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SUBJECT

CC MASTER

NOTE FOR THE RECORD

MEMBERSHIP OF THE EXCHANGE RATE MECHANISM OF THE E M S

The Prime Minister yesterday held a meeting to discuss whether the UK should become a member of the E R M. Present were the Chancellor, the Foreign Secretary, the Governor of the Bank of England, the Lord President, the Lord Privy Seal, the Chancellor of the Duchy, the Chief Whip, the Secretary of State for Trade and Industry, Sir Peter Middleton, Sir Terence Burns, Mr Eddie George and Professor Brian Griffiths.

Introducing the discussion, the Chancellor said he had given considerable thought to the proposal that the UK should now join. The belief that outside the E R M the UK would have greater freedom than inside, was, to a large extent, illusory: the Government never had complete freedom of action in the real world. Its economic policy depended critically on confidence in the market and that confidence could be greater if the Government had made the commitment to the E R M. The Chancellor recognised that, if the UK joined and there were substantial pressure on sterling during the run up to an election, the UK would have to take leave of absence from the system. But it could well be easier to manage pressure on sterling in those circumstances if the UK had shown its commitment by joining the E R M.

In a discussion of the possible political problems of persuading Government supporters on the merits of joining, the Chancellor of the Duchy gave his view that, if the Government decided to go in, any political problems could be overcome. The likely support from some back-benchers who were otherwise critical of the Government's economic policy might prove to be very helpful. The Lord Privy Seal was more doubtful and also argued that it would be wrong for the Government to tie its hands by making a commitment of this kind to its European partners.

The Secretary of State for Trade and Industry said he had in the past always been opposed to joining, in the belief that

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that membership would be de-stabilising. He had now concluded that it would be right to join, both because the fragility of present monetary policies had been displayed and because there was now a much weaker connection between movements in oil prices and the exchange rate.

The Prime Minister argued strongly against joining for two reasons. First, the UK had very low reserves by comparison with other members of the system and it also had more open capital markets than any other except Germany. Pressure on sterling would feed straight through to interest rate decisions in a mechanical way, leaving the Government no discretion. Secondly, for the UK to pull out of a system in advance of an election would, whatever the Government said, be taken as an indication that it lacked faith in its own economic policies. The important factors for maintaining confidence in Government policies were firm control of public expenditure and public borrowing. The Government must maintain some freedom of manoeuvre and should not tie itself to exchange rates within a rigid grid.

The Foreign Secretary acknowledged the political hazards. However, the M T F S had been crucial in creating confidence and giving long-term credibility to the Government's policies. However, everyone had now lost confidence in sterling M3 as a monetary indicator. The Chancellor's and Governor's Mansion House speeches had been masterly in making bricks without straw. The hazards to interest rates were now greater outside the E R M than inside it. He also took note that the Government's main economic advisers had now changed their minds and were in favour of joining.

The Governor pointed to the difficulties of explaining policies in the present circumstances. The Government had to say that it looked at the exchange rate in judging economic policy but this was inevitably followed by the question, what level for the exchange rate the Government had in mind as being acceptable. There was no answer to that. The Prime



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Minister suggested that this was an inadequate formulation of the question. The speed of movement of the exchange rate as well as its level had to be a factor.

The Lord President expressed confidence in the judgement of the Chancellor and the Governor. If they felt the time was right to join, their views needed to be given full weight.

The Chief Whip was surprised that there had been so little call for the UK to join the E R M since the Mansion House speeches had been made. It seemed likely that the calls for the UK to join would increase with the passage of time.

The Chancellor saw a distinct possibility that the UK might be forced to take a decision to join at some later date in much more difficult circumstances. The Lord President also saw difficulties in a situation in which the Government decided not to go in despite a growing belief that it should have decided in favour.

The Prime Minister, bringing the discussion to a close, said she had not been convinced by the arguments in favour of joining. She agreed, however, that it would be right to maintain rigidly the line which had been taken so far, that the UK would join when the time was right. As for the conduct of economic policy, it was all the more important now to maintain strict adherence to the public expenditure totals.

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