36A ELM PARK ROAD
LONDON SW3 6AX

Telephone: 01-352 9360

MS

PRIVATE & CONFIDENTIAL

21st October, 1986

The Rt. Hon. Margaret Thatcher, M.P.,
10, Downing Street,
Whitehall,
London, S.W.1.

Prime Minister
Michael Butler asked me to give you this on a personal basis. He does not expect a reply. CDP 21/10.

Dear Prime Minister,

I would like, if you permit, to put a few thoughts to you about the E.M.S. I do so because I believe that, for the first time since 1979, the moment is not far off when it would be both good economics and good politics to join the exchange rate mechanism. You have obviously been giving the question a lot of thought already. So please forgive me if I say nothing new to you. I write now in order to suggest that you avoid saying anything which would close off the option before the election.

You were, of course, right not to join at DM 3.70 or 3.40 to the pound. We could not have held the parity and we needed to get down to at least DM 3.00 from the point of view of export-led growth and import substitution. The risk, however, now is that the pound will overshoot downwards and threaten your achievements on inflation unless our interest rates are absurdly high. Stability at something like the present parity for the last year of your present Government and the first one or two years of your next ought on the other hand to produce a major increase in exports, a decline in imports of consumer goods and, therefore, still bigger growth in C.D.P.

Over the last year I have spent a lot of time trying to persuade people in the City and elsewhere that you were also right to see an election trap in joining the E.R.M. You clearly still need to be careful not to join at a time or a parity which would make it impossible to avoid a realignment conference of Finance Minsters before the election. But the lower the pound sinks and the nearer the election gets, the less the risk seems to be. At a

/certain

certain level and only a few months before an election the markets would not believe that we could be knocked off a recently established central rate which was low objectively in relation to import and export prices. At the very worst, much less action would be required to defend it.

My colleagues at Hambros, who have a good record at judging the money and gilts markets, take the view quite strongly that joining the E.R.M. at around or below the present parity would be accepted by the foreign exchange markets in general and the speculators in particular, as a signal to leave the pound alone. Stability at DM 2.75 or 2.80 might be credible up to the election even if we joined quite soon. They also consider that gilts would strengthen considerably. Money supply considerations permitting, interest rates could be 1% or even 2% lower, perhaps even more as confidence in our holding the rate grew.

If you were to decide to join, it would be very desirable that it should appear to the markets as a decision taken because you judged the time ripe and not because of speculative pressures. This would not only make the operation politically easier at home but would strengthen its credibility abroad. It would also be essential that the markets should get no prior warning or the pound would shoot up before the parity could be fixed. So the operation would admittedly be a bit tricky. But I do believe it would be a sound move to make during the next few months. My guess is that it would have the incidental advantage of opening up the divisions in the Labour Party on the subject of Europe which they are trying so hard at present to hide.

If you were to find the thesis in this letter persuasive, the timing would depend both on your private thoughts about when the election will be and on developments in the markets. Nobody but you could have a feel for when the time might be ripe.

If there were any points in this letter which you wanted to discuss, I should, of course, be at your disposal. And I should like to repeat what I said when I came to say good-bye on leaving Brussels - that I am very much on your side and would like to help in any way I can.

Yours ever

Michael Butler

MDB/MML

EL3BLW

PRIVATE AND CONFIDENTIAL

file

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

22 October 1986

I showed your letter to the Prime Minister. She has read it closely and - judging by the amount of underlining - with interest. She has not commented on the substance, which will not particularly surprise you. I am sure that she would like a talk at some point, but I fear that there is no immediate prospect of this. Let us be in touch nearer the end of the year.

CHARLES POWELL

Sir Michael Butler, G.C.M.G.

PRIVATE AND CONFIDENTIAL

The politics of the French franc/DM rate

Brendan Brown

So far, the Federal Republic of Germany's huge trade surplus — near DM80bn this year and rising, probably to DM90bn, next year — has created remarkably little strain in intra-EEC relations. The contrast with the years 1955-80 is striking. Then, large German trade surpluses led to a chorus of calls for the Federal Republic to revalue the DM and take other corrective measures. Why is history not repeating itself? Largely because of an unprecedented divergence of fiscal policy within the EEC — in particular, between France and the Federal Republic.

Why tolerate the strong DM?

The countries with the weaker trade performances and suffering most from German competition — for example, France, Italy and Belgium — are also those which are running large budget deficits (measured on the OECD basis of general government balances). Yet these deficits have not created substantial inflationary pressure, owing, in large part, to the readiness of investors in the fiscally-tight countries to put funds into the high coupon bond markets of the fiscally-easy countries and the willingness of borrowers in the latter countries to raise finance in the fiscally-tight currencies. Whilst this international cycling of funds has proved effective in suppressing the normal inflationary symptoms of budget laxity, it has produced an unwelcome side-effect. Manufacturing industry in the fiscally-easy countries has been losing competitiveness as their national currencies have been buoyed up, at least in real terms, by capital inflows.

Unfortunately, it is not possible to suppress the side-effect without attacking the basic malaise of large budget deficits. Any measures to discourage the inflow of capital into the fiscally-easy countries would unleash the forces of inflation. Bond markets would slump under the weight of the full supply of government paper. In turn, the authorities would most probably resort to a partial monetisation of their budget deficits rather than accept a crisis rise in interest rates.

The phenomenon of capital being cycled from the fiscally-tight to the fiscally-easy countries within Europe is part of a wider pattern. At the world level, Japan, the Federal Republic and Switzerland are the source of capital to the easy fiscal policy countries — the USA, France, the UK, Italy, Australia and New Zealand, for example.

Table 1: General government financial balances

% of GDP	*1979*	*1981*	*1983*	*1985**	*1986**
USA	+0.6	−0.9	−4.1	−3.7	−3.8
Japan	−4.8	−4.0	−3.5	−1.4	−1.0
Germany	−2.7	−3.8	−2.8	−1.5	−1.5
France	−0.7	−1.8	−3.1	−3.2	−3.4
Italy	−9.5	−11.9	−12.4	−13.1	−13.1
UK	−3.2	−3.2	−3.5	−3.6	−4.1

Source: OECD and P&D estimates. *Forecasts.

International flow of funds

The force behind the flow of funds between the fiscally-tight and easy countries is differential interest rates. Bond yields and interest rates in the fiscally-easy countries (both in nominal and real terms) tend to be substantially higher than those in the fiscally-tight countries, not surprisingly, given that large public deficits must compete with other possible uses of private savings.

Yet there are many potential sources of disturbance to the flow. For example, some of the fiscally-easy countries may eventually opt for inflation and currency depreciation, particularly as foreign creditors would bear part of the cost. Maybe investors in the fiscally-tight countries will have growing doubts about the wisdom of soft currency investment, belatedly recalling the cautionary tales of the 1970s, when investment in the low coupon and low interest currencies proved to be the winner.

Both within Europe and at a world level, there has been a dramatic increase in fiscal divergence between countries in recent years (see Tables 1 and 2). In the period 1981-85, budget deficits (defined as general government balances according to OECD practice) of the Federal Republic and Japan, measured relative to net private savings, have halved, whilst the same ratio for the USA has almost quadrupled and for France doubled. The Federal Republic and Japan may be ranked as fiscally-tight countries (budget deficits less than 20 per cent of private savings), whilst the UK, France and the USA are ranked as fiscally-easy countries (the same ratio

Table 2: Budget deficit as % of private savings

	1979	*1981*	*1983*	*1985**
USA	−9.3	14.9	69.0	52
Japan	29.8	26.5	28.2	12
Germany	27.8	47.6	33.6	18
France	6.7	23.5	45.5	50
Italy	51.4	74.4	85.4	87
UK	34.7	43.2	41.9	42

Source: OECD and P&D estimates. *Forecasts.
Note: Included in net private savings are households' and business gross savings less capital consumption.

more than 40 per cent of private savings).

Within Europe, the most striking increase in fiscal divergence has been between the Federal Republic and France. The years in which this divergence grew, 1981-85, can usefully be divided into two sub-periods, 1981 to spring 1983 and spring 1983 to the present.

In the first sub-period, the fiscal boost given to the French economy by the incoming Mitterrand Administration was the main force behind the diverging trend. Despite record high interest rates and bond yields in France, foreign capital was not attracted, principally because markets were concerned that government policies would produce even larger current account and budget deficits and an eventual inflation storm. In addition, there was the phenomenon of domestic capital flight.

In the second sub-period, from spring 1983, growing Franco-German fiscal divergence has been due principally to a tightening of budgetary policy in the Federal Republic, undertaken by the CSU/CDU/FDP Government. Meanwhile, following the March 1983 EMS realignment, the French Government committed itself to financial orthodoxy, and investors' fears about runaway deficits and inflation in France subsided.

French franc strength, 1983-85

The French franc has been remarkably firm against the DM during this second sub-period, sustained by the high real interest rates which are the product of relatively easy fiscal policy and by the conversion of the Mitterrand Administration to austerity. At end-September 1985, the French franc was 4 per cent higher in real terms (using CPI indices as deflators) against the DM than on average during 1978-82 and 9 per cent higher than in 1973-77. If the franc had been outside the EMS, it would have floated up against the DM over the past two years. Instead, there has been persistent intervention by the Banque de France to hold the French franc down against the DM.

The strength of the French franc has persisted despite the big deterioration of France's trade performance, relative to the Federal Republic's, over the past two years. Whereas the German trade surplus has increased from DM50bn in 1984 to an estimated DM80bn in 1985, France's trade is at best expected to be in deficit by Ffr20bn, down from Ffr28bn in 1984. German export volume growth of 8 per cent and 9 per cent in 1985 and 1986 respectively, contrasts with French growth of 2.6 per cent and 3.2 per cent.

At the same time as France has been underperforming the Federal Republic by an increasingly wide margin in trade, French interest rates and bond yields, underpinned by easy fiscal policy, have increased in attractiveness. For example, Euro-French franc bond yields (for 5-7 year maturities) still average above 10.5 per cent pa, compared with just over 6.5 per cent for equivalent DM paper. The nominal yield differential of 4.0 points compares with a forecast inflation differential between France and the Federal Republic in 1986 of 2.5 points.

Might fiscal divergence increase?

There is little chance of fiscal policy in France being tightened ahead of the Presidential elections — expected to be held two years beyond the legislative elections of March 1986. At best (from the viewpoint of a fiscal conservative), the Government that emerges in spring 1986 will continue the present policy of holding the budget deficit at around 3.3 per cent of GDP, albeit allowing for some slippage into off-budget accounts.

One scenario in which the budget deficit may increase significantly further in 1986-87 is that of landslide gains for the RPR (Gaullists). A coalition government of the RPR-UDF, having an absolute majority in the Assembly, and in which the RPR was the dominant party, would probably then be formed. Such a government might well embark on a programme of substantial tax cuts, in principle balanced by expenditure cuts and the sale proceeds

of denationalisation (see article on pages 19-21). But asset sales only produce quasi-revenue, and expenditure cuts may not reach the planned level. Thus, the budget deficit, on OECD definitions, could expand substantially.

An easing of fiscal policy, provided it is accompanied by a credibly firm monetary policy (to which end the Banque de France has recently reformed its operating procedures, moving, for example, to an M3R from an M2R target) has political attractions in the run-up to the Presidential elections. It is the method of reflation least likely to bring immediate downward pressure on the franc. Moreover, by sustaining high yields in the French capital market, it facilitates the abolition of exchange restrictions, an important part of the RPR programme. Once lifted, French investors might still not show a great interest in foreign bond markets, where yields are lower than in the high-yielding domestic bond markets.

Just as there is little prospect of a tightening of fiscal policy in France in the next two years, so the chances are slim of an easing of fiscal policy in the Federal Republic. The members of the Bonn coalition are presently discussing details of a common programme for cutting taxes by DM40bn over the next legislative period (1987-91). Their intention, however, is to balance these by cuts in industrial subsidies and by keeping a tight rein on state spending. In short, there is little prospect of fiscal convergence between France and the Federal Republic before the French Presidential elections.

French resistance to cheap DM

A scenario of no fiscal convergence between France and the Federal Republic would not be encouraging for French manufacturing industry, as the franc would most likely remain firm against the DM over the medium term. Already, the strong franc (in real terms) is taking its toll. According to recent INSEE estimates, France is suffering a serious erosion of market share. France's exports have grown this year at a rate 2 per cent below the expansion of its customers' total imports. In turn, the disappointing export performance has had a bearing on manufacturing investment. The growth of spending by manufacturing industry (in the competitive sector) on machinery and equipment has slowed to 6 per cent this year from 8 per cent in 1984. By contrast, in the Federal Republic, the same item is growing by 14 per cent this year, up from 2 per cent in 1984.

Such statistics suggest that the combination of easy fiscal and tight monetary policy is threatening French manufacturing industry in the same way as Reaganomics eventually threatened US industry. In the USA, Japanese imports became the scapegoat for policy failure. In France, the scapegoat may turn out to be imports from the 'cheap' currency countries, in particular, the Federal Republic. But France cannot feasibly follow the US-Japan precedent and threaten its largest trading partner, the Federal Republic, with protection unless it adopts a more expansionary fiscal policy. Alternatively, France might (behind the scenes) push for a big revaluation of the DM within the EMS (say, by 8 to 10 per cent), perhaps offering, in return, concessions on the EEC agricultural policy. But the scope for bargaining exchange rates against agricultural subsidies is now much less than at the start of the EMS. The Kohl Government would hardly welcome a French offer of co-operation towards reforming the agricultural policy with the January 1987 elections looming, in which the farmers' vote might be crucial.

A large unilateral revaluation of the DM could seriously damage German economic prospects. On the assumption of an unchanged degree of fiscal divergence and of France continuing to adhere to a conservative monetary policy, the revaluation would bring in its wake a large increase of capital outflows from the Federal Republic. Investors would realise that the next currency realignment would be far into the future and see even greater attraction in the high yielding bond markets of the fiscally-easy countries. In turn, the German economy would be hit by the double blow of higher interest rates and a stronger mark.

Gaullist nostalgia

Perhaps an RPR Government would decide to bring new life to French industry by a Gaullist-type devaluation, moving the French franc down 10 per cent, say, against the other EMS currencies and so liquidating five years of socialism. Again, it is difficult to see that the other EMS countries would acquiesce in such a competitive devaluation. In 1981 and early 1983, France's suggested devaluation had

to be reduced considerably in the face of strong opposition. In effect, a Gaullist-type devaluation would require France, at least temporarily, to withdraw from the exchange rate mechanism of the EMS.

In effect, given the probable decision to make no change in fiscal policy, the French Government has little scope for independent action in currency policy. At most, there will be a small change of emphasis. Probably, through 1986, monetary policy will become slightly more expansionary, with short-term rates coming down to 7.5 per cent whilst a 4-5 per cent realignment of the French franc against the DM is agreed within EMS. The French trade balance in manufactures would worsen further but there would be relief in the fall in energy prices, so, overall, the current account might be in small surplus. The economy would grow at around 1.5 per cent, up from 1 per cent, led by stronger consumer spending, reflecting the rise in real disposable incomes, helped, in turn, by the firm franc policy.

The SPD, Greens and M Barre

On this 'central case', investment in franc deposits and bonds would prove rewarding through 1986. The outlook beyond turns crucially on the outcome of the German elections in January 1987 and the French presidential elections of spring 1988.

In the event of the present coalition Government in Bonn losing its absolute majority in the January 1987 elections, a new fillip would be given to capital outflows from the Federal Republic. The prospect of a minority SPD Government, dependent on the toleration of the Greens, would undermine confidence in the DM, not least because of fears about a neutralist drift in the Federal Republic's foreign policy. The French franc would gain new strength vis-à-vis the DM, thus postponing the onset of the difficult mature stage that eventually follows in the wake of a move to an easy fiscal policy.

How would France react to further weakness of the DM, due this time to political causes in the Federal Republic rather than to divergence of fiscal policy? If fiscal policy were left unchanged, there would be a further erosion of competitiveness for French export industry. The dilemma could only be resolved by an early cut in French interest rates, matched by a tightening on the fiscal front.

For fiscal consolidationists, in particular for M Barre, the above circumstance would be ideal (from an economic, not security, viewpoint) for achieving the long-term reduction in budget deficits. Otherwise, fiscal consolidation would have to be accompanied by real depreciation of the franc which might have unwelcome inflationary side-effects. If M Barre were elected President he would probably embark on a programme gradually reducing the budget deficit through time. In order to prevent economic recovery being threatened by this fiscal retrenchment, there would have to be offsetting falls in interest rates. Normally, these would go along with some tendency of the franc to weaken — unless there were, meanwhile, an offsetting 'autonomous' rise in the demand for French investments — as in the case of the Kohl Government being defeated.

The combination of M Barre as President of France and an SPD minority government coming to power in Bonn would provide the jackpot to holders of French franc bonds. For French industry, however, the combination of a gradual depreciation of the franc alongside a fiscal tightening, would be kinder. Even then, the present holder of franc bonds could keep significant gains.

The next EMS realignment

In sum, a major change in French fiscal policy is improbable ahead of the 1988 presidential elections. In the interim, a modest realignment of the Ffr/DM rate is expected to be agreed during the next year, probably involving a 5 per cent reduction of the French franc's bands against the DM within the EMS. The actual move down of the French franc would be less during 1986 than the lowering of its bands, as the franc would start trading at its new ceiling after the realignment. A 3-4 per cent devaluation of the franc during 1986 is already more than discounted in present interest rate differentials between Euro-Ffr and Euro-DM deposits. The most likely date for the formal realignment is in spring or summer 1986 — in the wake of a shift towards lower interest rates in France after the elections. Alternatively — albeit of lower probability — the Federal Republic may unilaterally (together with the Netherlands) revalue the DM by, say, 5 per cent against the other currencies, as soon as the Christmas holidays, hoping thereby to avoid an inflow of 'hot' money ahead of the French elections which would complicate domestic monetary management.