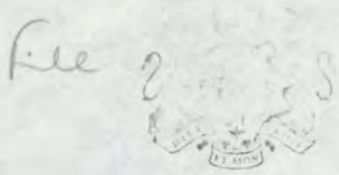


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10 DOWNING STREET

From the Private Secretary

26 January 1982

AD  
DC Peretz  
(Treasury)

✓. transfer act.

THE EUROPEAN MONETARY SYSTEM

The Prime Minister held a discussion about British membership of the European Monetary System (EMS) on Friday 22 January with the Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, the Governor of the Bank of England, Sir Robert Armstrong, Sir Douglas Wass, Sir Kenneth Couzens, Mr. Burns, Mr. Middleton, Mr. George and Mr. Walters.

The Chancellor said that our stance had been that we were prepared to join the EMS when the conditions were right. Our reasons for not joining, however, were often such as not to be affected by changing events. The petro-currency status of sterling, which militated against full UK membership, would be with us for a long time; on the other hand, the pressures on the exchange rate vis-a-vis the other European currencies which arose from this source were variable and this did not seem in itself to be a decisive consideration. It was always possible to argue that the re-alignment mechanism in the EMS could deal with this factor. The most powerful argument, in his view, against joining was the potential conflict with monetary policy. This too was a permanent feature of the scene, and it might be argued that it had not seemed a decisive consideration to the Germans against membership of the EMS. He saw attraction in the possibility of anchoring counter-inflation policy to an exchange rate target within the EMS. Public opinion might respond more easily to an external exchange rate target than to a set of complex and often conflicting signals from the monetary variables. He saw dangers, however, in putting too much faith in a disciplinary mechanism which bore a European label: it would probably have precisely the wrong impact on anti-EEC opinion, whose opposition to necessary corrective measures would gain public support from the accusation that the measures were imposed upon us by our EEC partners. Industrialists were not attracted to our joining at the sterling/DM parity now prevailing. He himself was clear that, for this reason alone, we were not in a position to join now, even if, on general grounds, we thought it right in principle to do so.

The Governor said that he was in principle in favour of our joining. He believed that it would be necessary to give much attention to the exchange rate in the coming years. Although

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forecasts of the exchange rate were particularly hazardous, he believed, on balance, that sterling might be rather vulnerable over the next few years. A world recovery and further upward pressure on the oil price would strengthen sterling, but, against this, our own economic recovery might well put pressure on the current account balance of payments, and there might be sizeable outflows as the election drew nearer. Although the present sterling/DM parity was too high, he would not otherwise like to see in present circumstances either a significant depreciation or appreciation from the present broad position of sterling. The evolution of monetary policy pointed towards a clearer policy on the exchange rate. Membership of the EMS would provide a framework within which to pursue such a policy. The EMS provided a web of rights and obligations in which we would have the help of others to hold our exchange rate where we wanted it. It would be very difficult to operate an explicit exchange-rate policy, with a published band, outside the EMS and, so to speak, in mid-Atlantic, in view of our position in the EEC and all that we had said about our possible EMS membership.

The Foreign and Commonwealth Secretary said that there was a good case for our joining the EMS at some stage, and he hoped that we would not rule it out now; we should keep the matter under review. He did not, however, believe that a decision now to join the EMS would have a particularly favourable impact on the attitude of our European partners in regard, for example, to our objectives in respect of the Budget.

In discussion it was argued that there were powerful reasons against joining. A sudden change in the fortunes of sterling or of one of the other currencies in the system would lead to heavy outflows from, or inflows into, the reserves over which the Government would have little control; on some occasions these flows would take place purely to assist other currencies which were in difficulty. There would be a loss of freedom of manoeuvre. Membership of the EMS had not helped Belgium or Italy to manage their economies successfully: it had not prevented the Belgians from running a huge deficit, with very high interest rates, nor the Italians from a continuing and high level of inflation. Sound economic management depended upon sound domestic fiscal and monetary policies; EMS membership offered no escape from these imperatives. It had been hoped that the EMS would lead to a convergence between the economies of its members. In fact, as the Bundesbank October Bulletin said, there had been a divergence. The discussions of realignments were highly politicised and could import into discussion of exchange rates wholly irrelevant and distracting bargaining factors which were at issue in other fora between the member countries.

Against this, it was argued that membership of EMS would provide a more predictable and stable world in the short run for our traders. A large and constantly increasing proportion of our trade was with other EMS members and it would undoubtedly be helpful for business if there were a more stable relationship between all the currencies concerned. The record of the EMS in this respect had been one of reasonable success. Membership of the system would not involve us in an unlimited obligation to use our

/ reserves.



reserves. It was arguable that the less successful economies within the EMS would have been in even greater difficulty outside the system.

The Prime Minister said that she was not convinced that there would be solid advantage in joining the EMS. She did not believe that in practice it would provide an effective discipline on our economic management. She was worried by the extent to which it removed our freedom of manoeuvre. She accepted, however, that when our inflation and interest rates were much closer to those of the Germans the case for joining what was essentially a DM-dominated system would be more powerful. We should, therefore, for the time being maintain our existing position on the issue.

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office), Tim Allen (Governor of the Bank of England's Office) and David Wright (Cabinet Office).

M. C. SCHOLAR

John Kerr, Esq.,  
H.M. Treasury.