SECRET

6

PRIME MINISTER

JOINING THE ERM

In addition to their four papers (and the note by

NO.5 Sir Alan Walters), the Treasury have produced an annotated agenda. Perhaps the best way to conduct the meeting is to invite the Chancellor to make the opening statement. You could then ask the Governor and the Foreign Secretary if they have anything to add. You could then work through the annotated agenda in the order set out. At the conclusion of the meeting you will want to identify any further work, including any consultations with other Governments if a decision were taken to proceed.

AT

12 February 1985

SECRET

PRIME MINISTER

For Wednesday's seminar, the Treasury have provided an annotated agenda and papers on

i) the implications for sterling and the economy of EMS

ii) the procedural aspects of joining

iii) the mechanics of EMS

iv) the history and development of EMS

Also enclosed is the relevant chapter from Alan Walter's book, which has been circulated to those attending the meeting.

FCO may provide a paper but what is needed from them is not waffle about how pleased the Europeans would be (the decision should be taken on its economic merits), but what we can screw out of them in return.

AT

NB Papers i – iv are in folder at back of this file (+ other seminar papers

Andrew Turnbull
8 February 1985

LO D&2 ACS.
bc John Redwood
2

cc MASTER SET

10 DOWNING STREET

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.

PAPER 1

cc DW.

STERLING AND THE EMS EXCHANGE RATE MECHANISM

This paper recalls the balance of argument on the question of UK entry to the EMS at the time of the Prime Minister's discussion in January 1982. It then considers how the balance of arguments looks now.

Past UK attitude

2. The stance that the UK is prepared to join the EMS when conditions are right has encompassed a wide range of considerations.

3. In the 1982 discussions, the "European" objectives of creation of a zone of monetary stability, and the reduction of exchange rate variations between members were given modest weight. There was some scepticism about the ability of the mechanism to deliver radical effects of this sort given the provision for realignments: or how important they were, given the possibility of hedging short term movements.

4. The general case for greater convergence of European economic policies was given more weight. It seemed likely that membership had achieved one of the original objectives of the founders ie keeping France on the rails.

5. The main potential attraction of UK membership was seen as an anchor to counter-inflation policy. It was suggested that public opinion might respond more easily to an external exchange rate target than to the performance of monetary aggregates.

6. Against this it was recognised that sterling differed from most other EMS currencies. First, it was an international currency and there could be problems about adding a second internationally-traded currency to the mechanism. Second there was the market perception of a petro-currency factor, leading

to differential movements of sterling against EMS currencies at times of oil price developments.

7. However the decisive consideration in the 1982 discussion was a judgement that there was not convincing evidence that entry would provide solid advantages. It was not clear that membership had been an effective discipline for the existing members of the ERM or that it would provide a more effective discipline for the UK than present policy based on the MTFS. Membership would also remove UK freedom of manoeuvre.

8. Some dangers were seen in putting faith in a disciplinary mechanism with a European label.

9. A paper put at that time to the Treasury Committee noted that there were potential conflicts between domestic monetary policy and exchange rate policy although they had not been acute for existing participants. Experience also suggested that in some circumstances membership could add to speculative strains. Expenditure in 1972 of over £1 billion of foreign currencies during membership of the "snake" was recalled.

10. The conclusion in 1982 was that when UK inflation and interest rates were closer to those of the Germans the case for joining a DM-dominated system would be more powerful.

Recent developments

11. In re-examining the question of entry now, some of the past inhibitions to membership have lessened. Although there is at present a substantial differential - over 6% - between UK and German interest rates inflation levels in the UK and Germany have come a little closer together (a gap of 2.5%) and the sterling/deutschemark rate has eased. There is less likelihood now of a conflict, such as there would have been in 1980 between monetary and exchange rate policies. Over this period, however, there has also been a significant rundown in our reserve position with the currency reserves falling from over $16 billion at the beginning of 1981 to less than $6 billion now.

12. There is some modest additional experience of the operation of the mechanism itself. Other relevant factors are the state of the oil market and the continued saga of the dollar. These are considered below. However it is suggested that the central question is probably again that considered in 1982: whether membership would help to achieve the ultimate aims of macro-economic policy. More specifically it seems worth considering the lessons from the exchange rate/interest rate problems last July and in recent weeks.

<u>Operation of the ERM since March 1983</u>

13. Since the realignment of March 1983, caused primarily by the weakness of the French franc and accompanied by strong measures to tighten fiscal and monetary policies, there have been no further realignments. For most of the remainder of 1983 the dollar strengthened and other ERM currencies were able to keep pace with the weakening German currency.

14. The see-saw movement of the deutschemark/dollar rate in 1984 from DM 2.5 to DM 3.2 took its course for the most part without unmanageable difficulties for the mechanism. This partly reflected greater convergence as French and Italian inflation rates fell. The different cyclical positions of France and Germany also helped. The German economy has been recovering at a time when the French were taking steps to reduce their current account deficit.

15. The major exception to this relative calm came in February 1984 at a time of dollar weakness. The strong rise of the deutschemark required the French, Italians and Belgians to spend over $1 billion each defending their currencies during the month. There have not been subsequent periods of dollar weakness. It is possible that further strains between the existing ERM currencies could become greater in the period ahead, eg in the run-up to the 1986 French Parliamentary elections.

The oil and dollar factors

16. In relation to the deutschemark, sterling has had a much bumpier ride from DM3.6 in March 1983 to over DM4.0 in August 1983. In 1984 there was also a wider swing than shown by other ERM currencies, from DM3.96 to under DM3.70. In 1985 sterling has eased further to a low of DM3.50¼. These swings are evidently in excess of a 2¼ per cent margin and have typically been associated with periods of oil price uncertainty. The strength of the dollar has, for the time being, masked the probable differential impact its substantial weakening would have on ERM currencies.

17. In terms of the deutschemark/sterling relationship there are three, additive, potential tests for sterling. The first is some weakening in the real price of oil over the next year or two. Secondly, while the latest US Budget proposals do not give promise of an early weakening of dollar interest rates or the level of the dollar, the underlying position remains unsustainable. When an easement occurs the deutschemark might appreciate substantially more than sterling. Thirdly the difference between the current deutschemark and sterling inflation rates (and in the underlying rates of growth of monetary aggregates) suggests that over time this will also lead to a need for some readjustment either through realignment or tighter policies.

Membership of the ERM and the aims of macro-economic policy

18. The main question about membership remains: would it help us to consolidate the reduction in inflation and set the conditions for a further fall. This objective has hitherto been judged more logically linked with targets for monetary growth than with membership of a regional exchange rate system. Linked with this main question, though separate from it, is the question whether membership of the ERM would make it easier or more difficult for us to cope with the day-to-day management of monetary policy (including the exchange rate itself), given the degree of prospective turbulence from external factors described in paragraph 17 above.

19. The ERM does not automatically operate as a tight discipline. It has shown itself to be more flexible than appeared likely at the time it was launched. At least in the period to March 1983 it has operated not as a fixed exchange rate system, but as a mechanism for short run stability combined with periodic sharp realignments.

20. Existing policies are working broadly as intended. Monetary growth is tolerably under control with £M3 at the top of its range and M0 in the middle. The inflation record has been transformed. The continuing prospect is fair especially following the recent tightening of domestic policy. Since 1981 output has been growing at an underlying rate of 3 per cent a year.

21. The conditions in which membership might help in achieving our counter-inflation aims are if we found operating our current monetary policy too difficult or too ineffective (or if it were perceived as such) and we needed to look elsewhere for a disciplinary mechanism that could be easily explained. In these circumstances, membership of the ERM would substitute an exchange rate target as the primary objective of policy for a monetary one. We would have to target ourselves on and follow German monetary policy and inflation performance much more closely. UK entry seems unlikely to make any major difference to the conduct of German monetary policy except in the situation where, against expectation, sterling appreciated relative to the deutschemark. At periods of significant dollar weakness in the past, the deutschemark has been subject to very substantial speculative inward flows. In that situation the Germans have shown themselves ready to either abandon or modify monetary policies. However that also does not seem an immediate prospect.

22. It perhaps has to be asked if the need to live with German fiscal and monetary policy would necessarily be a helpful rallying cry to expenditure control and fiscal discipline. In any event it would impose a new constraint on the operation of domestic policy. This has not been the case for Germany because the present system is deutschemark-driven. For the UK it could not be certain that a fixed exchange rate against the ERM

currencies would be consistent with achievement of the Government's political or economic aims. In particular for a switch of target to carry any conviction we would have to converge on German performance. At least in the first year or so the UK would have to eschew realignments to establish the credibility of its membership of the ERM (except possibly in the event of a sharp fluctuation unambiguously linked to an oil price change). Given German fiscal and monetary policy this would impose tighter policies on the UK. At the moment the presumption would be that this tightening would come about through higher interest rates. As noted in para 11 above, however, there is already a substantial differential between UK and German interest rates.

The ERM and interest rates

23. Would sterling membership of the ERM have helped in coping with exchange rate/interest rate problems in July or recent weeks? We considered this question in relation to the July interest rate increases, when there was a sharp movement against the DM, at the time. The conclusion reached was that it was difficult to make a convincing case that the increase in interest rates would have been any less if we had been in the mechanism: and it could have been more. If we had established a credible position for some time where sterling had been stable against the deutschemark combined with the presumption of infrequent exchange rate realignments, membership might have been helpful provided that we were able and prepared to intervene heavily. But these are strong assumptions. Nor would membership have enabled us to delay action. It is possible that we might have had to act on interest rates a little more quickly.

24. In October market behaviour was rather different. The DM/£ rate fell 3¾% from DM3.81 on 12 October to DM3.67 on 19 October, but interbank rates moved relatively little - from 10 7/16% to 10¾%. On that occasion membership of the ERM would almost certainly have required an interest rate increase which seemed unjustified by monetary conditions, and did not take place.

25. As regards recent events, there is room for argument about the mix of influences on the rate. But whatever the proportionate influence of dollar strength, oil price uncertainty, underlying doubts about the Government's commitment to firm monetary policies or the temporarily bearish influence of the miners' strike, there is no reason to suppose that membership of the ERM would have offered any protection. Those who have so argued have produced no evidence to support the suggestion that membership makes a country speculation-proof. The Owen/Steel approach seemed largely built on a misconception about access to others' reserves in the operation of the mechanism.

26. The recent experience has revived the line of thought that if it is impossible to persuade the markets of our approach to the exchange rate, we might as well give up and have an explicit exchange rate policy. It is true that we cannot give a precise or quantitative description of the implications of "taking account of the exchange rate" in interest rate decisions. It may not always be apparent which exchange rate we are most interested in and the nature of our concern. In the event some commentators have come to the view that there is a commitment to defend the sterling/dollar exchange rate. The need to demonstrate concern for the exchange rate, while not having a view about precise levels, is a further complication. This has become more acute with the record lows reached by sterling over this period. However the visibility of the exchange rate does not increase its merit as a target if the external influences upon it are volatile or even perverse: and clearly not under the Government's control.

<u>**Realignments and the reserves**</u>

27. The ERM combines the tendency of all fixed rate systems to set up "one-way bets" when a realignment is considered inevitable with a rather dilatory procedure for agreeing the realignments. In the past those ERM members that have requested weekend realignment meetings have often been expected to sweat it out for a while and in any case domestic events in ERM countries sometimes rule out particular weekends. In this context to delay a meeting from one weekend to the following one could

give rise to substantial problems of monetary management and involve sharper fluctuations in interest rates and reserves than under the present system. If the intention is to realign from time to time the markets will be constantly on the lookout for signs of impending changes and will tend to doubt the authorities' determination or ability to resist them. Speculative flows between two reserve currencies with no exchange controls, like the DM and £, are likely to be especially strong.

28. The likelihood is therefore that if the UK joined the ERM it would have to be prepared to deal in the early years at least with significant exchange rate crises. These would occur either if the intention was to defend the initial parities for a considerable time or if the intention were to adjust by realigning quite often. The UK is probably less well equipped to deal with such short-run problems than other ERM currencies such as the French and Italians partly because of the absence of exchange controls and also because of the low level of our reserves. In principle these problems could be eased if the procedures for changing parities could be made faster and simpler. But we could not be confident of being able to negotiate that. And if realignments were frequent the discipline would be reduced and problems of market management increased.

29. In the past overseas borrowing has been undertaken through the nationalised industries. There are now less of them and those that remain are more profitable and so have no need to borrow. Any substantial accretion to our reserve levels, other than intervention purchases which would tend to depress sterling, would therefore require borrowing in the Government's own name. Such action would tend to reinforce the impression that entry was a course of policy forced on us against our will. The worst outcome of all would be inability to maintain a chosen parity and repetition of the 1972 experience. At that stage it would be difficult to reassert the primacy of monetary aggregates.

Political arguments

30. Though other member states will welcome our membership of the ERM with varying degrees of enthusiasm, there is no reason

to suppose that our joining the ERM would make it any easier to achieve our other objectives in Europe, eg a budgetary control and the internal market. Nor is it likely to add to the popularity of Community membership.

31. It is sometimes suggested that the stronger Community currency bloc which would result from sterling membership might help to make it possible to develop a more coordinated response to US policy. This is certainly a desirable objective. But it is far from clear that membership is either a necessary or sufficient condition to achieve it.

The central issue

32. A check list of the arguments for and against membership of the ERM is annexed.

33. The fundamental issue is whether entry would provide the Government with an opportunity to restate its economic policy and give a new impetus to counter-inflation policy. Inflation is for the moment lodged at 5 per cent and there are pressures on the horizon which could put this at risk. Linked with this would be a possible gain in presentation associated with a more general understanding for the exchange rate.

34. The argument against this conclusion is the possibility that by joining we replaced uncertainty about the exchange rate for uncertainty about monetary policy. While the ERM remained as flexible as it has been so far there would be no necessary increase in discipline. Homing on German performance would, however, set a fierce pace. The expectation must be that over coming months and in particular over the period of prospective realignment of the dollar the rest of the Community would undergo repeated realignments. Would membership make difficult decisions any easier to take? Would the markets see it as an attempt to relax policy whatever was said?

35. Joining the ERM would not alter the centrepiece of the Government's strategy namely the determination to reduce inflation further. Retention of domestic monetary targets for the medium

term would give reassurance about the continuity of policy. But it would need to be accepted that such targets did not have primacy in the short term in relation to maintenance of ERM parities. There might need to be some reassessment of the chosen targets with perhaps a downgrading of £M3. This would not necessarily be unwelcome. We think £M3 will become increasingly subject to distortion and hard to interpret; and the policy of controlling it through "overfunding" results in a rise in debt interest and thus a rise in public expenditure offset by a rise in the Bank's holdings of commercial bills (the "bill mountain").

36. However it must be recognised that the markets might not necessarily see joining as a strengthening of policy. It would come against the background of advocacy of entry, in general, by those whose commitment to counter-inflationary policy was in doubt. While the natural time for such a decision would be the Budget, by March the memories of recent weeks will not have faded and the decision would not evidently be taken from strength.

37. To sum up: entry would at the very least present a substantial presentational task. But beyond this the central question for consideration is whether the credit to be put at risk in such a task, and the unknowns in the subsequent evolution of policy, would be matched by the gain from a potentially more intelligible anchor for counter-inflationary policy. If the answer to that is in principle positive, is this the right moment to take this step, bearing in mind the market and political pressures of recent weeks, the reserve position and the extent of the persisting gap with German performance?

ANNEX cc DW

Membership of the ERM: Checklist of arguments for and against

A. Nature of Sterling

For	Against
1. Should help reduce market's preoccupation with £/$ rate [assuming we wish to downgrade its importance.]	1. Problem of running a system containing two reserve currencies, subject to very large speculative flows between them.
	2. Sterling's petro currency status, causing £ to move against DM on oil price prospects.

B. Size of UK Reserves

For	Against
1. Membership would give automatic access to very short term borrowing facility. [But existing members have found this only of limited use.]	1. Currency reserves too small to withstand for long even temporary market pressure by intervention - as rules of ERM would require us to do. [In absence of exchange controls, this could put great strain on domestic interest rates.]
	2. Rebuilding reserves would take time, and substantial foreign borrowing in HMG's own name.

C. Financial discipline to reinforce counter-inflation strategy

For	Against
1. Simpler to explain, to public and markets, than present policy.	1. Getting inflation down quickly to German level may be over-ambitious with adverse short term effects on output and employment. But alternative, of accepting occasional realignments, could cause market problems and/or mean relaxation of discipline.
2. In principle, keeping up with DM means more rapid progress against inflation than existing strategy.	2. More generally, could be occasions - eg. when £ was moving for oil reasons - when sticking to DM gave a discipline that was either too tight or too lax.

D. Relationship with Monetary Policy

For	Against
1. Joining would provide a good opportunity to reformulate monetary targets. £M3 may be becoming increasingly distorted and misleading.	1. In principle conflicts can occur between exchange rate and monetary targets. Membership means that in the short term, the former will always be given precedence (in setting interest rates, and on occasion in fiscal policy).

E. Handling Periods of market turbulence

1. Membership could sometimes insulate the £ and domestic markets from pressures or potential pressures, having a useful, psychological, calming effect on the markets.	1. In general, would not avoid need to take difficult decisions. In July and January, for example, interest rates might have had to rise sooner and further - since exchange rate can take little none of the strain.
2. Would increase short run certainty for business about exchange rate other EMS currencies.	2. Fixed exchange rate systems are traditionally crisis prone. Expectations of realignments can lead to massive speculative pressures, and very volatile interest rates.

F. Presentation

1. Should make counter-inflation policy simpler to present.	1. Difficult to explain continuity of policy given intellectual and presentational capital invested in present policy and MTFS.

G. Political Arguments

1. A symbol of our commitment to Europe.	1. Would mean on occasion associating unpopular decisions with EC.
2. Would be welcomed by our EC. partners.	2. Problem of having to <u>agree</u> realign ments with our partners.
3. Should assist economic convergence in EC.	

H. Timing: Why now?

1. Sensible to join at time of a budget, when can be presented as part of coherent strategy.	1. Case for waiting for (a) long expected fall of $ (which would probably cause DM to rise against all currencies), and (b) more settled oil markets.
2. Increased need to cut through problems of interpreting £M3, and explaining policy to markets.	2. Risk of joining with inadequate reserves. Would take time to borrow enough abroad to rebuild them to a safe level.
3. EC budget negotiations are over.	3. Might be better to join at a lower level of interest rates and a lower £/DM exchange rate.

01 233 5149

211256 :LAWSON SAYS BRITAIN HAS NO EMS MEMBERSHIP PLANS:

LUXEMBOURG, Sept 21 - Britain has no short-term plans to join the exchange rate mechanism of the European Monetary System (EMS) despite mounting pressure from its partners within the currency float, Chancellor of the Exchequer Nigel Lawson said.

PSF

EMS

Talking to reporters after an informal two-day conference of European Community finance ministers, Lawson said +There is no change in our position ... We have no objection in principle to join the EMS.+

+But it is a question of keeping the situation under review and weighing up advantages and disadvantages,+ Lawson added.

MORE

211256 :LAWSON SAYS BRITAIN =2 LUXEMBOURG:

He denied rumours that an official annoucement on Britain's role within the EMS was due shortly, saying +I have no plans for an announcement.+

Delegates said although the issue of British full EMS membership had been raised only marginally at today's talks, the British government had come under mounting pressure from its partners to join, a move which they said would greatly strengthen the tie-up and boost Europe's role on the international monetary scene.

+The time is as right as can be (for Britain to join),+ Dutch Finance Minister Onno Ruding told reporters.

MORE

211257 :LAWSON SAYS BRITAIN =3 LUXEMBOURG:

Britain has argued that wild fluctuations in sterling's exchange rate, due to its status as a petro-currency, could upset rather than strengthen the system of currencies fluctuating within narrow bands.

British diplomats also say that Britain's refusal to join the exchange rate mechanism, currently adhered to by all other community states save Greece, stems from fears in the Bank of England that it will lose part of its control over monetary policy.

B.f. - ~~joining~~ ERM leave to leave European Council of Ministers Mr

REUTER

PROCEDURAL ASPECTS OF MEMBERSHIP OF THE EXCHANGE RATE MECHANISM

This note explores the procedures that would need to be adopted if it were decided that sterling should join the Exchange Rate Mechanism. Some points for consideration are summarised at the end of the paper.

The Process of Joining

2. The UK has the right to join at any time, but mutual agreement with other participants and the Commission is needed on the choice of central rate. The procedure would resemble a realignment conference. The probable outcome would be a central rate close to the prevailing market rate.

3. There would however be a certain option on timing which could affect the central rate finally chosen. There are three possibilities: to join with immediate effect and without prior announcement; to join unilaterally, announcing the intention to join fully as soon as the agreement of others to a central rate had been arranged; or to announce in advance the intention to participate within a specified fairly short period.

4. The first option would give no time for preparation or possible negotiation. The second would have the disadvantage of accepting the constraint for a possibly uncomfortable period in which arrangements with partners had not been settled. The third possibility would allow a little time for discussion before actually joining, and also allow the market that same period to digest and absorb the news, with whatever effect on the current exchange rate that might have, before the UK were obliged to settle and operate on a central rate in the mechanism.

Margins

5. The standard margin is 2¼ per cent each way. The very strong hope of others would be that we should join the core group at

2¼ per cent margins. It is doubtful whether additional leeway would give a great deal of relief from the difficulties of operating within the system and markets might take badly what could be seen as taking a soft option.

Daily Operation

6. The primary obligation would be to respect the fluctuation margins, short of a demand for realignment. Regard would also have to be paid to the "threshold of divergence", which would be separately calculated for sterling and fixed at 75 per cent of the maximum spread of divergence for each currency. The point of this is that, if sterling crossed this threshold, which can occur before the intervention margin is reached, there is ia "presumption" that the situation needs correction, by whatever choice of action may be appropriate. A decision not to act might have to be explained to the partners and could become the subject of consultations. But recent evidence suggests that these "threshold" arrangements are not operated at all rigorously.

7. The task of maintaining sterling within the required margins could normally be supported by:

- intervention;
- monetary policy/interest rates;
- other domestic policy measures.

8. In practice, as long as the general strategy within the mechanism were the same as the strategy that would have been pursued under our present arrangements, any resort to domestic policy measures, other than monetary changes, would be likely to be much the same either way. What would be new would be a more regular use of intervention and the possible need for prompter, even on occasion larger or more frequent, movements of interest rates.

Intervention

9. A fairly frequent use of intervention, on at least a modest scale, would probably be required. This would typically arise

on fluctuations well short of the limits of the permitted range, and in order to stop any still relatively harmless drift which, if left to itself, might develop into a more substantial speculative market. In principle, such intervention should, over time, broadly cancel out. But it could be one-way for an extended period, and accumulate to quite a large amount.

10. Any large-scale intervention, particularly if over a limited period, would require thought as to the effects on domestic money supply, in either direction: this could also apply to the UK's need to take account of intervention by others in our own currency.

11. Community support facilities are available though we may not want to place much reliance on them. Medium-term support is available only conditionally: it is akin to IMF borrowing, requiring statements of (usually substantially strengthened) domestic policies and expectations. The unlimited and unconditional very short term facility is callable only to finance obligatory intervention at the margin. Both have been used by existing members in the past, most recently by France.

12. In the UK's case prolonged intervention would be constrained by the relatively small size of our currency reserves which at present stand at less than $6 billion. In 1982/83 France - even with their exchange controls - spent over twice this amount in intervention. Past experience, as well as that of other countries, suggests that - with perhaps the occasional rare exception - the need for large intervention argues also a need for some, and prompt, change in interest rates or domestic policies.

13. Thus, in general, the UK may have to be prepared: first, to accept an increase in domestic interest rates quickly if strong pressure against sterling developed; secondly, to recognise quickly the existence of an even deeper problem and seek realignment and/or other domestic policy measures as considered appropriate.

14. There is one possible exceptional situation about which something special could theoretically be done, and which is perhaps worth consideration. The UK and Germany will be by far the largest

and most open capital markets in the Community, with our market the larger of the two in terms of accessibility both ways. Situations can readily be envisaged in which substantial international capital movement, to or from dollars in particular, could have a large differential effect on sterling and the DM, not because of a significantly different judgement about the relationship of the two currencies, but simply because one market was or had in the past been more accessible and was therefore attracting or losing a much larger share of funds in the total movement.

15. One possibility for consideration is whether an arrangement should be set up with the German authorities, in principle, for mutual bilateral support, to be invoked only in circumstances in which the judgement of both sets of authorities was that there was no grounds for a change reflecting underlying conditions, and that a temporary international shift of funds had to be covered with minimal damage. If we could get it, this could be a very useful facility. Its availability would also be relevant to the reserves issue discussed below. But it can by no means be assumed that the Germans would be prepared to contemplate such a special arrangement.

<u>**Strengthening the Reserves**</u>

16. Joining the ERM, with its consequent need for intervention, would require a return to own-name borrowing. The decision to join the ERM is unlikely to affect very much either way HMG's ability to borrow, or the terms on which it could do so.

Too small?

17. Consideration would also need to be given to the size of an HMG issue. An operation which might effectively increase the reserves by up to $1 billion, when taken with other borrowing opportunities and net of repayments due, would provide some extra liquidity. To go for very much more might give the impression that the UK was prepared to intervene on a very large scale from the outset. But not to do so might suggest that we would seek a realignment, or take other action, at the first sign of pressure.

18. A subsidiary question which would arise is whether it might make sense to change the pattern of holdings and the relative liquidity of the reserves. The two obvious moves for consideration would be some realisation of gold holdings and some switch from liquid dollar holdings to liquid holdings of DM. In practice, it may not make a great deal of difference whether we intervene in one currency or another.

The Oil Problem

19. This is a problem whose nature is recognised by the potential partners who might accept the proposition that the UK should be entitled to prompt realignment in the event of any significant move in the oil price evidently creating pressure on the exchange rate.

20. Awkward problems arise in practice, however, where there is uncertainty or where the oil price adjusts at an inconvenient time, say on a Monday. A situation could arise where an untenable exchange rate might have to be defended until a weekend realignment conference. One alternative would be for sterling to drop temporarily out of the Mechanism.

The Sterling/DM Relationship

21. This would be of central importance to the UK and should be the key relationship within the Mechanism as a whole. The underlying situation, that the German inflation rate is persistently lower than that of the UK, tending to generate greater market confidence in the German currency than in sterling could exert some pressure from time to time.

22. The importance of the relationship suggests the necessity for a specially close understanding between the British and German authorities; and there is a particular problem in that the Bundesbank carries rather more, and more independent, authority on both foreign exchange operations and monetary policy, than does the Bank of England, and the German Finance Ministry

correspondingly less than the UK Treasury. Careful consideration would need to be given as to the size of the role delegated to the Bank of England.

23. There is something to be said for establishing with the German authorities an understanding that any important actions taken or intended, which could affect the market relationship, should be at least indicated and explained to the other side as quickly as possible, and where possible with an opportunity for consultation, or time to take any corresponding or countervailing action. The arrangement could develop well, but there might be an initial problem in that it would be of less importance to the German authorities, or would seem to them to be of less importance, than it would to the UK.

UK Financial Policies

24. Consideration would need to be given to the presentation and formulation of the Medium-Term Financial Strategy. The focus of market attention would be bound to shift dramatically to the daily exchange rate performance which would have consequences for the operational significance of monetary targets.

Timetable and Checklist

25. The attached Annex contains a very tentative timetable with an indication of points which might arise, and approximately when, in the process of joining.

Summary of points for consideration

26. Emerging out of this note are the following points for consideration:

(i) the process of joining and particularly the question of timing (paras 3-4)

(ii) The width of fluctuation margin at which to join (para 5).

(iii) The effects of intervention on domestic monetary conditions (para 10).

(iv) The question of mutual bilateral support with the German authorities (paras 14-15)

(v) The implications for the external debt programme (paras 16-17).

(vi) The possibility of sterling temporarily dropping out of the mechanism (para 20).

(vii) The nature of communication and consultation with the German authorities (para 23).

(viii) The presentation and formulation of the MTFS (para 24).

ANNEX

TIMETABLE AND CHECKLIST

Start

Decision taken in UK, to join within, say, 4-6 weeks. Should include a provisional decision on the likely/desirable central rate and probably a firm decision on choice of margins.

During first three weeks:

Be ready with announcement, in case of leakage. If no leakage announce after 2/3 weeks the intention to join 2/3 weeks later.

First week:

Secretly approach German authorities to tell them of the decision and discuss:

- arrangements for specially close contact between German and UK authorities;

- possible mutual bilateral support arrangements.

Also discuss with German possibility of temporary drop-out limited strictly to a short period of oil price uncertainty.

Second week

Continue discussions with Germans.
Tell the President of the Commission and seek his support for the idea of a temporary drop-out.

Third week

Aim to conclude discussions with Germans.
Inform other members of the Community (and by now, if not before,

secrecy will have been broken and an announcement should be made). This might be a good time for a meeting of ECOFIN. The announcement could usefully point to a date 2/3 weeks ahead by which time sterling will have joined.

About 4th/5th Week:

A little inside the date which has been publically announced, arrange a week-end meeting to settle the central rate.

PAPER 3

MECHANICS OF THE EMS

Membership

With exception of Greece, all the EEC countries were, and are, members of the EMS. Since 1979, the UK has participated in all aspects of the EMS other than the exchange rate mechanism. 20% of the UK's gold and dollar reserves are placed with the European Monetary Co-operation Fund (EMCF), there is a sterling component in the European Currency Unit (ecu) and the UK plays a full part in all Community discussions about the development of the system.

The Parity Grid and the Fluctuation Margins

(i) The principal intervention rule relates to the cross rates between each EMS currency. At each realignment members agree a matrix of central cross rates between each of their currencies. This collective set of central parities is known as the "parity grid". Members maintain the market exchange rates within a band 2¼ per cent either side of the agreed central rates (except for the Lira which for the time being is kept in a $\pm$ 6 per cent margin).

(ii) Intervention at the intervention limits is compulsory and, in principle, is in Community currencies. Thus the central bank of the strong currency buys the weak currency, while that of the weak currency sells the strong currency. In practice, intervention at the margins also takes place in dollars. There are no formal rules distributing the intervention obligations between the stronger or the weaker country though concertation often takes place. Nor is there a formal limit to the amount of intervention expected. Participants would b e required to intervene as much as would be necessary to remain within the band. If there is a continuing need for intervention then additional action might be taken by a government; a change in monetary, fiscal or other domestic policy, or perhaps the members concerned would seek a realignment.

(iii) Central banks more frequently intervene between the intervention limits, undertaking so-called "intra-marginal intervention". Intervention need not, in this case, be in participating currencies and is usually in \$. If intervention is in a participating currency the prior agreement of the issuing central bank is required. Moreover under an agreement between the participating central banks, holdings of Community currencies are limited to working balances only and the limits laid down by the Committee of Governors can only be exceeded with the consent of the central bank concerned.

Divergence Indicator

(i) Whereas the parity grid system specifies bilateral exchange rates and margins, the divergence indicator acts as a warning system designed to limit the tendency for any single currency to depart from the system as a whole.

(ii) The indicator is expressed in terms of divergence from the ecu. First, a calculation is made of how far each currency would diverge from its ecu central rate if it were against the 2¼ per cent limit against all the other currencies simultaneously. In practice the smaller is the weight of the currency in the ECU, the further it can diverge from its ECU central rate. Second, a calculation is made of 75 per cent of each currency's maximum divergence from its ecu central rate. This figure is called the divergence threshold.

(iii) If the divergence indicator reaches its threshold (which may occur even though the $\pm$ 2¼ per cent margin has not been reached against any other currency) then there is a "presumption", rather than an obligation, that authorities will intervene, change policy or call a realignment conference.

EMS Credit Facilities

EMS intervention results in countries buying or selling other participants' currencies.

(i) Intervention at the margins automatically qualifies for the very short-term facility, though this has not been used extensively. Participating central banks are required to open for each other very short-term credit facilities, unlimited in amount, in accordance with certain conditions. The initial date of settlement is 45 days after the end of the month in which intervention took place. This settlement date can be extended automatically by three months, subject to certain limitations, and by another three months, subject to the agreement of the creditor central bank. These intervention debts can be settled in a number of ways. The formal procedures state that, insofar as the debt has not been settled in the first instance by means of holdings in a creditor's currency, then a settlement should be carried out by transferring ecus with the proviso that a creditor central bank should not be obliged to accept ecus in excess of 50 per cent of the claim. If by doing so ecu assets fall short of forward sales then interest is paid to the EMCF (and vice versa if there is a positive net ecu position). The balance can be settled by transferring other reserve assets according to the composition of the debtor's bank reserves (excluding gold). However, in practice, most of the debts resulting from obligatory intervention are settled by offsetting claims or the debtor central bank buys the currency of the creditor.

(ii) A complementary facility is provided by the mechanism of short-term monetary support, which exists to provide temporary balance of payments financing under certain circumstances, with a (renewable) duration of three months. The facility is funded by quota subscriptions.

(iii) Finally, medium-term financial assistance is also available on a conditional basis with funding either by way of country commitments up to agreed ceilings (the MTFA) or through a Community market borrowing (the Community loan mechanism).

PAPER 4

HISTORY AND DEVELOPMENT OF THE EMS

Following the breakdown in 1971 of the Bretton Woods system of fixed exchange rates, a number of European countries set up a currency arrangement known as the "snake". This was inaugurated in 1972 by the six original members of the EEC: joined soon after by the United Kingdom, Ireland, Denmark and Norway (at that time the four new applicant countries).

2. The main provision of the snake was to reduce the permissible margins of fluctuation of the member country's exchange rates vis-a-vis one another. This had been advocated as a first step by the Werner Committee Report in 1970 which had called for the establishment of a complete European Monetary Union by 1980. The Report's recommendations were adopted by the Community in 1971 and the launch of the snake was thus associated with the ultimate objective of EMU.

3. Membership of the snake proved unsustainable for a number of the original members. Sterling left the snake in June 1972 after massive intervention had failed to stem pressure on the £. The Danish krone also left in June 1972 but rejoined in October. The lira left altogether in February 1973; the French franc left in January 1974, rejoined in July 1975 and left finally in March 1976. Eventually the snake became virtually a deutschemark zone, a grouping of smaller currencies, including several from outside the European Community (including Austria and Switzerland who adhered to the system without being members of it) with the deutschemark as the major currency. Throughout the life of the snake there were a number of changes in parity.

4. The target of establishing EMU by 1980 was officially abandoned in December 1974 and the momentum for progress in this area seemed to have disappeared completely by the mid-1970's.

5. Then, in 1978, a Franco-German initiative put forward the idea for a European Monetary System at the European Council in Copenhagen in April of that year. In the run-up to the next European Council in Bremen in July 1978, the Franco-German ideas were worked up into a more detailed proposal which was considered at the European Council and published shortly afterwards. The objective was the creation of a "zone of monetary stability in Europe" and involved a new currency unit, the European Currency Unit (ECU), to replace its predecessor, the European Monetary Unit of account, as the centre of the system. The importance of convergence of economic policies of the success of such a system was also emphasised.

6. Negotiations within the Community took place during the autumn of 1978 and the details of the EMS were approved at the December European Council in Brussels. The system came into operation on 13 March 1979. All the then nine members of the Community were members of the system, but the United Kingdom chose not to participate in the exchange rate mechanism. Greece did not choose to join the EMS when she acceded to the Community in 1981.

7. The document agreed between Community heads of government at Bremen envisaged a move to a second, institutional, stage after two years of operation, which would have involved some permanent transfer of reserves to a new European Monetary Fund (EMF). By general agreement in the Community the move to this second stage has been postponed, and no new target date has been set.

8. Annex A indicates in very broad terms developments in the exchange rate mechanism since March 1979.

9. The system has enjoyed greater stability than many expected at the outset though there have been a number of significant realignments (see Annex B). It is a widely held view that the major reason for this has been the unexpected weakness for much of the period of the deutschemark against the dollar (see attached chart).

ANNEX A

In very broad terms, developments in the foreign exchange markets since March 1979 fall into the following phases:

(i) From spring 1979 until autumn 1979 the deutschemark (DM) was relatively strong against the dollar, and some other EMS currencies (notably the Danish krone) relatively weak. There were realignments in September and November 1979 in which the DM was revalued by 2 per cent and the Danish krone devalued by 8 per cent against other participating currencies.

(ii) From late 1979 to autumn 1980 there were few major tensions within the system, although the DM was generally weak through much of the period.

(iii) From October 1980 the DM began a steep decline against other major world currencies which was not finally halted until February 1981, with a sharp rise in German interest rates. Over this period other currencies, notably the French franc and Dutch guilder, rose to their upper intervention limits against the DM.

(iv) Following the lira devaluation in March 1981 and the French elections in April 1981 there was a period when the DM appeared strong against most other EMS currencies, and the French franc in particular, while it remained comparatively weak against the dollar. This was the background to the general realignment on 4 October 1981.

(v) From October 1981, The DM tended to be at or near the bottom of the ERM band with the French franc and Danish krone towards the top. But the Belgian franc came under severe pressure in mid-December, and remained generally weak until the February 1982 realignment,in which it was devalued by 8½ per cent and the Danish krone by 3 per cent against other EMS currencies.

(vi) <u>From February 1982</u> to the widely expected general realignment on 14 June, the system was under fairly constant strain, with the currencies broadly in two groups - the DM, Dutch guilder and Danish krone towards the top and the Belgian and French francs and Irish £ at or near the bottom. The lira was also weak throughout this period, remaining below all the "narrow-band" currencies for much of it.

(vii) <u>After the mid-June 1982 realignment</u>, there was a period of considerable calm up to end-August 1982, followed by one of relative volatility and, from mid-November, considerable pressure within the ERM with the Dutch guilder at or near the top of the narrow band, and the Belgian franc and (from mid-December) the Irish £ towards the bottom. From early February 1983, the DM strengthened and the French franc came under heavy pressure ahead of the widely-expected general realignment on 21 March (following the German and French elections in early March).

(viii) <u>From March to August 1983</u>, conditions within the ERM were relatively stable, although it was fully stretched for much of the period. The DM remained at or near the bottom of the narrow band, with the Irish £ and French franc at the top.

(ix) <u>During September and early October 1983</u>, the DM strengthened, leaving the Belgian franc isolated at the bottom of the narrow band with the other currencies grouped closely together at the top. <u>Since then</u>, developments in the ERM have largely reflected the position of the dollar. The system was rather less stretched in December 1983 and January 1984 as the dollar strengthened, but the Belgian franc came under renewed pressure in February and March as the DM benefitted from the dollar's weakness. From April to November 1984, the system was under no pressure against a background of dollar strength, with the DM and Belgian franc respectively at the top and bottom of the band. The Danish krone has generally been at the top thereafter; and in early January the Dutch guilder replaced the Belgian franc at the bottom, and is currently near its lower intervention limit.

5 February 1985

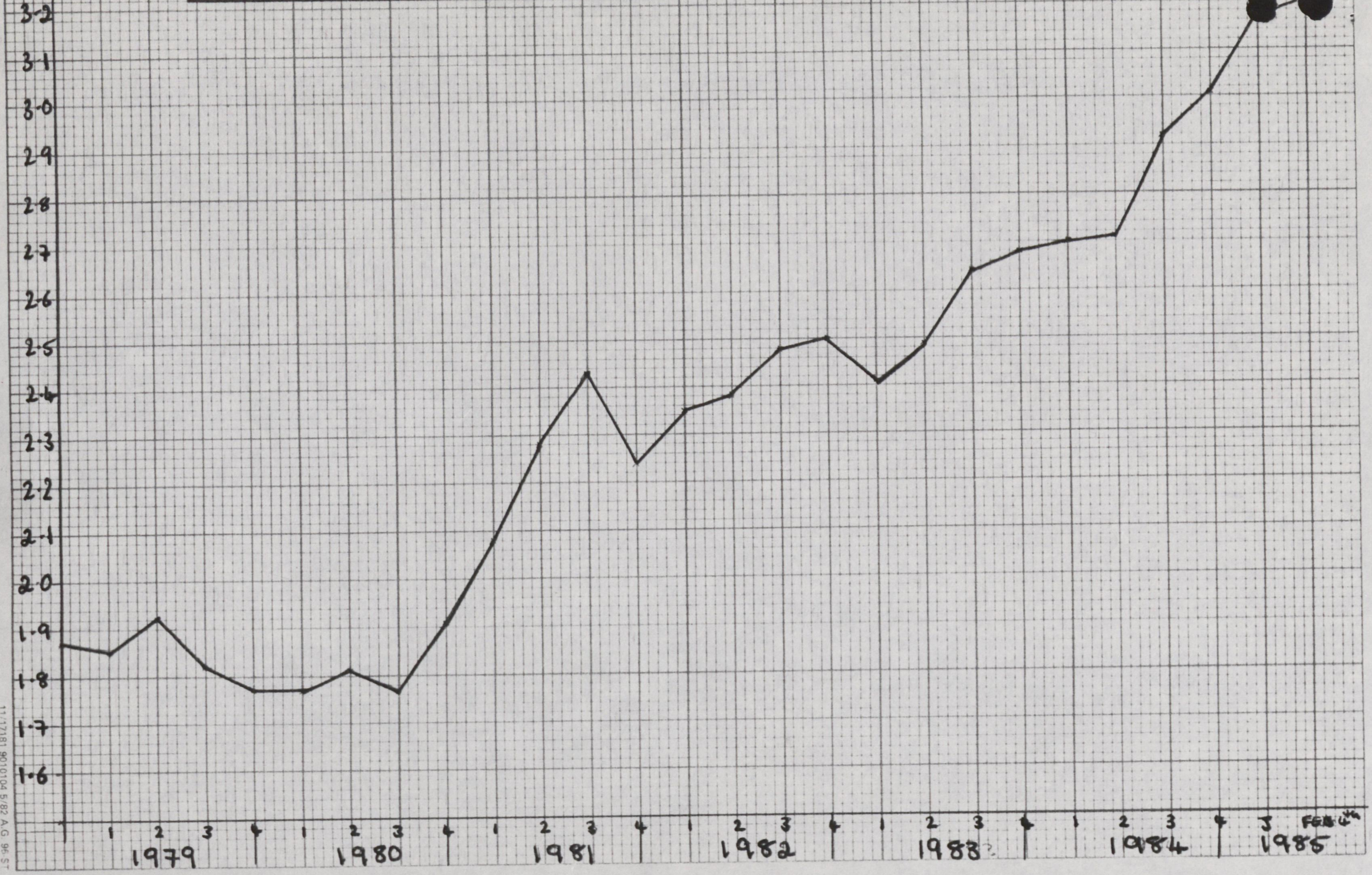
EMS: Economic Measures in Connection with Realignments[1]

Realignment Date	Realignment: Wording Based on Official Communiqué	Major Measures in: Belgium	Denmark	France	Italy
September 24, 1979	Shift in cross-rate between DM and DKr of 5 percent. Shift in cross-rate between DM and other EMS currencies of 2 percent	—	—	—	—
November 30, 1979	Devaluation of DKr by 5 percent against other EMS currencies (no communiqué)	—	• Energy component removed from wage-regulating index • Short-term price and wage freeze measures • Increases in direct personal wealth and corporate taxes	—	—
March 23, 1981	Devaluation of Lit by 6 percent against other EMS currencies	—	—	—	• Discount rate up 2½ percent to 19 percent • Government spending cut plans
October 5, 1981	Revaluation of DM and f. by 5.5 percent against DKr, BF, Lux F, £Ir. Devaluation of FF, Lit by 3 percent against DKr, BF, £Ir	—	—	• Temporary price and profit freeze • Incomes policy aiming at maintenance of average income purchasing power, narrowing of income range • FF 10.15 billion government expenditure in suspense	—
February 22, 1982	Devaluation of BF, Lux F, by 8.5 percent and of DKr by 3 percent against other EMS currencies	• Temporary freeze of wages and longer-run measures to impede complete wage indexation • Temporary price freeze • Reduction in corporate tax burden • Measures to stimulate the stock market	—	—	—
June 14, 1982	Change in bilateral rates: between FF and DM, f.: 10 percent; between Lit and DM, f.: 7 percent; between DKr, BF, Lux F, £Ir and DM, f.: 4.25 percent	—	—	• Temporary freeze of wages, prices, rents and dividends (except minimum wage) to be followed up by agreements on price and dividend behavior and indexation practices for wages • Revision of 1983 budget to restrict deficit to FF 120 billion (3 percent of gross national product)	• Announcement of budgetary austerity measures, June 23.
March 21, 1983	Change in central rates: Deutsche mark +5.5 Netherlands guilder +3.5 Danish krone +2.5 Belgian franc +1.5 Luxembourg franc +1.5 French franc −2.5 Italian lira −2.5 Irish pound −3.5	—	—	• Package of restrictive measures in budgetary, monetary, and foreign exchange fields.	—

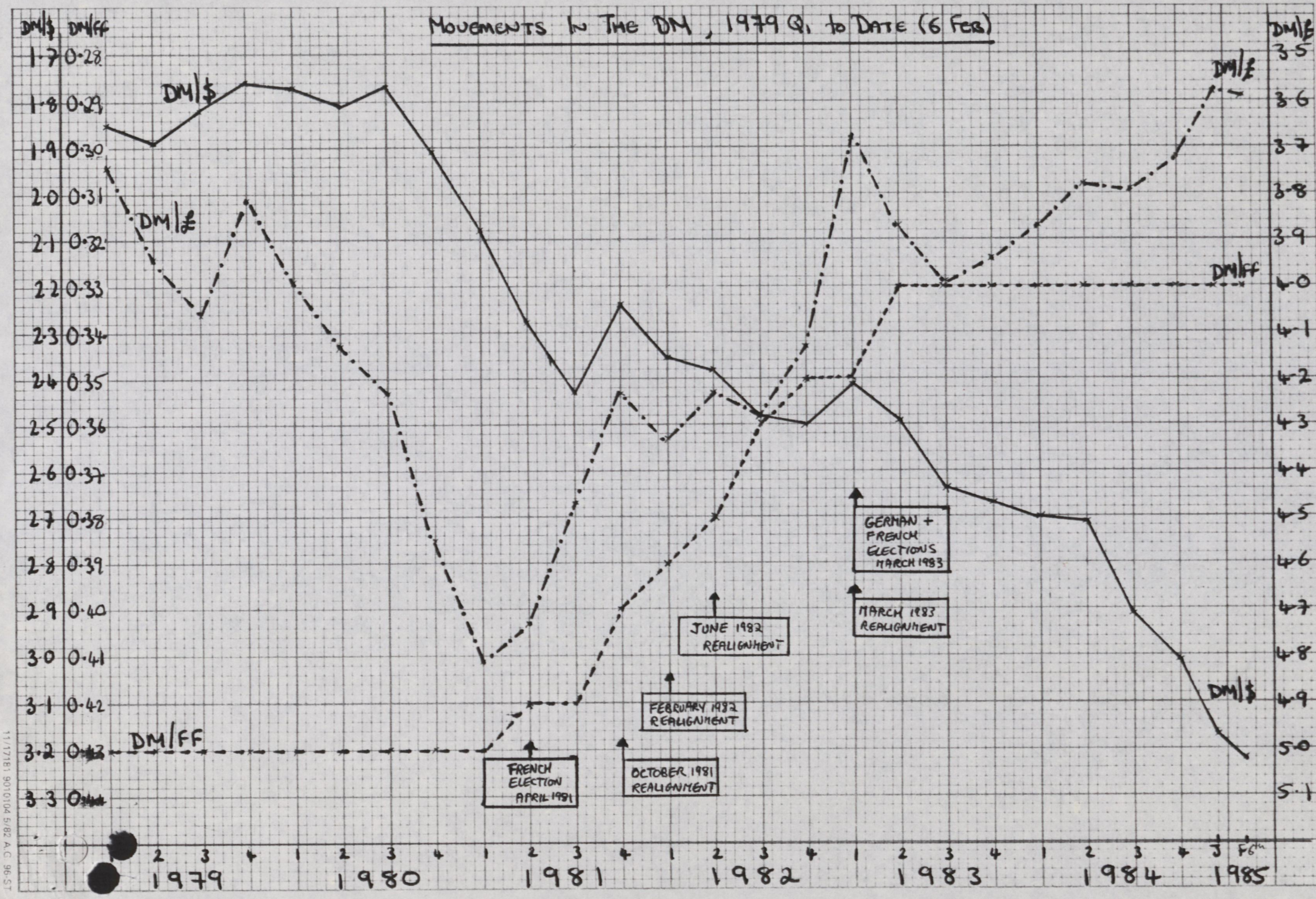
Sources: Commission of the European Communities and Fund staff.

[1] Notation: BF—Belgian franc; DKr—Danish krone; FF—French franc; DM—deutsche mark; £Ir—Irish pound; Lit—Italian lira; Lux F—Luxembourg franc f.—Netherlands guilder.

DM/$ EXCHANGE RATE, 1979Q1 to DATE



11/17181 9010104 5/82 A.G 96 ST



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5

LETTER FROM PROFESSOR SIR ALAN WALTERS TO MR. ANDREW TURNBULL

JOINING THE EMS - SOME ADDITIONAL QUESTIONS

1. Speculation against sterling is one of the main problems of the existing system. The EMS will not prevent such speculation - on the contrary, unless other undesirable measures are taken, it is likely to increase the profitability of shorting sterling. The authorities do not object to gradual movements in sterling - what they object to is sharp downward movements, arguing that it might be a "bottomless pit" which would destroy confidence. Yet the EMS re-alignments are all sudden changes. And, as French experience during 1982 shows, there is no guarantee that, in the EMS, the sudden shift halts the slide. Why is the plan unacceptable outside but good inside the EMS?

2. As is clear from the history of the French franc, joining the EMS is unlikely to reduce speculation against sterling and I would conjecture, because of the "step" movement on re-alignment, it would be made more profitable and so increase. In any case, the only way to deal with this is to make speculation against sterling unprofitable without, at the same time, making investment also unprofitable and depressing the economy. The present techniques and conventions of monetary control make this very difficult and chancy - essentially the need is sharply to raise overnight to seven-day rates without raising three-month (or more) rates. The French experience shows that, in the EMS structure, this is the only effective way of taking out the bears. Since we are a more open economy, the UK would be subject to much more pressure, so the need to tame the bigger bears is the greater.

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Do the proponents of EMS plan to change the monetary arrangements so that we can squeeze those shorting sterling? If so, could we know the institutional changes involved and how they are to be implemented?

3. It is not true that if we change the present system so that we can punish would-be bears, the difficulty of the bearish rush precipitating a fall of sterling would disappear. Joining the EMS would be likely to, at best, be irrelevant to the main issue.

4. Even if the UK joined, the DM would continue to dominate the EMS. Britain would have a role like France or Italy (the Netherlands is really part of the DM block). Both France and Italy have exchange controls and regulated credit rationing. In spite of the rigorous enforcement of exchange control in 1982-3 and the (3?) devaluations, the French Government had to intervene on a massive scale; indeed, there was much talk of the EMS having, in fact, broken down.

5. In view of our open capital and exchange markets and the continued role of sterling, the UK would come under much greater pressure than France, even if the latter had free credit and exchange markets. But with France and Italy regulated, it is very likely that Britain would have to bear much more speculative activity. Would the sponsors of Britain's entry envisage the introduction of credit rationing and exchange controls in Britain, at least as stringent as those in France as a concomitant of entry? Are we prepared to dismantle our open-market, free-exchange system in order to join the EMS grid?

6. Control of money and credit markets and insulation from the Euro market, a la France, would enable us to immitate the French in raising the overnight rate to tame the bears. However, it is worthwhile noting that this did not offset the need for massive and costly intervention, nor did it prevent the sequence of falls of the franc.

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7. To sum up:-

(i) EMS membership will not ease the stability problem and is likely to make it worse;

(ii) To deal with the stability of financial markets one needs either to:-

(a) not validate market expectations as the authorities reaction to a slide in sterling, or

(b) change institutional arrangements to enable the bears to be squeezed;

(iii) joining the EMS is likely to strengthen the argument for the reimposition of exchange controls like those of France and Italy with great disadvantages to a currency such as sterling;

(iv) one can understand the enthusiasm of the EMS members to include the UK since Britain would act as safety valve for much speculation in the System, and as the DM strengthens in the months ahead, sterling's position would continue to be precarious.

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Exchange rates

THE GOVERNOR

Copies to DGC members
Mr M J Balfour
Mr Goodhart
Mr Gill

1 The question of joining the ERM is a complex one, which has been argued back and forth in the Bank for more than five years and on which a very large number of complex considerations can be adduced on both sides. Whether to join or not will always be a matter of broad judgement and may well involve risk. My own, doubtless rough and ready and over-simple, position is now as follows.

2 The main arguments against joining have always been:

(i) we may destabilise the ERM itself and come under strong pressure ourselves when there are large and erratic movements in oil prices or the dollar.

(ii) we may constrain ourselves unsatisfactorily in terms of our effective exchange rate;

(iii) we may blur the lines of policy, losing a clear money supply discipline while gaining something less clear and satisfactory in exchange.

3 These arguments are always likely to have some force. My guess is that they are never likely to have less force than at present. Consequently, there is not much to be said for waiting as a deliberate policy: though it is of course perfectly possible to decide that we should never join.

4 My view on the contrary is that we should join now.

5 The dollar may fall soon, pushing the deutschemark up further than the rest of us and forcing early realigments: but we have been expecting this for a long time, and may have to wait a long time yet. And if it happens, it happens. There is no reason why the ERM should not pick itself up again.

6 The oil price may fall further and cause problems for sterling. But recent experience shows that these are very painful for us outside the ERM: it is not clear to me that they would be worse inside it.

7 As regards getting hooked on to an unsatisfactory exchange rate, it has become very hard to know what that means. Over the past five years, we have had a large variety of exchange rates, many of which have had unsatisfactory features of one kind or another; and there is surely now a general perception that current policies have been accompanied by a rather obvious lack of control over the exchange rate which a wide section of the public, including politicians, find increasingly unsatisfactory. It is hard to believe that, whatever happens after joining, developments in our exchange rate could be less welcome than they have been from time to time in the past.

8 There is a real risk that an entry into the ERM, especially if propelled by some unsatisfactory motives, will blur somewhat unsatisfactorily the thrust of policy. But I think a good deal of blurring has already occurred. The problems of keeping sterling M3 just inside the top of the range, with high interest rates, buoyant bank lending and continued overfunding, do not look as if they are going to go away, and are likely to put us increasingly on the defensive. Thus there may be a question of how much we would actually be losing.

9 On the positive side, I would make three points:

(i) we would be linking ourselves with a demonstrably anti-inflationary bloc: the Germans' record is exemplary - second to none perhaps. Thus, there is no reason why joining should be a soft option. In practice, one could make it a soft option by breaking out or realigning too frequently: but that may be politically unattractive enough not to make it a serious threat.

(ii) at least in my view, the public at large understand better the anti-inflationary constraints of holding the exchange rate than they do one of holding a money target. That, of course, does not go to the economics of the question; but on these it can be surely argued, as Mr Flemming has done, that there are respectable reasons for regarding purchasing power parity to hold at least as well in the long run, as constant velocity of money;

(iii) Floating exchange rates seem to me demonstrably to be getting out of control and producing economic disequilibria and policy difficulties for the world's major economies which by now are surpassing those distortions and difficulties provided by the Bretton Woods system in its late and damaging phase. There is likely (and rightly in my view) to be an increasing desire everywhere to moderate exchange rates fluctuations. How far this will prove practicable for the world as a whole must remain a very open question. But one can certainly argue that our joining the ERM is a step in the right direction: one more building block, even though it leaves large problems untouched.

10 Two final points of a different kind. I have not mentioned Europe. But it cannot be denied that there is something strange about an effectively permanent self-exclusion from a set of arrangements which the rest of the Community regards as central and important. Secondly, if we are to enter the ERM we shall have to equip ourselves to do so by augmenting our reserves on a substantial scale.

CWM

6th February 1985