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11 November 1985

David Norgrove Esq
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LONDON SW1

Dear David

ERM

I attach a copy of the Chancellor's paper on the ERM for the Prime Minister's seminar on Wednesday 13 November. For the benefit of others attending the meeting, I am also now circulating the answers to the questions posed in your letter to me of 15 October. (They were prepared jointly by the Treasury and the Bank).

I am copying this to Joan MacNaughton (Lord President), Len Appleyard (FCO), John Mogg (DTI), David Morris (Lord Privy Seal), Andrew Lansley (Chancellor of the Duchy), Murdo Maclean (Chief Whip) and John Bartlett (Bank of England).

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary

THE EUROPEAN MONETARY SYSTEM

Paper by the Chancellor of the Exchequer

On any objective test the British economy is doing well. For over four years now it has grown at a steady 3 per cent a year and we have the prospect of this continuing in the period ahead. We are achieving the steady growth which governments have sought in vain for many years.

But we cannot take this for granted. The only way we can keep growth going (and with it any prospect of a fall in unemployment) in the world in which we live is to keep inflation coming down - and convince people that it will continue to come down and stay down. The main threat to steady growth is the fear that inflation will re-emerge and that measures which the Government would then take to combat it will thrust the economy into recession and a further rise in unemployment.

Given our record since 1979 it is fair to ask why these fears about inflation persist. The answer is history. Low inflation is a relatively recent phenomenon. In the eyes of the world's financial markets, and this includes our own, British governments remain suspect. There is still a nagging fear that sooner or later we will succumb to the temptation of going for an easy inflationary option. The only means of countering this fear has been explicitly to constrain our own freedom of action by setting targets for monetary growth and supporting this by a tight fiscal policy. This was the thinking that lay behind the publication of the MTFS. The conduct of economic policy must always be guided by a mixture of rules and discretion. Since the collapse of Bretton Woods in 1971, policy in the UK seemed to rely wholly on discretion, and not at all on rules - and we were simply not trusted to use our discretion in a consistently non-inflationary way. So we had to make a fresh commitment to a new set of anti-inflationary rules - the MTFS.

This commitment has served us well. But it is running out of steam. First, as a matter of substance, the measures of money (including in particular £M3) are going through a prolonged period of instability. They are doing so for the best of reasons: the liberalisation of the economy which is an essential element in our overall strategy includes financial liberalisation, which is progressing apace. But the fact remains that the money numbers cannot be taken at their face value when the institutional structure is in a state of flux. The rules based on them have inevitably lost much of their original clarity. And, to carry conviction in the markets, we have needed to buttress them by adopting a visibly cautious approach to setting interest rates - certainly since last January.

Second, it is most unusual for a British Government to maintain the same policy for as long as we have done. This carries with it great advantages. But it does give us a growing problem of presentation. After a period of some years, there is a need for a shot in the arm - a touch of imagination and freshness to help the explanation and to ensure that our policies continue to carry conviction.

After grappling with these problems as Chancellor over two years now, I have come firmly to the conclusion that joining the exchange rate mechanism of the EMS would deal with both the issue of substance and the issue of presentation, and is the only practicable means of doing so. The exchange rate is more readily comprehensible than monetary targets, and we are already relying on it to a major extent as an indicator. To join the EMS would reinforce the discipline and commitment inherent in the MTFS - and be seen to do so. The interested public seem ready for it.

Industry certainly is. We should respond to a general yearning for a greater degree of exchange rate stability. And we could give policy the new impetus we need to carry us up to the election and beyond.

The public stance of the Government has consistently been that sterling would join the Exchange Rate Mechanism (ERM) when the time was right. Answering Dr Owen on 31 January this year in the House of Commons, the Prime Minister said:

> "We have always said that we shall join the exchange rate mechanism of the EMS when we believe that the time is appropriate. It is kept under review from time to time, but I must make one thing clear. Joining the EMS would not obviate increases in interest rates, it would not obviate the need for financial discipline and, indeed, it might increase it."

I am convinced that the time is now right. The economy is strong, inflation is coming down and the exchange rate is not under threat. Over the past three years now (see Chart 1) the sterling/deutschemark exchange rate has bobbed about within a range of broadly DM3.60 to DM4.00 to the £: we are now in the lower half of that range at a little over DM3.70, and we should take the opportunity to join at around this rate. On the other hand, if we defer a decision much longer we will simply run out of time: we clearly could not join too close to the election and I have in any case to recast the presentation of policy fundamentally between now and the Budget following the patching up job I did at the Mansion House. I believe we should seize the initiative and join now.

Of course, there are risks. But the balance of argument is now very different from what it was two or three years ago. We are not now in a state of general crisis with Europe over our Budgetary contribution. We do not have an inflation rate that is out of line with the EMS countries in general. The petrocurrency problem - the tendency of sterling, alone among European currencies to move in line with the price of oil - is a shadow if its former self (see Chart II). And the main currency concern - the dollar, and to some extent the yen - is one that we share with the other EMS currencies.

The main risk that remains is one that will be with us indefinitely: that sterling will be subject to excessive fluctuations because of the openness of our markets and the fact that ours is such a widely-held currency: the plain fact is that if a bout of exchange rate pressure were to arise on this account we should be bound in practice to adjust our interest rates accordingly, whether or not we were in the EMS - as the experience of this January clearly showed.

We must recognise this reality. If interest rates are going to change anyway in response to the exchange rate we should be foolhardy to forego the advantages of an explicit exchange rate policy which, through its effect on expectations, will have a beneficial long term influence on interest rates. And the only possible explicit policy we could have is to join the ERM.

The state of affairs I have just decribed is, indeed, likely to become progressively more pronounced. Now that we are disabled from steering by £M3 (although of course we continue to watch it closely) and are obliged to place greater weight on the exchange rate, markets will increasingly come to wonder why it is that we are <u>not</u> joining the EMS. And the only conclusion they can reach - aided and abetted by periodic moans from industry - is that we may wish to see the exchange rate lower, if not now, then before too long. Thus the gap between the level of interest rates needed to maintain the sterling parity within the EMS, and the higher level of interest rates needed to maintain roughly the same parity outside the EMS, already evident today, will steadily widen.

The reference to industry deserves some elaboration. We all know that our most intractable economic problem apart from unemployment itself (and with which indeed it is closely linked) is the persistent tendency of British industry to allow its labour costs per unit of output to rise faster than its competitors' do. This can be resolved only in one of two ways: a falling exchange rate to accommodate inordinately rising costs, or industry controlling its costs better. Industry is far more likely to buckle down to the latter, which is the infinitely preferable course, if it knows that the former has been rendered unlikely by virtue of our joining the exchange rate mechanism of the EMS - a step, incidentally, which (for reasons of exchange rate stability) they themselves have called for.

There is, however, one further risk, which cannot be left out. Whether or not we are in the EMS, it must be quite likely that the outcome of the next General Election will not seem a foregone conclusion in advance, and thus that there will, before polling day, be a precautionary flight from sterling which could well be of considerable dimensions. In or out of the EMS, we will wish to turn this to our political advantage, by pointing out that if the mere prospect of a Labour Government causes such alarm, it is not difficult to imagine how much worse the reality would be. But in or out of the EMS, this would still leave us with a nasty financial crisis to handle.

In my judgement it would be marginally easier to handle if we were inside, rather than outside, the EMS. This is because inside the EMS, the flight would be likely to arise at a much later stage (and thus last much less long) and could be pinned much more convincingly on the political threat rather than being seen as a lack of confidence in our own economic management. Indeed, if we <u>were</u> in the EMS at the time, we would almost certainly wish to take temporary leave of absence to deal with what would clearly be a temporary <u>political</u> phenomenon.

But well before then we would, if we were to join the EMS now, have established our fundamental credibility as a member of the system. Indeed, for the reasons set out in the earlier parts of the paper, I am forced to the conclusion that <u>not</u> to join now would be a historic missed opportunity in the conduct of economic policy which we would before very long come bitterly to regret.

One last point. My judgement that the advantages of joining now outweigh the risks is shared not only by the Governor of the Bank of England, but also by senior officials in both the Treasury and the Bank. They all believe that it makes operational sense to join and that they can now deliver our policy objectives more effectively in the EMS than if we remain outside it.

N.L.
11 November 1985

ANNEX

History and Mechanics of the EMS

The European Monetary System (EMS) was set up following a Franco-German initiative at the European Council in April 1978, the detail being finally approved at the European Council in December. The objective of the system was the establishment of a "zone of monetary stability in Europe". The agreement included the creation of a new currency unit, the European Currency Unit (ECU). The importance of convergence of economic policies for the success of such a system was emphasised.

2. All the then nine members of the Community were members of the system, but the United Kingdom decided not to participate in the Exchange Rate Mechanism (ERM). However, Britain participates in all aspects of the EMS other than the exchange rate mechanism: 20 per cent of our gold and dollar reserves are deposited with the European Monetary Co-operatin Fund (EMCF) for which we in exchange are credited with ECUs; there is a sterling component in the ECU and the UK plays a full part in all Community discussions about the development of the system.

3. The ERM is the heart of the system. Countries participating in it agree to fix a set of central cross rates between each pair of currencies (known as the "parity grid"). Members are then committed to maintain their market exchange rates against other ERM currencies within a band 2¼ per cent either side of the agreed central rates (except for the Lira which for the time being is kept within a ± 6 per cent margin). It is assumed that the UK would enter the system with the 2¼ per cent margin.

4. Action to maintain ERM currencies within the agreed bands usually takes the form of:-

- Intervention in the exchange markets. (This is compulsory at the outer limits of the band, but discretionary when "intra-marginal")

- Changes in domestic interest rates

- Some combination of the two.

Members may also seek a currency realignment - usually only done if intervention and interest rate changes are judged unlikely to suffice to maintain the parity. Intervention may either be in dollars or in the participating currencies (subject to certain limits for intra-marginal intervention). There are substantial short-term credit facilities available for financing intervention, but these have been used relatively sparingly.

5. The system has enjoyed greater stability than many expected at the outset. There were several significant realignments notably in the period October 1981 to March 1983; including three devaluations of the French franc. But there has been no general realignment since March 1983 - this July's change was confined to the Italian lira.

6. Following the March 1983 realignment the ERM withstood a see-saw movement in the deutschemark-dollar rate in 1984 from DM2.5 to DM3.2 without unmanageable difficulties, though the French, Italians and Belgians each had to intervene to the tune of over $1 billion in February 1984. During 1985 the deutschemark has strengthened against the dollar by about 25 per cent, from a low of 3.47 to 2.60, without any significant strain on the mechanism. This includes the period since the G5 agreement of 22 September in which the DM has risen by 7½ per cent against the dollar.

7. The stability of the ERM since March 1983 reflects greater convergence between ERM countries following the strong French measures of March 1983 to tighten fiscal and monetary policies and the sharp (and continuing) fall in both French and Italian inflation rates.

HM TREASURY
11 November 1985

CHART I: MOVEMENTS IN STERLING AGAINST DM

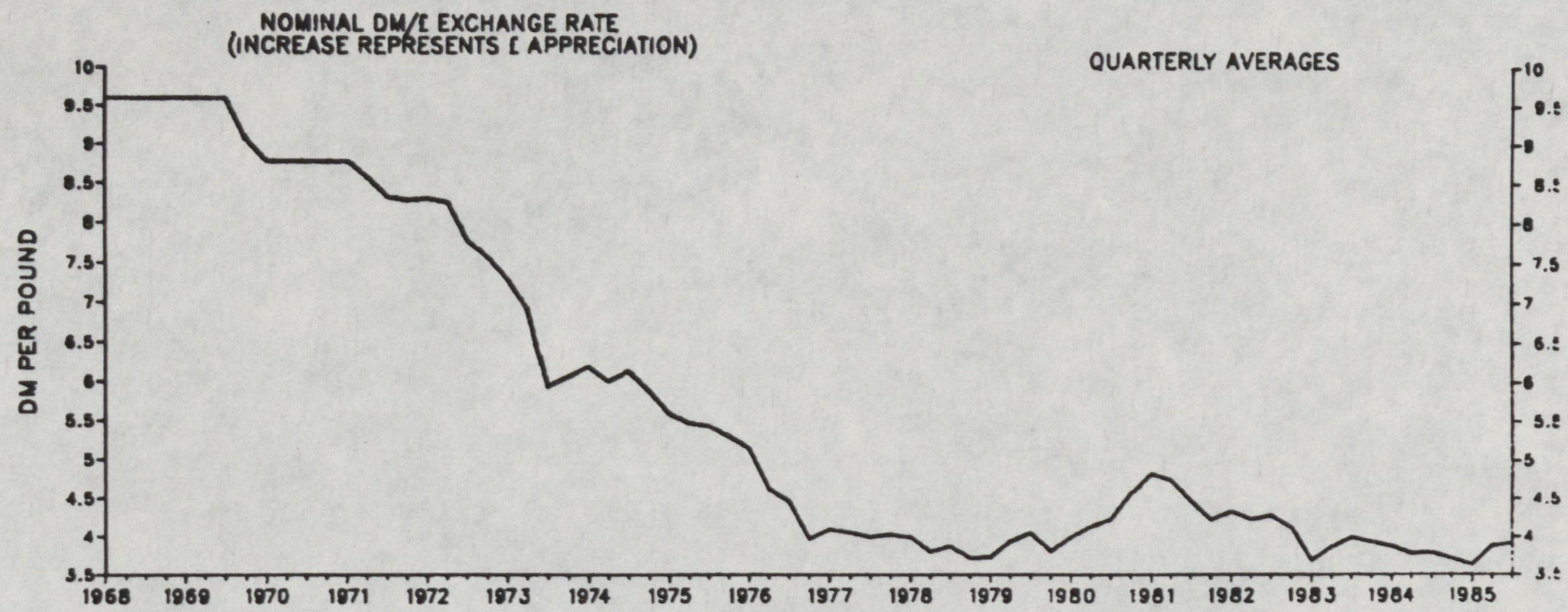

CHART II: OIL PRICES AND THE EXCHANGE RATE