FW SUBJECT cc Master

VC 4 ACB 21

cc: FCO
Bank of England

blind copies:
Sir A Walters
Brian Griffiths (Policy Unit)

10 DOWNING STREET

1 October 1985

From the Private Secretary

Dear Rachel,

EUROPEAN EXCHANGE RATE MECHANISM

The Prime Minister yesterday held a meeting to discuss whether the UK should join the Exchange Rate Mechanism of the EMS. Present were the Chancellor of the Exchequer, the Economic Secretary, Sir Peter Middleton, Sir Terence Burns, Mr. Cassell, the Foreign Secretary, the Governor of the Bank of England, the Deputy Governor, Mr. George, Mr. Loehnis and Professor Brian Griffiths.

Opening the discussion, the Chancellor noted that the balance of argument as seen in February had been against joining the ERM, for two main reasons: first, sterling had fallen and to join might have been misinterpreted; secondly the reserves were then rather low. However sterling was at present not weak, and the reserves had been strengthened, though swap arrangements would have to be negotiated if sterling joined the ERM.

The case now for joining was the need to reinforce existing anti-inflationary policy. This policy was continuing to be successful. But the monetary indicators were proving increasingly difficult to interpret. To join the ERM would be a natural development in view of the increasing weight that had been placed on the exchange rate and it would strengthen the strategy in the eyes of the markets. It would make clear to industry that they could not look to depreciation of the exchange rate to solve difficulties which were of their own creating, and it would set the right financial context for the government's own decisions on expenditure. Policy itself was adequately tight; the task was one of presentation and market psychology.

The Governor of the Bank of England agreed. There was a need to reinforce the strategy. With the divergence of the targetted monetary aggregates it was proving an increasingly difficult challenge to present monetary policy in a credible and operable way. In discussing their approach to monetary policy the authorities were compelled to point to their subjective assessments of monetary conditions and to the behaviour of the exchange rate as an indicator. Yet there was then no answer to the question what range for the exchange rate the authorities had in

CST

mind. If sterling joined the ERM all the presentational difficulties would be met. The Governor said the UK would be joining the ERM from a position of strength and would contribute strength to the system.

The Foreign and Commonwealth Secretary noted that the Treasury and Bank had changed their view from a position of great scepticism to a belief that it would now be right to join. This change had been a product of experience. The Foreign Secretary further drew attention to the increasing convergence of the economies of the EMS countries and to the unwritten framework for realignments which now existed. It was also important to bear in mind that economic decision making in the UK was already in practice dominated by the behaviour of the exchange rate. The MTFS had served the Government well. It now needed strengthening.

The following were the main points made in discussion.

(i) To join the ERM would reduce the Government's room for manoeuvre. With large and open capital markets and relatively small reserves, interest rates might well need to move more sharply than otherwise and there would be greater automaticity about the changes. The result might be a faster speed of adjustment towards German economic performance, and higher unemployment. It was not clear that an external discipline would enable decisions to be made or accepted more easily than they were with an economic policy based on self-discipline. Against this it was argued that the events of January in particular, with sharp increases in interest rates as the exchange rate fell, had already fundamentally changed market perceptions of the basis of policy, putting the exchange rate in the forefront. There were risks, but membership of the ERM would of itself help towards greater stability in the exchange rate through the effect on expectations, and if interest rates rose earlier when the exchange rate was weak the increases might be smaller. The greater stability and confidence given by membership would help towards lower levels of interest rates.

(ii) Monetary targets would need to be maintained, but the emphasis given to each of the indicators would change. Joining the ERM would improve the credibility of monetary policy, particularly if the target range for £M3 had to be increased, and against the background of the end of overfunding.

(iii) Sterling was a very different currency from those of the other members. The behaviour of the ERM with sterling in it could not be predicted on the basis of past experience.

(iv) Sterling was increasingly the chosen vehicle for speculators. To join the ERM would help reduce speculative activity. Speculation would however tend to be encouraged if sterling approached the limits of its band and the parity was called in question. There had been wide fluctuations but no trend in sterling against the other European currencies as a group.

(v) The markets and commentators now had a more balanced understanding of the importance of oil to the UK economy. There were however major uncertainties about the prospects for oil prices, which could cause wide fluctuations in the sterling exchange rate.

(vi) Particular problems might arise from capital movements out of sterling as the end of the Parliament approached, though, it was noted, these might be eased to the extent that the UK had by that time established a good track record as a member. The German elections in 1987 were also a factor to be taken into account.

Bringing the discussion to a close, the Prime Minister said she was not convinced that the balance of the arguments had shifted in favour of joining. A further discussion would be needed, to which other colleagues should be invited. A list of questions would be circulated as a basis for discussion.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and John Bartlett (Bank of England).

Yours,

David.

DAVID NORGROVE

Mrs Rachel Lomax
HM Treasury