

*PW Norcross*  
*1*  
*CC/BA*

● PRIME MINISTER

EMS

There is a widespread expectation that we shall become full members of the EMS after the election. It will be a priority for the Chancellor. You will want to give early thought to the merits and handling of this decision.

The Chancellor's position

The Chancellor will undoubtedly argue as before that:

- (i) full membership would provide an anchor for Government economic policy, and give assurance that policy will continue to be operated responsibly and prudently;
- (ii) the obligations of membership would be understood by management and workforce alike, and would influence pay and price expectations; *Doubtful*
- (iii) the result of these first two factors would be lower interest rates on average; *or higher if, under pressure*
- (iv) a more stable exchange rate would help business.

He will probably also say that the grounds for opposing full membership are now weaker than they were in autumn 1985 when this was last discussed:

- (v) the oil factor is much less important because the exchange rate has already adjusted to a sharp fall in oil prices;
- (vi) our foreign exchange reserves are in a healthy state;  
*We haven't picked up enough this month to meet obligations*

*nd*

(vii) other European countries, including particularly France and to a lesser extent Italy, have removed many of their exchange controls; many *introduced*

(viii) the election is out of the way, so there need be no fear of pre-election sterling jitters;

(ix) the Government is already committed to holding the exchange rate at about its present level and in recent months has done so very successfully.

A further possible argument is that there is a widespread expectation that the UK will now become a full member. To disappoint it could lead to a movement out of sterling. To join now would in contrast show conviction in the new strength of the British economy.

#### Arguments against membership

Lower oil prices, higher reserves, lower exchange controls )  
in other countries and the passage of the election all ease  
the way to full membership. But they do not affect the  
major objections:

(i) full membership would reduce flexibility, causing the entire weight of exchange rate pressures (in either direction) to be taken on the reserves and interest rates; less volatility in the exchange rate is likely to mean greater volatility of interest rates; *yes*

(ii) the influence of EMS membership on pay bargainers is likely to be slight; with cost pressures higher here than in Germany and less scope for exchange rate depreciation the strain would be taken sooner or later in higher unemployment;

---

(iii) the entry of sterling into EMS could well substantially change its character, both because of the size of our financial markets, and the continuing importance of oil;

(iv) EMS membership would cede to other countries, particularly Germany, a major role in Britain's economic policy; this would be in some ways a sign of weakness, not strength, and the process of EMS realignments is itself messy and undignified.

The relative stability of the exchange rate in recent months is an argument which works both ways: if we can achieve stability outside the EMS, why do we need to join?

#### Next steps

The Chancellor is likely to press for an early discussion and decision, and the markets and many financial commentators more than half expect it. The handling of the decision needs careful thought, to achieve the outcome you want with minimum difficulty.

You will want first to decide your own position. If you are now in the last resort prepared to accept full membership the procedure could be reasonably straightforward: a meeting with the Chancellor, the Governor, the Foreign Secretary and Lord Whitelaw to settle the principle and perhaps one or two more technical matters (e.g. whether sterling's central rate should be the market rate or below it), followed by a week-end meeting of EMS members.

If you remain adamantly opposed to full membership - and the fundamental arguments have not changed - a meeting of colleagues could well prove exceptionally difficult. The position of those who argued in favour of membership in autumn

1985 is likely if anything to have hardened since then. You could again find yourself isolated.

Avoiding a meeting would require you to be prepared to tell the Chancellor that you remain opposed to full membership, and that you are not prepared to hold a meeting to discuss the possibility. You will want to consider whether that would be a sustainable position, in view of the support the Chancellor would receive from the Foreign Secretary and possibly others also.

If you decide to hold a meeting you will want those attending to know your own views in advance.

The Chancellor could raise this question at your first bilateral next week (not yet fixed). You may like to have a word about it beforehand. *Yes mt*

*D.R.*

(D.R. NORGROVE)

10 June 1987