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Treasury Chambers, Parliament Street, SW1P 3AG
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6 November 1985

David Norgrove Esq
10 Downing Street
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Dear David

ERM

As requested the Treasury and the Bank have prepared full written answers to the questions attached to your letter of 15 October, in preparation for the Prime Minister's seminar on sterling and the ERM on 13 November. These are attached.

I am copying this to John Bartlett (Bank of England).

Yours ever
Rachel.

RACHEL LOMAX
Principal Private Secretary

The questions are not answered strictly in the order in which they were listed; some reordering has been done where this might help by bringing related answers together.

Q21. What are the implications for the way we conduct and present policy, of sticking to the present arrangements?

No

(a) The conduct of policy would lack a visible discipline, and its presentation would lack clarity.

(b) The MTFS framework of monetary targets has, successfully, provided an objective guide to the conduct of policy. But, as discussed at the PM's July seminar, financial innovation has made it increasingly difficult to interpret the monetary aggregates (especially at present £M3), and so to rely on them as a policy discipline as heavily as we have in the past. We have to be guided by a wide range of factors, and have in practice - especially since January - placed much greater emphasis on the exchange rate, without of course any explicit target. The discretionary element in policy decisions has correspondingly increased.

(c) Without a more clearly-defined intermediate objective, policy is also harder to explain, and a high premium attaches to maintaining the markets' trust in the skill and judgement with which policy is operated. The Mansion House speeches were well received in this respect but have only provided a breathing space in which to rethink the presentation of policy. More precise policy guidelines will be looked for when the MTFS is updated at the time of the Budget.

(d) Unless we can find more robust guidelines our handling of interest rates in particular will remain under exceptionally close scrutiny. To maintain confidence, we will need to be very cautious indeed - more cautious probably than if we had successfully established a clear external discipline.

This seems to me the main argument in favour of joining, to be weighed against the risks.

(e) Moreover while sterling remains outside the ERM it is a particularly tempting target for speculation on the foreign exchange markets.

Q2. Would joining the ERM amount solely to an evolution of the policy framework or would it also imply a change in the policy stance?

!! (a) Joining the ERM would not imply any change in the policy stance. Rather it would reinforce the framework and give policy new impetus.

(b) It would be an evolution. As explained above, we have already been obliged to modify the operation of monetary targets and forced to pay more attention to exchange rate changes in making decisions about interest rates. This started in Autumn 1980 and Spring 1981 when interest rates were reduced in the face of sterling's strength despite rapid growth of £M3. Chart 1 shows that the sharp interest rate hikes of Autumn 1981, January 1983, July 1984 and January 1985 were all triggered by exchange rate weaknesses. Interest rate reductions have generally been accompanied by exchange rate strength or, at least, stability.

(c) Joining the ERM would be a logical further step in this direction. Within the ERM we could continue to operate policy to keep sterling strong and maintain pressure to bring inflation down.

Q1. What are the reasons for wanting to take a decision now - one way or the other?

No (a) The balance of argument has now shifted towards joining (see Question 19) and we could now go in from a position of strength. This is widely recognised not least by the Government's own supporters. And membership of the ERM is increasingly seen as the missing piece of jigsaw as far as monetary policy is concerned.

Undoubtedly true. (b) As a result there is recurring speculation that we are going to join. This is unsettling to markets and industry. It would be better to resolve this uncertainty now, well before the run-up to the next election.

(c) Moreover if we do not join markets will start to ask why not. They are likely to conclude that we want to keep our options open. In practice this means the option to devalue - as persistently argued by the CBI. The price we will pay for these suspicions is the need to maintain conspicuously high interest rates.

Q16. What flexibility would be lost by sterling joining the ERM, in terms of (i) the policy stance (ii) timing of decisions (iii) presentation?

(a) As explained above the policy stance is directed towards putting downward pressure on inflation and ERM membership would not involve any change in this.

What?

(b) Reinforcing our disinflationary strategy inevitably entails some sacrifice of discretion over the operation of policy, but imposing constraints on discretionary action in such a visible way would improve credibility and confidence. It would reassert the principle of self-discipline inherent in the original MTFS.

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(c) As a result there would be some loss of flexibility in the timing of decisions. In particular, it would create pressures for changes in interest rates to take place earlier than they have tended to do in the present system. This would be helpful if it reduced the "bias in delay" which is a potential problem in any discretionary system. It would only be a problem if the market's view of the need for action were different from our own - a situation that can arise whether or not we are in the ERM.

(d) There would be little change in the presentation of policy. As explained above interest rate increases have almost invariably been associated with exchange rate movements. But the underlying explanation can usually be presented in terms of the ultimate counter-inflationary objective of policy and this would continue to be so.

Q19. Are the objections to joining of a fundamental nature or are they questions of timing?

(a) Objections to joining are no longer a matter of timing. Those that remain are more fundamental.

(b) The exceptionally good cost performance of Germany. Our relative performance has improved. In terms of consumer prices from 15% compared with 8% average for EMS countries in the final quarter of 1979 to 3¾% compared with 3% average for EMS contries prospectively by the middle of next year. In this respect the greater freedom of action outside ERM is illusory; we should not wish to avail ourselves of the freedom to depreciate. One purpose of joining would be to put pressure on our costs to develop more in line with those in Germany.

(c) The oil factor. This makes us potentially vulnerable to any weakening in the oil price and, in the long term, to the decline in North Sea output. But the real oil price has already declined from its peak and oil price movements no longer exercise as great an influence on sterling as in the past (see chart 2). In 1980-81 the market took an exaggerated view of the importance of changes in oil prices for sterling. More recently, with the prospect of gradually declining oil production, the markets' perception has changed, and the impact of oil price movements on sterling has become less pronounced. But it cannot be denied that this factor will continue to distinguish us from other members of the EMS (see question 18).

(d) The dollar problem. Sharp changes in the dollar can affect the relationship between the DM and sterling. This partly reflects the size, openness and dollar orientation of our financial markets. But major swings in the dollar can produce strains within the existing ERM too. While the dollar has already had a sizeable adjustment, there may be more to come.

(e) The oil and dollar problems will pose difficulties whether or not we are in the ERM. Both have become somewhat less acute recently. But there is no reason to expect them to ease significantly in the short term. So the arguments in terms of 'unripe time' are no longer convincing. It is a matter of judgement if the longer term difficulties are so fundamental that they offset the clear advantages of joining.

Q3. 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?

(a) We judge present policies to be tight enough to bring down inflation. Over the past two years or so - despite some short term volatility, not shared by ERM members - there has been no downward trend in the DM/£ exchange rate (see chart 3). Relative to the German inflation rate we expect to be at least as well placed as other major ERM countries over the period ahead.

(b) The biggest risk to stability within the existing EMS is a sharp fall in the dollar which might cause the Deutschemark to appreciate against all other EMS currencies. In such an event there would probably be some realignment within ERM. If we were within the ERM we would consider the position of sterling in the light of our performance against domestic monetary targets and other indicators. The overriding consideration would be the need to maintain downward pressure on inflation.

Q4. 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?

(a) There is no uniquely 'right' rate; a balance has to be struck between the need to maintain downward pressure on inflation and the need to avoid impairing industry's international competitiveness. The DM/£ rate of 3.50 reached last February was clearly too low and threatened anti-inflationary policy; the rate of 4.00 reached in July was probably too high and threatened to put too much pressure on industry's competitiveness.

(b) The current rate of 3.74 is close to the average over the past 2½ years of 3.84 and has been consistent with anti-inflationary pressure and steady 3 per cent output growth. And over this period employment growth in the UK has been clearly better than in ERM countries.

(c) These considerations together probably point to a central rate somewhere between DM3.65 and DM3.75. But if we decide to join we would have to be prepared to join at something close to the current rate. The ERM margins would give us some room for manouevre, however.

Q5. How would the role of the monetary targets change if sterling were to join the ERM?

Q6. How much weight would in practice be given to them?

(a) The role of monetary targets has already changed. We interpret their behaviour in the light of other information - particularly exchange rate movements which have taken a more decisive role.

(b) Inside the ERM short term interest rates would be operationally determined, particularly at times of exchange market pressure, by the need to stay within the band. But monetary developments would remain just as important as before in influencing the course of inflation in the medium term, and monetary targets would play the same role as now.

(c) Other EMS members have monetary targets and there is no reason to expect any fundamental conflict between pursuing those targets and operating within the ERM.

(d) If a conflict did arise, however - eg if we persistently found that the level of interest rates required to keep sterling within the ERM was not high enough to deliver monetary conditions sufficiently tight - then we would need to consider whether to seek a realignment.

Q7. In what ways would joining the ERM have a helpful effect on expectations?

(a) By demonstrating our determination to pursue a firm anti-inflationary policy.

(b) By enabling policy to be presented more clearly and convincingly.

(c) The exchange rate commitment would make it plain to companies that excessive pay increases would not be bailed out by a depreciating exchange rate.

(d) Greater exchange rate stability would provide a firmer basis for industrial decision-making which could ultimately be helpful to employment.

Q8. 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?

(a) A tightening of policy would normally, as now, be presented as necessary to the counter-inflationary strategy.

(b) The exchange rate is a more widely understood form of financial discipline than the monetary aggregates. ∴ U-turn.

(c) In current circumstances of uncertainty about the interpretation of the monetary aggregates, the monetary "rules" implied by the present approach are far from clear even to those who find it easy to think in such terms.

Q9. How would the decision to join the ERM be presented both to the markets and more widely?

(a) As a logical extension of our present financial policies (reflecting the increased weight placed on the exchange rate).

(b) The formal exchange rate commitment involved in membership of the ERM would be seen by the markets as reinforcing the intended discipline of monetary targets.

(c) More widely, it would be presented as underlining the Government's determination to reduce inflation.

Q10. How would the admission of sterling change the ERM?

It would introduce a second internationally traded currency and one that would tend to be affected by oil price changes in the opposite way to other ERM currencies. In order to minimise any potential instability arising from this change very close collaboration between the German and UK monetary authorities would be needed, but there is every reason to believe that the Germans would recognise this as clearly as ourselves.

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Q11. What turbulence would you expect if we were to join?

Joining the ERM would probably not in itself generate turbulence. However, speculators would no doubt take an early opportunity (eg if there were a weakening in the oil price or further instability in the dollar) to test the £/DM rate. We would obviously need to be ready to react to such turbulence - should it arise (see question 17).

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Q12. 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?

(a) Our available reserves are relatively small, as the table shows. And they may in any event need to be strengthened, by further borrowing if necessary, in due course. In the ERM they would need to be buttressed by close co-operation with Germany.

(b) Our reserves could provide a cushion against modest downward pressure. But if the pressures on sterling were severe there would be no alternative to raising interest rates.

(c) There is no reason why, over time, the pressures should be one way. Hence there should be no net reserve loss.

INTERNATIONAL COMPARISON OF RESERVES*
(Convertible currencies)

	$ billion	% of 1984 exports
UK	10.4 (1)	8.6
Germany	36.9	17.5
France	21.5	18.4
Italy	19.2	22.6
Netherlands	8.4	10.9
Belgium	3.8	7.1
Ireland	3.4	32.1

(1) Including the $2.5 billion FRN borrowing.

* The UK figure is for end-October: other countries are for July or August.

Q13. In periods of upward pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?

(a) If intervention led to a large increase in the reserves there would be a presumption that interest rates could be reduced.

(b) If we felt that intervention and/or interest rate reductions were inconsistent with our anti-inflationary objective we would consider seeking a realignment. This situation might arise, for example, if the Germans were not to stick to their traditional disciplined policies in the future eg in the aftermath of an SPD victory in the German elections in (March) next year. In practice, however, even if the SPD were to win the next German election this is most unlikely, given the SPD's track record when in office before, to signal any departure from financial orthodoxy.

Q14. Is it envisaged that interest rates would change more often than they do now?

(a) If we are successful in establishing credibility, membership of the ERM should promote more stable monetary conditions than we could enjoy outside it. The general level of interest rates could then be lower, and change less frequently if we joined. The present level of UK interest rates currently includes a premium for uncertainty about the Government's monetary policy and the future course of the exchange rate.

(b) But at some - possibly quite early - stage the market may well test our resolve and commitment to the ERM. We would need to react promptly and effectively by raising interest rates. It could well be only after weathering that test that the benefits outlined in (a) above would emerge.

(c) In the face of exchange rate shocks - a fact of life whether we are in the ERM or not - there would be even less scope inside for the exchange rate to take any of the strain. The shock would be quickly transmitted to the money markets and its impact on interest rates might be more immediate. But in practice the difference is unlikely to be very great, as the events of this January demonstrated.

Q15. Is there a risk that the decision to abolish exchange controls would be seriously called in question?

Doubtful — Nigel's line has been same as Treasury

(a) No. There is no influential body of opinion nowadays that argues that exchange controls allow a country to prop up the exchange rate and so avoid higher interest rates for long if confidence weakens. Currently the pressure is on those EEC members that have exchange controls to dismantle them. Not very successful

(b) This pressure would be reinforced by Britain's membership because the continuation of controls, rather than the absence of British membership, would then be more obviously the most important obstacle to the proper working of the EMS.

Q17. What are the downside risks?

(a) The main downside risk of giving greater emphasis to the exchange rate is that sterling will come under strong pressure in the foreign exchange markets confronting us with a difficult choice between devaluing and a sharp tightening of policy. That risk exists now. But in the ERM it would have a higher political profile. Devaluation would be seen as a defeat for the Government.

(b) Devaluation could also seriously undermine the credibility of policy that membership of the ERM is intended to bring. On the other hand, avoiding this by a sharp rise in money market rates, which would almost certainly be quickly followed by an increase in mortgage rates, would itself be very unattractive, particularly at a time when unemployment was high. But this dilemma also exists now, outside the ERM. The real difference would be the heightened profile.

Q18. Does the UK's position as a major oil producer and exporter **exporter mean that it is too risky to join?**

(a) Obviously these characteristics of the UK's position do make it harder to Britain to be a member of the ERM. It is partly for this reason that Britain has not so far joined.

(b) The importance of the oil factor is less than early years of EMS when UK oil production rose at a very rapid rate and oil prices rose by large amounts.

(c) With gradually declining oil production, fluctuations in oil prices are likely to have a diminishing impact on sterling; and there are clear signs - see the attached chart 2 - that this has been occurring over the past two years.

(d) Over the longer period some fall in the real exchange rate will probably be necessary as the economy adjusts to gradually lower oil output (even though we may be self sufficient at the end of the century). In any case, this would best come about through a deceleration of domestic wage costs. Membership of EMS should improve the chances of this happening.

Q20. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?

(a) No.

(b) Working to an unpublished band would be very close to continuing present policy and give us none of the benefits that membership would.

(c) Working to a published band would give us the effective obligations of membership - and all the downside risks mentioned in answer to question 17 - without the benefits of the institutional backing and credibility tht formal membership would give.

(d) It would also make it very difficult indeed to explain why we had decided not to join the ERM.

Q22. Given that financial innovation is proceeding fast in the US and Germany why is it more difficult to interpret financial conditions in the UK?

(a) The US is also going through a period of rapid financial change and has for some time experienced similar difficulties to our own in interpreting their monetary aggregates. They have, for example, already raised their M1 targets once this year, but remain well above the new, higher, target range. And, like us, they have had to give more emphasis in policy decisions to their exchange rate.

(b) In Germany, on the other hand, financial innovation is much less pronounced. German banks have traditionally provided the wide range of services now being introduced by banks in the UK; and the pressure for change is also less because decades of comparative stability mean there is less demand for new instruments and techniques as protection against interest rate volatility. As a result the German authorities have been more easily able to deter innovation by informal controls. Where such pressure is felt it can be deflected to the banks' activities outside Germany (eg in Luxembourg) without apparent effect on domestic conditions, though even this has so far been on a relatively modest scale.

Q23. What can the Bank/Treasury do within the existing system to improve the reliability and usefulness of the financial indicators?

(a) Very little that has not been done already.

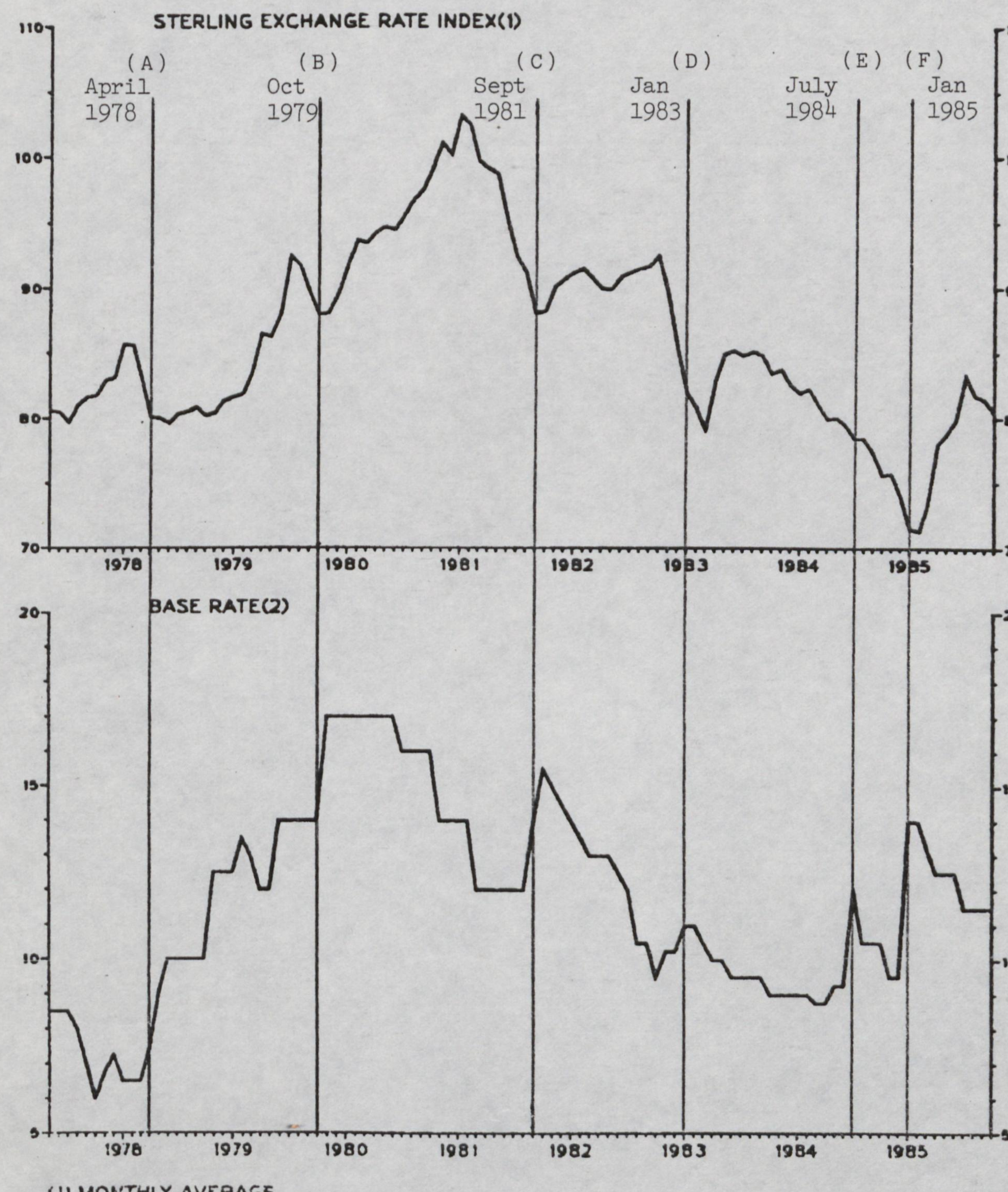
(b) Following the abolition of controls in 1979/80 there are further big structural changes in the financial system in train - including liberalisation of the building societies and "Big Bang" in the securities industry. Given this, the monetary aggregates are likely to continue to be very difficult to interpret for some years ahead.

(c) In the Mansion House Speeches we probably went as far as we could in justifying an intepretative approach to monetary targetry. We have only bought time and, as noted earlier, will need to provide more robust policy guidelines in March. Any additional emphasis on the exchange rate will pose the question: 'why not join the ERM', with consequent problems in the markets/see Question 1.

This of course is intended to answer Alan Walters on MBC.

(d) To move to a monetary base control system would be a bigger, riskier, step than joining the ERM - and one which would be much worse received by the markets, who remain unconvinced about M0. It would involve a major shift in the demand for monetary base, which would be difficult to identify for several years. During that time the money numbers would be impossible to interpret, interest rates would be highly volatile and it would be extremely difficult to establish credibility for policy.

CHART 1 : **BASE RATES AND EXCHANGE RATES**



(1) MONTHLY AVERAGE
(2) END OF MONTH

BASE RATE RISES:

(A) from 6½% to 7½% (21 April), 9%(10 May) and 10%(12 June)
(B) from 14% to 17% (16 November)
(C) from 12% to 14% (16 September) and 16%(1 October)
(D) from 10¼ to 11% (12 January)
(E) from 9¼% to 10% (9 July) and 12%(11-12 July)
(F) from 9½% to 10½%(11 January), 12%(14 January-MLR reintroduced) and 14%(28 January).

CHART 3: MOVEMENTS IN STERLING AGAINST THE DEUTSCHEMARK AND THE DOLLAR

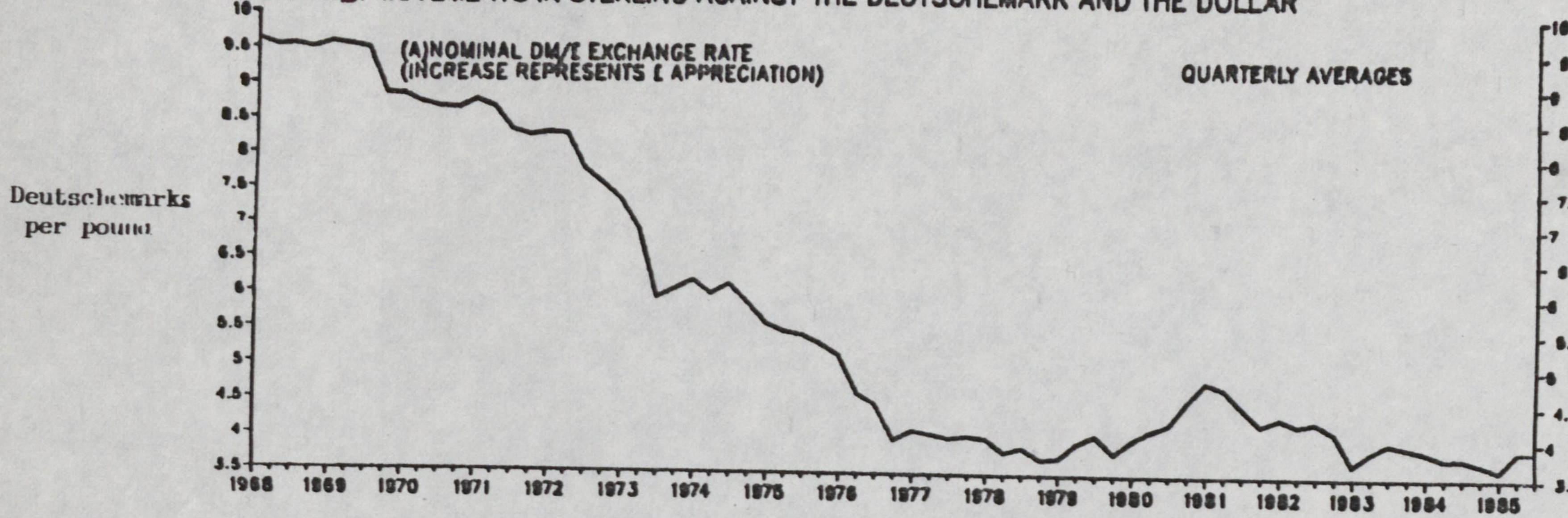


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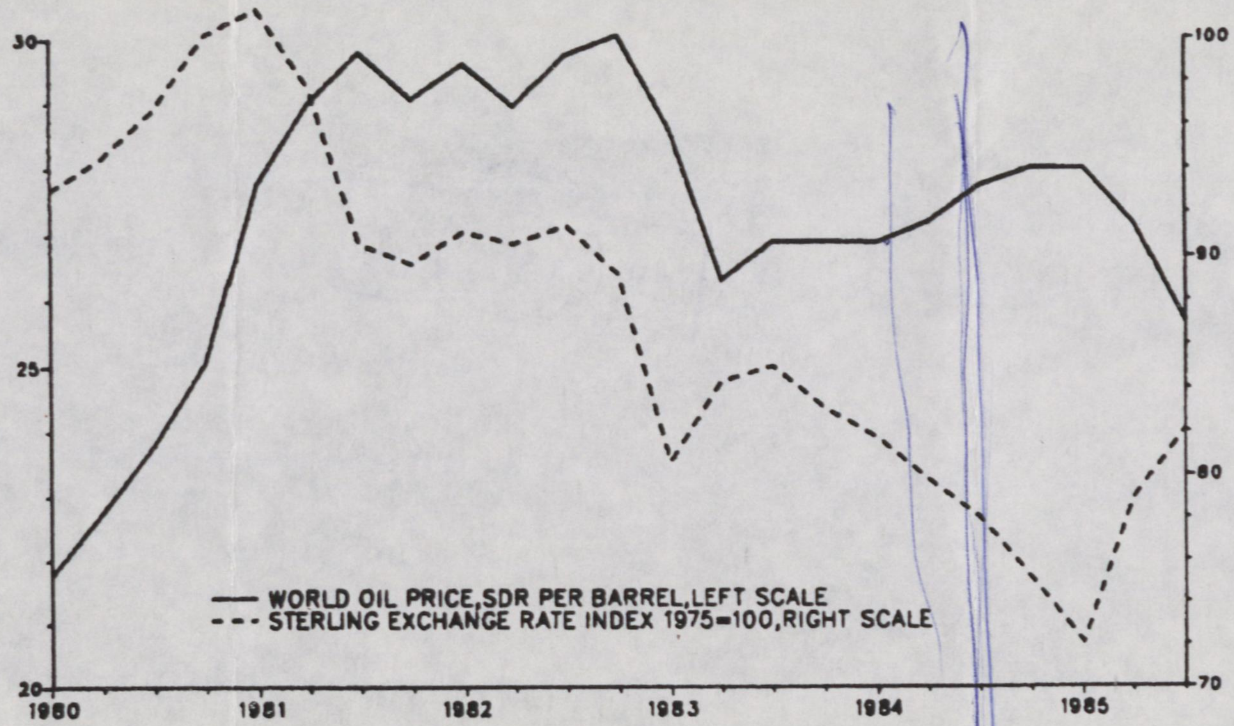
CHART 2: OIL PRICES AND THE EXCHANGE RATE



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