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From the Private Secretary

4 February 1985

EUROPEAN MONETARY SYSTEM

The Chancellor of the Exchequer discussed EMS with the Prime Minister last night. He said there was growing interest, in Parliament and elsewhere, in the possibility of joining the exchange rate mechanism of EMS. The Government had said that it was ready to join EMS when conditions were right and it would be appropriate, before the Budget, to consider whether this was now the case.

The Chancellor of the Exchequer said that controlling inflation required acceptance of a financial discipline which could be provided either by monetary targets or by a fixed exchange rate. It was essentially a secondary matter which was chosen. The arguments against EMS were familiar, but new arguments were now being put forward in favour of EMS. First, it was proving difficult to get financial markets to understand what the Government's policy on the exchange rate really was - EMS would provide much clearer "rules of the game". There was substantial support in the Conservative Party in favour of EMS and, in arguments about additional spending and borrowing, it would be helpful to be faced with a discipline of their choosing. EMS would move the focus of attention away from the dollar exchange rate. £M3 was becoming increasingly suspect as a monetary indicator as its control depended increasingly on over-funding, with the resulting rise in the bill mountain.

The Chancellor suggested that the Prime Minister should hold a seminar with the Treasury, Bank, Foreign Office and Sir Alan Walters. I hope to be able to arrange this before the Prime Minister leaves for the US. I will be in touch shortly about a date. Meanwhile I have said nothing to the Bank or Foreign Office. We will also need to discuss the papers required for this meeting, which should cover how the EMS works, the implications for the UK of joining the exchange rate mechanism, and the timetable for decisions.

BP

Andrew Turnbull

Mrs. Rachel Lomax,
H.M. Treasury.