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10 DOWNING STREET

From the Private Secretary

15 October 1985

Dear Rachel,

ERM

The Prime Minister has asked that the Treasury and Bank should give full written answers to the questions attached in preparation for the next meeting on sterling and the ERM. The meeting is scheduled for 13 November, and I should be grateful if the replies could reach me by 7 November.

The Prime Minister, as you know, wishes to invite a wider circle of Ministers to the meeting on 13 November. They will need a suitable paper to give them an overview of the issues. I shall be in touch separately about the circulation of this and about the circulation of the questionnaire answers to the wider group.

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

Yours ever

David

David Norgrove

Mrs Rachel Lomax
HM Treasury

ERM QUESTIONS

Why decide now?

1. What are the reasons for wanting to take a decision now - one way or the other?

The policy framework and stance

2. Would joining the ERM amount solely to an evolution of the policy framework or would it also imply a change in the policy stance?
3. Are present monetary and fiscal policies tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy? For how long?
4. Would a decision on when to join be affected by the rate of sterling against the DM at that particular time? What do you see as the appropriate rate for sterling against the DM.?
5. How would the role of the monetary targets change if sterling were to join the ERM?
6. How much weight would in practice be given to them?

Expectations and presentation

7. In what ways would joining the ERM have a helpful effect on expectations?
8. Would a tightening of policy (if that proved necessary) be more easily accepted within Government and by the Government's supporters if sterling were in the ERM rather than outside it? Why?

9. How would the decision to join the ERM be presented both to the markets and more widely?

Effects on the ERM and the markets

10. How would the admission of sterling change the ERM?
11. What turbulence would you expect if we were to join?

Managing Sterling within the ERM

12. To what extent would the present level of reserves provide a cushion against temporary downward pressure on the exchange rate, on the basis of past experience here and in other countries? Would you expect a net cost to the reserves over time?
13. In periods of upward pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?
14. Is it envisaged that interest rates would change more often than they do now?
15. Is there a risk that the decision to abolish exchange controls would be seriously called in question?
16. What flexibility would be lost by sterling joining the ERM, in terms of (i) the policy stance
(ii) timing of decisions
(iii) presentation

Risks

17. What are the downside risks?
18. Does the UK's position as a major oil producer and exporter mean that it is too risky to join?

19. Are the objections to joining of a fundamental nature or are they questions of timing?

Alternative options

20. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?
21. What are the implications, for the way we conduct and present policy, of sticking to the present arrangements?
22. Given that financial innovation is proceeding fast in the US and Germany why is it more difficult to interpret financial conditions in UK?
23. What can the Bank/Treasury do within the existing system to improve the reliability and usefulness of the financial indicators?

14 October 1985

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Sir Peter Middleton KCB
Permanent Secretary

10 October 1985

D Norgrove Esq
Private Secretary
10 Downing Street

Dear Mr Norgrove

The ERM

file with DRN (EMS)

Thank you for showing me your proposed list of questions. I think they are a good lot - though we might not wish to answer them in their present order. I have only three suggestions:

- a. Questions 14 and 15 could be reframed to make a single question: what are the implications, for the way we conduct and present policy, of sticking to the present arrangements.
- b. I think we should have a question to cover the Prime Minister's concern about the petro currency status of sterling. I suggest:
 "Does effect on £ resulting from the UK's position as a major oil producer and exporter mean that it is too risky to join the EMS "
- c. I suggest you add a couple of questions on timing:
 "Are the objections to joining of a fundamental nature or are they questions of timing."
 "What are the reasons for wanting to take a decision now - one way or the other."

Johnson,

Peter

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10 DOWNING STREET

From the Private Secretary

18 October 1985

ERM

Could you please send a copy of the reply to the questionnaire and the paper for the 13 November meeting to Sir Alan Walters (personal and confidential) c/o Julian Exeter at the British Embassy, Washington? They ought to catch the confidential bag on either Monday 4 or Tuesday 5 November if he is to have an opportunity to consider them and to comment.

DR

(David Norgrove)

Mrs. Rachel Lomax,
H.M. Treasury.

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