Sir P Middleton
Sir T Burns
Mr Littler (OR)
Mr Cassell
Mr Sedgwick Mr Ilett
Mr Lankester Mr Monck
Mr Fitchew Mr Unwin
Mr Kelly Mr Battishill
Mr Hannah Mr Culpin
Mr Lavelle Mr Hall
Mr Ridley

Treasury Chambers, Parliament Street, SWIP 3AG
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The Rt Hon Dr David Owen MP
House of Commons
London SW1A 0AA

31 October 1984

MWG 31/10.

Dear David

You wrote to me on 19 October about sterling and the EMS; and on 23 October about Johnson Mathey Bankers. Perhaps I could reply to both letters at the same time.

Sterling and the EMS

You suggest that sterling has in recent months moved into a closer relationship with the major European currencies; that market confidence in sterling would be further enhanced by our joining the mechanism; and that membership would provide a sensible alternative to raising interest rates.

On your first proposition, I wonder if you are not attributing your own views to the market. The predominant factor in the exchange market over the period has surely been the strong dollar: only in this sense would it seem reasonable to speak of sterling having a closer relationship with other non-dollar currencies. In intermittent periods of dollar weakness the ERM has in fact come under strain.

More recently, the oil market has been another significant factor in the exchanges: and in times of oil market uncertainty, the performance of sterling and the deutschemark has also tended to diverge. It may be that divergence which you recognise in the third paragraph of your letter: but since the rate you quoted there, rather unexpectedly, was the dollar/deutschemark rate of the day, it is difficult to be sure.

Membership of the mechanism would not, in any event, abolish these influences or the differences in the effects of such uncertainties on European currencies.

Turning to your other comments, you began by attributing - to me this time - a statement in the Mansion House speech about the interpretation of domestic monetary conditions which I did not make: and on that basis went on to question the logic of my position.

When I spoke in this context of the markets' misplaced preoccupation in July with the sterling/dollar rate I did not say that the markets should instead take notice of the sterling trade weighted index. On the contrary, the point I was making was that the market had shown a misconceived preoccupation with the exchange rate as such. This took the form in July, when there was a surge in the dollar, of a misplaced preoccupation with the sterling/dollar exchange rate. I went on to explain that we take the exchange rate into account when its behaviour suggests that the domestic monetary indicators are giving a false reading, which I did not believe they were. And I added that the markets seem now to be taking a more balanced view of financial developments and the central role of monetary aggregates in judging monetary conditions and determining interest rates.

At the end of your letter, this time after attributing sentiments to the Bank of England which they do not recognise, you spoke of joining the ERM as an alternative to raising interest rates.

Leaving aside the fact that during the recent autumnal turbulence interest rates have not, in fact, risen, it is misleading to suppose that membership of the ERM as such would have removed any such requirement. In fact the position is rather the reverse. You quoted an average sterling/deutschemark rate in recent months of DM3.80. The fall in that rate to DM3.6696 on 19 October would have taken sterling well outside the 2¼% band. Resisting this might well have required us to consider raising interest rates.

More generally, the Government have never regarded the ERM as some kind of easier option. What we have said, and what I said in the Mansion House speech, is that provided monetary conditions are kept under firm control, excessive movements whether in the money or exchange markets in response to outside influences will tend to correct themselves relatively quickly.

<u>Johnson Mathey Bankers</u>

Unlike the EMS, the rescue of Johnson Mathey Bankers (JMB) is primarily a matter for the Bank of England. The Bank has substantial, and traditional, freedom to take its own decisions about the use of its own resources. As I have already made clear to Parliament, the Governor neither required nor sought my approval for the operations he undertook, including the Bank's acquisition of JMB and the Bank's commitment on a contingent basis to the indemnity being arranged.

Turning to the specific questions you ask, you will by now, of course, have seen the speech given by the Deputy Governor at the Manchester Chamber of Commerce on the day on which you wrote (23 October).

On your first point, the Bank's view is that you are wrong to attribute JMB's difficulties to insufficient business in the bullion market. JMB's difficulties arose entirely with its commercial lending business - smaller than, and separate from, its main activity as a bullion trading bank. Whether and how to realise assets and run down the commercial lending side of the business is a matter which those now in charge of the operation are considering: the quickest solution may not necessarily be the best. But the Bank's judgment is that the prospects for the future viability of JMB's bullion activities is a good deal better than you suggest; and therefore that the dangers to the Bank from its exposure to JMB are much less than you imply.

The Bank saw the main purpose of the rescue operation as being to prevent damage that might otherwise have occurred to members of the London Gold Market. The rescue package had to be in place before the markets opened on 1 October. The reason why the Bank acquired JMB was, essentially, that no other solution was possible in the time available; but as you know, the private sector is making a very substantial contribution through the indemnity which the Bank is in the process of negotiating.

On your final question, I am advised that Johnson Mathey PLC did not give any form of guarantee to its former subsidiary and was not, in strictly legal terms, under any obligation to make good JMB's liabilities.

For my part, I have little doubt that there will be important lessons to be drawn from the JMB failure, and the Bank is reviewing the events surrounding the failure with this very much in mind.

Yours
Nigel

NIGEL LAWSON