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PRIME MINISTER

EXCHANGE RATE MECHANISM

I have not thought it right to cover in what is a joint Treasury/Bank paper one further contingency.

Whether or not sterling is in the ERM, it must be likely that, during the immediate run-up to the next General Election, fears of a possible change of Government would lead to a massive precautionary move of funds out of London, leading to intolerable pressure on the exchange rate. (The only reason this did not occur before the last General Election was that the polls consistently gave us a substantial lead: the result was never in doubt. But that was exceptional.)

Either way, given that the pressure would not only be wholly political in origin but would be for a strictly limited duration, it would be absurd to respond other than by letting the exchange rate take the strain - and we would need to draw the obvious political lesson, too.

If, when this occurred, we were in the ERM, we would need to announce our temporary cessation from operating the system, coupled with an undertaking that, on our return to office after the election we would immediately resume operating the system at the same parity as before.

I can't see why the Government should give this hostage.

Although there is no formal provision in the rules of the EMS for a manoeuvre of this kind, temporary infractions have already been condoned on a number of occasions on the basis of force majeure, and given the absence of any sensible alternative course, not to mention the lack of any sanctions that could be used against us, I have little doubt that our partners would recognise that they had no option but to go along with it.

I am copying this to the Foreign and Commonwealth Secretary.

NL.

N.L.

2~~0~~7 September 1985

Dated in error