

PRIME MINISTER

27 September 1985

EMS

Britain should not join the EMS. There are a number of political and economic reasons:

1. Sovereignty. As soon as you join the EMS, British monetary policy, the level of interest rates, the amount of the Reserves spent on intervention in foreign exchange markets and, in turn, growth and inflation themselves, will be to a great extent determined by German policy rather than by the British Treasury.
2. In the pre-Election period there could be great pressures against the pound. If we were forced into devaluation during this period, it would be seen as a defeat for Government strategy. It will be more difficult to convince the electorate that it was all Labour's fault because devaluation is such a visible national humiliation under the EMS system.
3. It reverses our overseas borrowing and debt repayment policy. We have already surprised people by borrowing an extra \$2.5 billion to bolster the Reserves; and we may well need more if we are to have enough resources to intervene under the EMS system. It was a much better line for the general public to say that we are the Party that repays overseas borrowings and goes in for sound housekeeping.
4. The industrial lobby, which currently favours joining the EMS, would soon change its mind if, for the first 18 months, we did indeed hold the Deutschmark rate level. This is feasible, particularly if we enter at a slightly lower valuation than the current pound/Deutschmark rate. After 18 months of higher cost inflation by British business (which will continue regardless) business will be against

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the EMS because they will think it has made them uncompetitive.

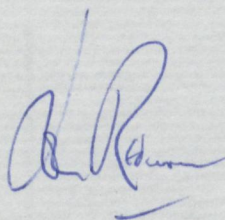
5. Sterling is a very different currency from many other European ones, subject to huge capital flows around the world, and part of a much wider international trading system. The cost of defending the pound or defending others' currencies could amount to hundreds of millions of pounds at each attack.
6. There is no evidence that the European currencies, after joining the EMS, have been any more successful in producing similar and lower inflation than before they went in. Messels show this clearly on page 7 of their note (attached). Nor did the current account positions become less volatile after joining the EMS.
7. The EMS is not a soft option which enables you to drop other types of policy. It may well force you into raising interest rates when you do not wish; into cutting public expenditure when departments do not wish; or in borrowing overseas to defend the rate.
8. Sterling has not tracked the European currencies in a stable manner over recent years. In 1980, sterling rose 20% against the European currency unit. In 1981, sterling fell by 15% from peak to trough. In 1982, sterling again fell 15% from peak to trough. In 1983, sterling rose by 10% at extremes. In 1984, it was more restrained, falling less than 10% at extremes. And in 1985, it has risen by more than 10%. In order to control these strong movements, the Government will need recourse to huge quantities of international reserves, and to a very tough interest rate policy. The band for intervention only allows 4.5% divergence, 2.25% either side of a specified rate - much less than the volatility of the last decade.

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Conclusion

The Treasury, Bank and City are uniting behind a new fashion. As each successive monetary target - Sterling M₃, M₁, M₀ - has been subject to distortion or waning interest, the Establishment invents a new one. There is no reason to suppose that we will be any more successful steering by a single currency target than by anything else; whilst there is every reason to say that we have had considerable success through a more pragmatic approach, at times taking care of the exchange rate, and at other times placing more reliance on monetary targets.

This may not be intellectually pure, but it is politically much more sensible; keeps our own destinies in our own hands and not in those of the Germans; and still leaves us free to try and track the DM exchange rate if we wish to do so, and if it suits us. It does not leave us open to City speculators - having lobbied us into the EMS - using all their might and main to try and wobble the Government out of a particular fixed parity. And it avoids adopting one of the main planks of the SDP's programme.

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