years we were to run into a major crisis of confidence in sterling - and that possibility cannot be entirely excluded in the run-up to a General Election - we might well find it easier to see it through from inside the EMS than from outside.

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11. So far as the "stability" argument at paragraph 4(b) is concerned, any assessment needs to take account of the following:

- (i) Four realignments have already occurred, and more must be expected - especially if sterling is inside the EMS. The EMS might therefore provide only relatively short-term stability for the sterling exchange rate against other EMS currencies. But the trading sector of the United Kingdom economy would still prefer that to total floating, and it should become increasingly welcome as the proportion of our exports to other Community countries rises.
- (ii) The exporter can secure short-term stability by obtaining cover against exchange risks from the forward exchange markets, at a cost, for periods of less than a year. But this safeguard is in practice open only to the largest companies: many small firms and businesses have neither the expertise nor the resources to venture into this field on their own account.
- (iii) Although the United Kingdom economy has become much more orientated towards Europe over the past decade, and although the United Kingdom inflation rate is not now so far out of line with that of other EC members as it was in 1979, sterling still has some different characteristics from those of EMS currencies. For example, Community currencies together account for only 38 per cent of our effective rate compared with 47 per cent of the DM effective rate, 51 per cent of the French franc effective rate and 64 per cent of the Belgian franc effective rate. Sterling is still much more an international currency than any other EC currency apart from the DM. Moreover it is likely to be affected in a contrary direction to the DM by movements in the oil market.
- (iv) Any greater stability of the exchange rate could be - but would not necessarily be - at the price of less stable interest rates.

The Political Case

12. I agree with the Chancellor's analysis, in paragraph 13 of his minute of 18 September 1981, that joining the EMS would improve the climate for the current negotiations on the budget and the CAP, but that we could not use it as a bargaining counter. If it were linked with other issues, the danger of EMS adding to the unpopularity of the Community would only be reinforced.

13. The political case is, it seems to me, a much broader one, and concerned with our relations with other members of the Community. We are members of the European

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Community, and we intend to remain so. The EMS is a significant element in the Community: as one of the big members, we should be fully inside it rather than outside one element of it. We have said that we will join the exchange rate mechanism when conditions are right. Unless that is a hollow commitment and our real intention is not to join at all, we have to ask ourselves - as others may ask us - if not now, when else? A further postponement would probably not be politically damaging to our position in the Community, if we could credibly demonstrate that our intention to join was serious and that we foresaw conditions for joining more propitious than those of today. But if it were to become apparent that the United Kingdom had no serious intention of joining, this could have profound consequences for our relations with at least some of our partners in the Community, especially (but not only) when the Community comes to consider further developments in the EMS.

14. The political case against joining is largely a domestic one, that joining the exchange rate mechanism of the EMS might add to the risk of our economic difficulties being attributed by British public opinion to membership of the Community. In these terms perhaps the best time for joining the exchange rate mechanism would not (other things being equal) be now, when we still have the mandate negotiations to complete, but when those negotiations are successfully completed and a satisfactory longer-term solution to the problem of our financial contribution has been agreed. But perhaps British public opinion is unlikely to see joining the exchange rate mechanism as having much bearing on our economic problems one way or the other; and in that case the political benefits to our relations with Community partners (cf. paras. 12 and 13) would weigh more heavily.

15. Paragraph 8 of the Chancellor's minute of 18 September 1981 gives the reasons which could be advanced, consistently with the position the Government has taken up, for joining now. Our inflation rate is now closer to the Community average. Oil prices are not having an abnormal effect on sterling. Our present rate against the ECU is not an unreasonable one in terms of our competitiveness.

Technical Considerations

16. If on balance Ministers considered that we should now join, there would be the option of taking the wider 6 per cent band like the Italians. It would be preferable not to have to suggest that we shared the Italian reason for having a wider band.

  
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Nonetheless it would give us greater freedom within the EMS, and could be justified on the grounds of the differences in characteristics between sterling and the other European currencies (see paragraph 10(iii) above).

Handling

17. If this question is to be reviewed again before the Budget, you may like to invite the Chancellor of the Exchequer to produce a new paper, or a supplement to his minute of 18 September 1981, taking account of developments since his minute was written. Other Ministers who will have views include the Foreign and Commonwealth Secretary, the Secretaries of State for Defence, Industry, Trade and Energy, and the Minister of Agriculture. The subject could be discussed either at a meeting of the Cabinet - perhaps the pre-budget economic discussions which the Chancellor has proposed for the end of January - or at a meeting of the Ministerial Committee on Economic Strategy, or at an ad hoc meeting under your chairmanship.

18. At the meeting you might direct discussion towards these questions:

- (i) Given the best assessment one can make about future trends of sterling, are the possible consequences of joining the exchange rate mechanism of the EMS for the Government's economic and financial strategy acceptable?
- (ii) Are the economic and political conditions as favourable as they are likely to be for joining?
- (iii) If so, how should the domestic political reaction be handled?
- (iv) What benefits, if any, could we expect to secure within the Community from joining? Would there be any assurances or technical changes we would need to seek?
- (v) If the judgment is that it would be unwise to decide in favour of full membership now, how should our position be presented in public to avoid casting doubt on the Government's commitment to assume full EMS membership in due course?

*RTA*

ROBERT ARMSTRONG

5 January 1982

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