5

PRIME MINISTER

EMS

You will want to discuss your position on the EMS with the Lord President: he will have the key role in this.

I suggest you tell him that you remain firmly opposed to membership and that your position will not be shaken by the Chancellor, the Foreign Secretary and the Governor. You will be willing to discuss the EMS with the Chancellor but you see no point in another large meeting involving a wider group of colleagues. The Chancellor should be discouraged from expecting one. Anything which the Lord President can do to reduce the Chancellor's expectations would be helpful.

In explaining your opposition to the membership of the EMS I recommend you not to emphasise the size of UK reserves or the fact that there are capital controls in France and Italy. The strength of these objections is gradually falling over time and a major liberalisation by France in particular could be announced at a time in future which might undermine your case. Indeed arguably the weaker the capital controls within Europe, the greater the risk of de-stabilising capital flows.

I suggest that the main arguments against membership are as follows:

(i) the Government should not rely on an external discipline as the basis of its economic policy. Policy should be based on self-restraint;

(ii) membership could well prove de-stabilising; investors and companies would be unable to predict how the Government would react to severe exchange rate pressure and there would be greater volatility of interest rates;

(iii) with the core rate of cost growth in the UK higher than that in Germany, there is likely to be a gradual erosion of competitiveness; to tie ourselves to Germany would cause output and employment to take the strain;

(iv) the exchange rate should not be the subject of haggling in Brussels;

(v) the behaviour of the EMS with a major addition like sterling, with large and open financial markets, cannot be predicted with confidence.

I attach the record of your meeting with Sir Alan Walters.

D.R.N.
20 July 1987

PMMADD

4

PRIME MINISTER

EMS

The Chancellor has in the last few weeks from time to time pressed me about the best way from his point of view of taking forward discussions on the EMS. I have discouraged him from approaching you directly or through the Lord President at this stage. But he will undoubtedly return to this in the autumn, if not in the next week or two, and you might like to take half an hour to talk this through. There may be a gap after E(EP).

In this context you might like to look at the papers enclosed in the folder which I have gathered over the past few weeks. The note on capital controls is based on a paper of November 1986, so it is somewhat out of date.

DRN

(DAVID NORGROVE)

14 July 1987

3

pa EMS.

SECRET

Estimated level of currency reserves

	$ billion	Equivalent in numbers of weeks imports
Japan	61	24½
Germany	55	14
France	35	13½
Italy	21	10 =
UK	23	9 =
Netherlands	11	7
Canada	4	2½
US	17	2

SECRET

pa EMS.

LIBERALISATION OF CAPITAL MOVEMENTS: RESTRICTIONS IMPOSED BY MEMBER STATES

1. Community legislation on liberalisation of capital movements, to implement Article 67 of the Treaty is enshrined in the 1960 capital movements Directive, as amended by Directives of 1962, 1985 (accompanyiny the Directive on UCITS) and 1986 (implemented 28 February 1987).

2. For liberalisation purposes, Community legislation divides transactions as follows:

(a) those subject to unconditional liberalisation, (unless covered by a specific derogation);
(b) those in effect subject to voluntary liberalisation. This includes a category of transactions which member states are supposed to liberalise unless liberalisation could be an obstacle to their economic policy objectives, and a category for which there are no liberalisation obligations.

3. In broad terms, unconditional liberalisation (2(a)) applies to direct investments, new issues of securities, most operations in securities, investment in real estate, commercial credits (where residents participate), and most personal capital movements. The main transactions to which voluntary liberalisation (2(b)) applies relate to short term capital eg Treasury bills and bank deposits.

4. Information on individual member states is given below. This is taken largely from a Commission paper of November 1986 prepared for the Monetary Committee.

GREECE

5. On 2(a) above, Greece currently has a derogation under Article 108(3) of the Treaty of Rome, agreed as part of the Community Loan package in November 1985 to help Greece with balance of payments problems. The derogation covers direct investments, investments in real estate, and some personal capital movements (which may be made subject to prior authorisation), and some operations in securities (which may be prohibited or made subject to prior authorisation). It is intended to last until November 1988.

6. Greece also maintains some restrictions on transactions under 2(b) involving in some cases prohibition and in others need for authorisation.

7. Greece is likely to be cautious about full liberalisation, stressing the need for step by step progress depending on other factors such as convergence and supporting the availability of safeguard provisions and support facilities. At the November 1986 ECOFIN, when the 1986 Directive was adopted, Greece made a statement for the Council minutes stressing the dangers of free movement of capital for the weaker economies and currencies, and the need for better co-ordination of economic policies.

SPAIN

8. On 2(a), Spain has a derogation under the Accession Treaty, covering direct investment, investments in real estate, and some operations in securities. This derogation lasts until 1988 - 1990 (depending on the type of transaction). Further, Spain does not have to implement the 1986 Directive until 1989 - 1990 (depending on the type of transaction).

9. Spain also maintains some restrictions on transactions under 2(b) mainly involving need for authorisation.

10. Spain seems to be moderately enthusiastic about liberalisation. According to the Commission's November paper, some of Spain's recent liberalisation measures on portfolio investment have gone beyond those necessary to comply with the Accesssion Treaty. At the October ECOFIN, when it was tacitly agreed that Spain and Portugal could delay implementation of the 1986 Directive, Solchage said that for Spain this delay was not a matter of practice but of principle.

FRANCE

11. On 2(a), France's balance of payments derogation under Article 108(3) of the Treaty of Rome was rescinded by the Commission in June 1986. This was made possible because of liberalisation measures taken at the end of 1985 (in respect of direct investments) and in May 1986 (notably in respect of acquisition of foreign securities - the ending of the devise titre system, immovable investments abroad, and certain personal capital movements).

12. France still maintains some restrictions on transactions under 2(b) mainly involving need for authorisation or use of approved intermediaries. According to the Commission's November paper, France has, during 1986, taken measures towards liberalised exchange controls in respect of some commercial and financial operations of enterprises, and some transactions by residents. French residents, though, remain unable to hold foreign currency bank deposits.

13. Thus France is at the moment fairly enthusiastic about liberalisation. However discussion in the Monetary Committee suggests that they would want to move gradually (with the next stage perhaps full liberalisation for companies) and with the possibility of safeguard provisions.

IRELAND

14. On 2(a), Ireland still has a balance of payments derogation under Article 108(3) of the Treaty of Rome, covering some operations in securities, to last until end 1987.

15. On 2(b), Ireland also maintains some restrictions on transactions under 2(b) involving mainly need for authorisation (which for some transactions may only be given in certain circumstances).

16. Like Greece, Ireland is likely to be fairly cautious about full liberalisation.

ITALY

17. On 2(a), Italy still has a balance of payments derogation under Article 108(3) of the Treaty of Rome, to last till end 1987. In broad terms, this derogation permits the imposition of non interest bearing bank deposits for residents investment in real estate abroad (15%), and for acquisition of foreign securities (15%). The Commission have recently tightened up this derogation (the deposit percentages used to be somewhat higher) in line with Italian moves to relax some of their restrictions on capital movements.

18. On 2(b), Italy still maintains some restrictions on transactions including some prohibitions as well as requirements for authorisation.

19. Despite their recent moves towards it, Italy is likely to be cautious about full liberalisation of capital movements. At the November ECOFIN when the 1986 Directive was adopted, Italy made a statement for the Council minutes, about the possible destabilising effects of free capital movements on the EMS, and on the need for co-ordination of economic policies and policies on financial markets and instruments, and for measures to help with balance of payments and other problems which might arise.

PORTUGAL

20. Portugal has a derogation under the Accession Treaty, covering direct investment, investment in real estate, personal capital movements over a certain amount , and some operations in securities. These provisions last until up till 1992 (depending on the type of transaction). Further, Portugal does not have to implement the 1986 Directive until 1990 - 1992 (depending on the type of transaction).

21. Portugal also maintains some restrictions on transactions under 2(b) mainly involving need for authorisation.

22. Portugal may also be fairly cautious about full liberalisation.

OTHER MEMBER STATES

23. None of the other member states has a derogation of any sort on transactions under 2(a). Nor on the whole do they maintain restrictions under 2(b), although:

(a) according to the Commission's November paper, Denmark still has prior authorisation provisions on some transactions. However, Denmark is regarded as being substantially liberalised.
(b) Germany still has restrictions on certain transactions in ecus. (At the last informal ECOFIN, Stoltenberg said that Germany would consider full recognition of the private ecu if there was progress on liberalisation of capital movements, but nothing concrete has happened on this.)
(c) Belgium operates a dual exchange market, which separates purchases and sales of currencies for investment purposes from commercial flows. The 1986 Directive has in principle tightened up on this: for all transactions subject to

unconditional liberalisation, the exchange rates applied "must not show any appreciable and lasting differences from those ruling for payments relating to current transactions".

23. All these countries are likely to support moves towards full liberalisation. Belgium is likely to be the most cautious of the group: when the new initiative was discussed at ECOFIN in June 1986, Eyskens mentioned the difficulties which full liberalisation would cause for some member states, and linked it with completion of the EMS.

SECRET

2

Ch (pub poor)
Meeting on this?
AA
(PEM bilateral?)

From : D L C Peretz
Date : 7 July 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr C W Kelly

Yes. r.

EMS

You asked whether there are any changes in the working of the ERM that we should be seeking; and if so whether there is anything on which we could make common cause with the French. Sir G Littler, Mr Kelly and I have discussed this, and pooled our ideas.

Background

2. As you know, the Monetary Committee of the EC (on which Sir G Littler represents the Treasury) has been looking at a series of ideas for "strengthening" the operation of the ERM, with some background work carried out in the "Alternates Committee" (on which I have been representing the Treasury). Tietmeyer gave an interim progress report at the last ECOFIN; and the exercise is due to be completed in time to report to the September ECOFIN.

3. The French contribution to these discussions has at times been a little unfocused, starting with an 11 page memorandum of proposals for change (tabled in February with some press publicity), which was however subsequently presented in the Monetary Committee as just some "ideas put forward for discussion". It has, however, become reasonably clear what changes the French would like to see, and what the national line up on these is. What is less clear is what changes if any they might (as has been suggested) be expecting us to want to see before joining the ERM.

4. Our own assumption hitherto has been that if we were to join we would join the system as it stands. We think that should remain the assumption. Although one or two ideas for change have

emerged in the course of the Monetary Committee review to which we would probably want to give mild support, there is nothing that we would see as of sufficient importance to want to insist on before joining.

<u>French Ideas</u>

5. The original French paper contained the following :-

a) some rather vague ideas about a more co-ordinated European contribution to the G5/G7 moves towards more stable exchange rates, with regular discussions by EC Finance Ministers and Governors of the dollar and yen. This is a traditional French preoccupation.

b) better ERM realignment procedures.

c) various proposals for improving the technical working of the ERM :-

i) rethinking the divergence indicator;

ii) greater mutual surveillance of monetary and economic policies in EMS countries;

iii) increasing resources available for intervention within the ERM, in particular by :-

- making the very short-term financing facility (VSTFF) available to finance intra-marginal intervention as well as marginal intervention.

- merging the two longer-term financing facilities (that is the MTFA and CLM); and possibly increasing the effective total available.

Monetary Committee Discussions

6. Tietmeyer's report for the 15 June ECOFIN (copy attached for reference) gave the then state of play. There has since been further discussion at the Monetary Committee; and a further meeting of the Alternates Committee. In making the UK contribution to these discussions we have had very much in mind what our interests would be were we to be full members of the ERM.

7. There is a reasonable list of changes in the way the ERM works in practice that we would (or in some cases would not) like to see, some of which, I suspect, would in any case be given a new impetus were sterling to become a full member :

i) better prepared, conducted and less public realignment procedures. Everyone is in favour of that. The question is how to make it happen in practice.

ii) greater readiness to use short-term interest rate differentials alongside intervention in exchange rate management. As exchange controls are dismantled and capital flows increase this will become more important for existing ERM countries (as it is already for the Dutch). We have always assumed that is how we would need to operate within the ERM. It does, of course, require better co-ordination of domestic monetary and other policies between ERM countries. This strand of thought has got pretty widespread support in recent discussions, and indeed the Monetary Committee has now instituted regular discussions of interest rate and monetary policies in member countries.

iii) greater readiness to use movements of exchange rates within the margins to keep speculators guessing. Again there is a reasonable consensus on this.

iv) abolition of capital controls within the Community. This is, of course, agreed in principle. But there are still plenty of arguments to come about the extent to which there should be safeguard clauses to allow reimposition of controls (and the conditions in which they can be triggered); and the extent to which capital liberalisation should be matched by an increase in EMS medium-term financing facilities, to help the weaker members through the transition.

v) no new revamped role for the Divergence Indicator. This was originally constructed to give a signal of when pressures are building up within the system and which are the divergent currencies whose authorities might reasonably be expected to do something about it.. But in reality the signal can be any combination of exchange rate movement within the permitted bands, interest rate movements, or intervention. So the divergence indicator actually performs <u>no</u> useful function : there seems to be a fair consensus on this too.

vi) an acceptance that on occasion intra-marginal intervention makes sense, and should to some degree qualify for financing under the very short financing facility (the VSTFF). The Germans and Dutch have so far been opposed to this.

shouldn't we go much further?

vii) a removal of any artificial inhibitions there may be on cross holdings of Community currencies in national reserves. Again there is a certain amount of German and Dutch resistance to this.

vi) and vii) are both issues on which we might to some degree be able to ally ourselves with the French - though on both they want to go further than we would.

<u>Intra-marginal Intervention</u>

8. Our position is a pragmatic one. We accept that it will sometimes make tactical sense to try to prevent the exchange rate reaching the margin, and to use intra-marginal intervention for the purpose; just as on other occasions the right approach would be to let the rate move towards the margin fairly quickly. The German attitude to this is coloured by the monetary problems

caused for them by intervention that involves selling DM. Making access to DM borrowing under the VSTFF available for intra-marginal intervention (as it is, automatically, for intervention at the margin) would they think simply add to these monetary problems. To some degree we should share this German worry. Sterling could on occasion be the strong currency within the system, and we might find large scale sterling drawings by, for example, the Irish creating problems of domestic UK monetary management. On the other hand we deal with such problems rather better, technically, than does the Bundesbank. On balance we would I think support access to the VSTFF for intra-marginal intervention, but within some kind of limits. Or perhaps on terms that make it slightly less attractive to the borrower than drawings to finance marginal intervention : for example VSTFF drawings for intra-marginal intervention might have to be settled entirely in the currency of borrowing, rather than up to 50% in ecu as is the present rule for intervention at the margin (this too is under review).

Cross Holdings of Each Others' Currencies

9. Again our position is a pragmatic one. Greater cross holdings of currencies seem likely to be make for smoother intervention operations in some circumstances. This is true in the wider international context, as well as in the ERM. Consider, for example, the problems the Bundesbank had recently in acquiring the yen it needed to sell in a concerted intervention operation.

10. Moreover, with sterling in the ERM it would seem pretty likely that the Irish would want to hold significant sterling balances (as they have in the past) : and we would probably want to let them do so. The present rules limit cross holdings to working balances, except with explicit permission of the other central bank. The Germans and Dutch would like to remain pretty restrictive on this. The French on the other hand seem to have in mind some kind of idea of a "political" initiative to promote cross holdings - no doubt they see this as a way to lend some support to the weaker ERM currencies.

11. We certainly would not want to be forced to hold currencies in our own reserves where that served no practical purpose, or where we thought they represented a poor investment. But we might go some way to meet the French, by supporting a move to a more permissive regime : allowing cross holdings to develop naturally where that seemed sensible to the central banks concerned.

Italian 6% Band

12. If sterling joined the ERM on the narrow margins, that would almost certainly add to pressures on the Italians to move to a narrow margin too. The 6% band is, we know, a source of some irritation to their partners. We would no doubt be happy to support any pressure on the Italians in such circumstances (though it could lead to a bumpier ride for the ERM as a whole).

Conclusion

13. In short, there are two areas currently under discussion in the Monetary Committee where we might be able to make some kind of common cause with the French : intra-marginal intervention and cross holdings of Community currencies. In neither case would we want to go as far as the French, though. Nor would we actually attach any great importance to either. Indeed we cannot think of any change in the operation of the ERM that we would want to <u>insist</u> on before joining.

14. Finally, I should say that we have had it in mind for some time that Chris Kelly and I might pay a short visit to France, of the kind that Joe Grice and I paid to Germany in May. (In France we would aim to spend more time with the Tresor and less with the Central Bank). Sir G Littler will speak to Lebegue about this later this week. If we could arrange the visit fairly soon it might provide an opportunity to get a little closer to the French ~~Ministry~~ thinking on these issues, and to explore how far our interests coincide.

DLCP

D L C PERETZ

Attachment to Brief B

ALL MEMBERS OF THE MONETARY COMMITTEE

THERE FOLLOWS THE TEXT APPROVED BY MR TIETMEYER WHICH HE INTENDS TO DELIVER TO THE ECOFIN ON JUNE 15. SINCE THIS IS A STRICLY ORAL STATEMENT NO WRITTEN TEXT WILL BE DELIVERED TO THE COUNCIL IN ADVANCE. SHOULD YOU HAVE A FUNDAMENTAL RESERVATION THERE IS A POSSIBILITY OF CONTACTING THE SECTETARY BY TELEPHONE UNTIL NOON ON THURSDAY 11 JUNE.

A. KEES
COMEU B

STRENGTHENING THE EMS
- STATE OF DISCUSSIONS AND WORK IN THE MONETARY COMMITTEE
ORAL REPORT BY THE CHAIRMAN
TO THE ECO/FIN MEETING OF 15 JUNE

FOLLOWING THE REQUEST EXPRESSED BY THE FINANCE MINISTERS AT THEIR INFORMAL MEETING AT KNOKKE, THIS REPORT, WHICH IS PRESENTED BY THE CHAIRMAN ON HIS OWN RESPONSIBILITY, GIVES AN OVER-VIEW OF THE PROGRESS MADE BY THE COMMITTEE IN ITS WORK ON THE STRENGTHENING OF THE EMS. AS ALREADY MENTIONED AT KNOKKE, THE SUGGESTIONS IN THE FRENCH MEMORANDUM AND IN OTHER WRITTEN CONTRIBUTIONS HAVE BEEN TAKEN INTO ACCOUNT. THE SECOND PART INDICATES THE DIRECTION BEING TAKEN BY WORK ON A NUMBER OF OPEN QUESTIONS. THE COMMITTEE WILL DEAL WITH THESE AT ITS NEXT THREE MEETINGS AND INTENDS TO PRESENT SOME OF THE SOLUTIONS WHICH MIGHT BE ENVISAGED TO MINISTERS AT THEIR INFORMAL MEETING IN SEPTEMBER.

I. PROGRESS AND NEW APPROACHES

COOPERATION IN INTEREST RATE POLICIES

1. FOR WELL OVER A YEAR, THE EMS HAS BEEN CHARACTERIZED BY INCREASING CONVERGENCE OF FUNDAMENTAL FACTORS, WHILE CAPITAL WAS BECOMING MORE MOBILE AND SOME MEMBER COUNTRIES WERE RELAXING THEIR EXCHANGE CONTROLS. AT THE SAME TIME THE TENDENCY TO USE INDIRECT INSTRUMENTS IN THE EXECUTION OF MONETARY POLICY BECAME GENERALLY STRONGER. IN THESE CIRCUMSTANCES THE STABILITY OF EXCHANGE RATES IN THE EMS HAS FOR SOME TIME BEEN HEAVILY DEPENDENT ON THE DEVELOPMENT OF INTEREST RATES AND OF INTEREST RATE POLICIES. FURTHER, THIS IS ALSO TRUE AT PRESENT OF EXCHANGE RATES AGAINST THE US DOLLAR.

2. IN THE OPINION OF THE MONETARY COMMITTEE, SINCE PRICE AND COST DEVELOPMENTS IN PARTICULAR CONTINUE TO DIFFER, EMS CENTRAL RATES CAN BE KEPT STABLE ONLY IF APPROPRIATE INTEREST RATE DIFFERENTIALS ARE MAINTAINED. WHEREAS PREVIOUSLY THE POLICY DEBATE OFTEN FOCUSED EXCLUSIVELY ON A GENERAL REDUCTION OF INTEREST RATES, THE PRIME CONCERN AT PRESENT, IF EXCHANGE RATE STABILITY IS TO BE RESPECTED, MUST, IN THE VIEW OF THE MONETARY COMMITTEE, BE TO ENSURE THAT THE DIFFERENCES BETWEEN THE INTEREST RATES OF EMS COUNTRIES ARE ADEQUATE, NOT LEAST IN ORDER TO MAKE THE EMS SECURE AGAINST EXTERNAL INFLUENCES. INTEREST RATE POLICY, HOWEVER, CANNOT BE CONDUCTED WITHOUT TAKING DUE ACCOUNT OF THE CENTRAL OBJECTIVES OF MONETARY POLICY. IN PARTICULAR THE ACHIEVEMENT OF STABILITY OF THE DOMESTIC PURCHASING POWER OF CURRENCIES ON A LASTING BASIS. IT MUST BE INTEGRATED INTO A GENERAL POLICY WHICH SEEKS THE CONVERGENCE OF FUNDAMENTAL ECONOMIC FACTORS.

3. WHILE SCRUPULOUSLY RESPECTING THE ALLOCATION OF RESPONSIBILITIES IN THE INDIVIDUAL COUNTRIES. THE MONETARY COMMITTEE HAS MADE NEW ARRANGEMENTS WHEREBY IT STUDIES

CAREFULLY THE MOST RECENT EXCHANGE AND INTEREST RATE DEVELOPMENTS AT EACH MONTHLY MEETING AND DISCUSSES SUCH CONCLUSIONS AS CAN BE DRAWN FOR OFFICIAL ACTION. THESE DETAILED DISCUSSIONS MAY MAKE AN IMPORTANT CONTRIBUTION IN THE FUTURE TO CLOSER COOPERATION IN THIS AREA.

THE FULL USE OF THE FLUCTUATION MARGINS

4. LASTING STABILITY OF INTRA-EMS EXCHANGE RATES CAN ALSO BE MADE MORE PROBABLE IF MONETARY AUTHORITIES MAKE MORE FLEXIBLE USE OF THE FULL FLUCTUATION MARGINS OF THE EMS THAN THEY DID IN THE PAST.

THE OBJETIVE OF THE FULL USE OF THE BAND MUST BE TO ENSURE THAT SPECULATION IS A TWO-WAY RISK. IT MUST BE MADE CLEAR THAT THE AUTHORITIES WHOSE CURRENCIES HAVE MOVED IN ONE DIRECTION WITHIN THE BAND ARE WILLING TO ACCEPT THAT THEIR CURRENCIES SUBSEQUENTLY MOVE IN THE REVERSE DIRECTION. THIS APPROACH WILL BE ALL THE MORE EFFECTIVE BECAUSE THE IMPROVEMENT OF FUNDAMENTAL FACTORS IMPLIES THAT FUTURE REALIGNMENTS SHOULD BE SMALLER THAN THE MARGIN OF MANOEUVRE AVAILABLE WITHIN THE BAND. THEY WILL THEREFORE NOT GENERALLY RESULT IN IMMEDIATE CHANGES IN THE MARKET VALUES OF CURRENCIES. BY USING THE FULL EMS BAND IN THESE WAYS. THE AUTHORITIES CAN, IN TIMES OF HIGH CAPITAL MOBILITY, GIVE THE MARKETS A CLEAR INDICATION THAT SPECULATION IS A MATTER OF HIGH AND IMPONDERABLE RISK. ON THIS QUESTION ALSO THE COMMITTEE WAS ABLE TO IDENTIFY A GROWING AREA OF CONSENSUS AS WELL AS CHANGES IN OFFICIAL PRACTICE.

EXCHANGE RATE POLICY TOWARDS THE USA AND JAPAN

5. THE LOUVRE AGREEMENT, WHICH MADE WIDER INTERNATIONAL MONETARY ARRANGEMENTS AT THE TIME MORE CONCRETE, ALSO HAS IMPLICATIONS FOR ALL EMS COUNTRIES. THE MONETARY COMMITTEE

THEREFORE REGULARLY REVIEWS THE DEVELOPMENT AND THE CONSEQUENCES OF THESE ARRANGEMENTS IN THE LIGHT OF THE DEVELOPING STANCE OF ECONOMIC POLICY. AT ITS MAY MEETING, THE COMMITTEE COULD NOT BUT TAKE NOTE THAT THE US DOLLAR HAS HAD TO BE SUPPORTED IN RECENT MONTHS BY HEAVY INTERVENTION WHICH IN TOTAL ACTUALLY EXCEEDED THE US CURRENT ACCOUNT DEFICIT. A SUBSTANTIAL PART OF THIS INTERVENTION WAS UNDERTAKEN BY A NUMBER OF CENTRAL BANKS WHO WISHED TO REPLENISH THEIR RESERVES AND IT IS DIFFICULT TO KNOW FOR HOW LONG THEY WILL CONTINUE TO WISH TO DO SO. THIS INCREASES THE IMPORTANCE OF THE RISE WHICH HAS SINCE OCCURRED IN THE INTEREST RATE DIFFERENTIAL BETWEEN THE USA AND THE EMS COUNTRIES. THIS RISE MAY BE EXPECTED TO HAVE A SIGNIFICANT EFFECT ON AUTONOMOUS CAPITAL FLOWS TO THE DOLLAR AREA AND THUS ON THE CONTINUED STABILITY OF THE EXCHANGE RATE OF THE US DOLLAR.

~~SU~~RVEILLANCE ON THE BASIS OF MACRO-ECONOMIC INDICATORS

6. TENSIONS WITHIN THE EMS CAN BE COUNTERED MORE EFFECTIVELY IF THERE IS A MORE EFFECTIVE MEDIUM-TERM COORDINATION OF THE COURSE OF ECONOMIC POLICY, AND IF INCOMPATIBILITIES ARE REVEALED AT AN EARLIER STAGE. THE MONETARY COMMITTEE IS OF THE OPINION THAT THIS IS NOT TO BE ACHIEVED BY A RIGID PROCEDURE, BUT ONLY THROUGH THE PRACTICAL ASSESSMENT OF THE MACROECONOMIC INDICATORS RELEVANT IN EACH SITUATION. THE COMMITTEE WILL HOLD THE FIRST OF ITS TWICE-YEARLY EXAMINATIONS OF THE COMPATIBILITY OF THE INDICATORS IN JULY, ON THE BASIS OF SUPPORTING DOCUMENTATION FROM COMMISSION STAFF.

II. THE DIRECTION TAKEN BY CURRENT WORK

7. BEYOND THIS PROGRESS AND THESE NEW APPROACHES IN THAT COORDINATION OF ECONOMIC POLICY WHICH IS OF DECISIVE IMPORTANCE TO THE EMS, THERE REMAINS A NUMBER OF QUESTIONS WHICH FOR THE MOST PART CONCERN FEATURES OF THE EMS MECHANISM. DISCUSSION OF THESE SUBJECTS IS STILL DEVELOPING AND WILL NOT PERMIT DEFINITIVE JUDGEMENTS TO BE MADE UNTIL SEPTEMBER. FURTHER, SOME OF THESE MATTERS COME EXCLUSIVELY UNDER THE AGREEMENT BETWEEN CENTRAL BANKS. THE MONETARY COMMITTEE WILL NEVERTHELESS ENDEAVOUR, IN THE THREE MEETINGS WHICH IT WILL HOLD BEFORE THE NEXT INFORMAL MEETING OF FINANCE MINISTERS, TO DEVELOP, SO FAR AS MAY BE POSSIBLE, CONCRETE PROPOSALS AND SUGGESTIONS FOR THEIR RESOLUTION.

THE DIVERGENCE INDICATOR AND THE QUESTION OF A CONVERGENCE INDICATOR

8. THE DIVERGENCE INDICATOR WAS REVIEWED IN THE INTERIM REPORT AT KNOKKE. AS REQUESTED BY MINISTERS, THE COMMITTEE IS NOW UNDERTAKING SOME ADDITIONAL TECHNICAL ANALYSIS AND IS STUDYING, WITH THE AID OF SIMULATIONS, SOME SLIGHTLY DIFFERENT DEFINITIONS OF THE INDICATOR, AND THE POSSIBLE ADOPTION OF A LOWER DIVERGENCE THRESHOLD. HOWEVER, EVEN IF CERTAIN TECHNICAL MODIFICATIONS ARE ADOPTED, THE DIVERGENCE INDICATOR SHOULD BE REGARDED AS A USEFUL BUT NOT AS A PRIVILEGED SOURCE OF INFORMATION. THERE WILL ALSO BE FURTHER STUDY OF THE POSSIBILITY OF ESTABLISHING A CONVERGENCE INDICATOR, BUT THERE ARE SUBSTANTIAL DOUBTS AS TO WHETHER IT WILL BE POSSIBLE TO CONSTRUCT A USEFUL SINGLE INDICATOR FOR THIS PURPOSE. CONVERGENCE CAN BE ASSESSED BETTER IN THE CONTEXT OF THE MACROECONOMIC INDICATORS, PARTICULARLY AS THE MORE COMPREHENSIVE NATURE OF SUCH AN EXERCISE GUARANTEES THE NECESSARY DEGREE OF FLEXIBILITY.

THE FINANCING OF INTRA-MARGINAL INTERVENTION WND THE REMOVAL OF THE ECU ACCEPTANCE LIMIT.

9. THE CENTRAL QUESTIONS HERE ARE WHETHER THE VERY SHORT TERM CREDIT FACILITY CAN BE MADE AVAILABLE FOR FINANCING INTRA-MARGINAL INTERVENTION., AND THE RELATED ONE OF THE ACCEPTANCE LIMIT FOR THE OFFICIAL ECU.

ON THE ONE HAND, IN THE VIEW OF SOME MEMBERS THE VERY WIDESPREAD USE OF THIS TYPE OF INTERVENTION IN RECENT YEARS MIGHT MAKE IT SEEM REASONABLE TO TREAT INTRA-MARGINAL INTERVENTION ON A PAR WITH OBLIGATORY INTERVENTION AS FAR AS ITS FINANCING IS CONCERNED. SUCH A DEVELOPMENT WOULD NOT, IN THEIR VIEW, NECESSARILY INVOLVE EITHER AN INCREASE OF THE TOTAL AMOUNT OF ALL INTERVENTION OR A WEAKENING OF THE DISCIPLINARY EFFECT OF THE EMS.

ON THE OTHER SIDE, IT WAS ARGUED IN THE COMMITTEE THAT STEPS IN THIS DIRECTION WOULD REPRESENT A DAMAGING SHIFT OF THE FUNDAMENTAL RELATIONSHIP BETWEEN THE ADJUSTMENT AND THE FINANCING OF DEFICITS, AND THUS OF THE SYSTEM'S CHECKS AND BALANCES. FURTHER, THE PRACTICE OF PARTNER CENTRAL BANKS IN GIVING THEIR CONSENT WOULD PROBABLY BECOME MORE HESITANT IN THESE CIRCUMSTANCES, AND MIGHT ACTUALLY RESULT IN A REDUCTION OF THE VOLUME OF INTRA-MARGINAL INTERVENTION.

ON THE OTHER HAND THERE ARE SIGNS THAT IT WILL BE POSSIBLE TO REACH A MEASURE OF AGREEMENT ON CHANGES TO THE ECU ACCEPTANCE LIMIT.

10. OTHER POINTS, SUCH AS THE HOLDING OF EMS CURRENCIES IN OFFICIAL RESERVES, AN INCREASE OF THE FECOM SWAPS AND THE QUESTION OF AN EXTENSION OF THE ECU MOBILIZATION MECHANISM ARE AT PRESENT STILL AT THE EXAMINATION STAGE. THE COMMITTEE HOPES THAT IT WILL BE ABLE TO STATE ITS VIEW ON THESE QUESTIONS IN SEPTEMBER.

THE EMS AND THE FULL FREEDOM OF CAPITAL MOVEMENTS

11. THE FULL FREEDOM OF CAPITAL MOVEMENTS WILL HAVE IMPORTANT IMPLICATIONS FOR THE EMS. ON THE ONE HAND THE GREATER NEED TO ADJUST ECONOMIC POLICIES WILL HELP TO MAKE THE SYSTEM SECURE ON A LASTING BASIS. ON THE OTHER HAND, THE TRANSITION TO THE COMPLETE FREEDOM OF CAPITAL MOVEMENTS IS NOT WITHOUT RISK.

12. THE COMMITTEE BELIEVES THAT THE PROCESS OF LIBERALIZING CAPITAL MOVEMENTS WILL BE ACCELERATED BY THE PRESENTATION OF A DRAFT DIRECTIVE IN OCTOBER. SOME MEMBERS HAVE ARGUED THAT THE OPENING-UP PROCESS SHOULD BE SUPPORTED BY PRECAUTIONARY MEASURES. THE COMMITTEE'S DISCUSSIONS HAVE EXTENDED TO THE FOLLOWING FIELDS.

- THE PROCESS OF COMPLETING THE FREEDOM TO PROVIDE FINANCIAL SERVICES, IN THE CONTEXT OF THE ESTABLISHMENT OF THE SINGLE DOMESTIC EUROPEAN MARKET, WILL RAISE A NUMBER OF ISSUES CONCERNING THE SUPERVISION OF FINANCIAL INSTITUTIONS. THE COMMITTEE'S CONCERN IS TO IDENTIFY ISSUES TO WHICH IT IS ABSOLUTELY NECESSARY TO GIVE PRIORITY.

- SOME MEMBERS CONSIDER THAT FISCAL ARRANGEMENTS WILL HAVE TO BE ADAPTED IN SOME RESPECTS.

- WITH REGARD TO SAFEGUARD CLAUSES, SOME MEMBERS HAVE ARGUED THAT THE EXISTING CLAUSES (108, 109 AND 73) COULD NOT, AT THE TIME WHEN THE TREATY WAS NEGOTIATED, BE DRAWN IN A WAY WHICH IS APPROPRIATE TO THE MONETARY NEEDS OF A SITUATION IN WHICH CAPITAL FLOWS ARE GROWING RAPIDLY AND ARE EXTREMELY MOBILE. THESE MEMBERS ARGUE THAT THE DRAFT DIRECTIVE SHOULD INCLUDE AN ESCAPE CLAUSE WHICH WOULD ENABLE ACCOUNT TO BE TAKEN OF EXCEPTIONAL MONETARY DISTURBANCES. IN THIS CONNECTION THE COMMITTEE WILL CONSIDER WHETHER THE 1972 DIRECTIVE ON REGULATING INTERNATIONAL CAPITAL FLOWS NEEDS TO BE AMENDED.

- THE DETAILED REPORT TO MINISTERS IN SEPTEMBER WILL ALSO COVER THE QUESTION AS TO WHETHER, AND, IF SO, TO WHAT EXTENT, AMENDMENTS OF THE PRESENT MEDIUM TERM COMMUNITY CREDIT ARRANGEMENTS ARE NECESSARY FOR THE ACHIEVEMENT OF THE FULL FREEDOM OF CAPITAL MOVEMENTS.

RA3.89

SECRET

FROM: A C S ALLAN

DATE: 22 June 1987

MR KELLY

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Peretz
Ms Goodman

EMS

hm

In the light of the French interest in improving the working of the EMS, the Chancellor would be grateful for a quick note about what improvements <u>we</u> should be seeking. He feels it would be helpful if we could get a common front with the French; and now may be a good moment to secure such changes.

ACSA

A C S ALLAN

pa EMS.

SECRET & PERSONAL

JOINING THE EUROPEAN EXCHANGE RATE MECHANISM

This note reviews, in summary form, the arguments for and against joining the exchange rate mechanism of the EMS.

2. The main arguments in the past have been:-

(i) Membership of the ERM would reduce the Government's room for manoeuvre. With large and open capital markets and relatively small reserves we have recognised that it would put more strain on interest rates, which might have to move more sharply. There would be much less scope for taking part of the impact of external stocks in the exchange rate. Moreover linking sterling to the deutschemark might require a faster speed of adjustment towards German inflation rates.

(ii) The counterpoint to (i) is that membership of the ERM provides a clear external discipline for the operation of financial policy. Difficulties in interpreting monetary aggregates have led to uncertainties about the operation of policy which may in turn have added an "uncertainty premium" to the average level of interest rates needed to deliver a given inflation path.

(iii) Sterling is particularly vulnerable to external pressures; with its international status, large money and capital markets, absence of exchange controls. Petro-currency factors have added further to the currency's variability. Moreover the UK status as a net oil exporter means that if the price of oil moves substantially then some corresponding movement in sterling is both necessary and desirable. In some circumstances membership of the ERM might serve to reduce potential speculative pressures; but in other circumstances defending particular margins for sterling could be difficult, particularly against the DM which shares sterling's status as a major internationally traded currency.

(iv) The variability in sterling has been a factor affecting investor and industrial confidence. It may itself have added to the uncertainty premium on sterling interest rates. As to industrial confidence, although forward markets and other hedging devices can help reduce uncertainties, most firms are much more concerned about the impact of exchange rate variability than movements in interest rates. In 1980 the economy needed shock treatment, and a sharp rise in sterling helped deliver that. With inflation now much lower, and on a downward track, more weight can be given to the impact of exchange rate stability on industrial confidence.

(v) Sterling's membership of the ERM would be seen by many as an important step in the development of the EC. As time goes by it becomes harder to sustain the argument that we intend to join in due course, but not yet.

3. The balance of argument has shifted over the years, and is affected by recent developments:-

(a) The Government has successfully managed a move to a more complex exposition of policy, placing less emphasis on monetary targets, without losing the market's confidence. This has been achieved in large part by giving increased emphasis to the exchange rate in the operation of policy.

(b) G5 and G7 moves towards achieving a period of wider exchange rate stability (including the yen and dollar as well as European currencies) have affected the substance and presentation of policy. We have laid stress on the need for a period of stability in the exchange rate. And this has been widely interpreted - not without a little help from the authorities - as meaning stability primarily in relation to the DM rate. If we continue to operate, in effect, alongside the ERM within the G7 framework it may become increasingly difficult to explain to EC partners why we do not wish to join. And we deny ourselves some of the benefits of membership without any compensating advantages if we continue this approach to the exchange rate.

(c) There are a number of developments that suggest sterling might be less subject to speculative strains within the ERM in the future, than might have been the case in the past. First, the petro-currency factor is reduced with the 1986 fall in the oil price, and the prospect of greater stability in oil prices for the period ahead. Second, convergence between inflation rates in EC countries should mean that general strains within the ERM will be less than in the past. Third, the dismantling of exchange controls in other EC countries should reduce the degree to which any speculation within the ERM is likely to concentrate on the sterling-deutschemark rate. We were also particularly concerned about the prospect of joining when a period of pre-election market uncertainty was ahead of us. The market can now see the prospect of four or five years of settled Government policy ahead.

(d) The sharp rise in the level of the reserves during 1987 (they now stand at a level of $41.7 billion spot and forward) means we are much better placed than in the recent past to intervene to see us through periods of temporary pressure within the ERM.

(e) We shall in any case need to consider the way in which we have operated our monetary policy, and the implications for funding. Membership of the ERM would provide a much simpler basis for this.

4. In general the balance of arguments has shifted in favour of joining the ERM, with many of the difficulties seen in the past somewhat reduced. Whenever we join, some risks will remain; but with the election behind us these risks now look as low as they are ever likely to be. We are of course already gaining some of the benefits previously seen from ERM membership, from participation in the G7 arrangements to promote greater worldwide currency stability. By the same token a move to an explicit exchange rate target within the ERM is now a smaller step than it would have been in the past.

26/3070E

JOINING THE ERM : TIMING

This note discusses possible dates for joining the ERM over the next few months. It is assumed that there would need to be a full meeting of EC Finance Ministers, and that this would take place over a weekend, when the markets are closed. Apart from the constraints discussed below, timing could also be affected by a view about the correct rate at which to join (see separate paper); and it may be sensible to allow the markets some time to settle down after the election.

2. The main factors are as follows:-

(a) Parliament. We have assumed hitherto that Parliament should be in a position to debate a decision to join within a few days (normally not later than the following Tuesday). If we joined when Parliament was in recess it might be difficult to resist pressure for early recall . No proper business can be done before the Queen's Speech now scheduled for 25 June. The first week of the new Parliament is for swearing in etc. This rules out the weekend 13/14 June and effectively also 20/21 June - since we could not wait till Thursday or Friday to make a statement. There is likely to be an economic debate - in which the Chancellor will speak - on 31 June. It also rules out August, September and October up to 17/18. (It would in any event no doubt be difficult to arrange a meeting of EC Finance Ministers in August).

(b) Cabinet could be told of the decision on the Thursday preceding realignment. Given the risk of leaks this assumption may need further consideration. In any event it is not a real constraint since Cabinet always meets when Parliament is sitting except when the Prime Minister is away.

(c) On present thinking the Autumn Statement is likely to be in the first half of November. Last year it was on 7 November. Joining the ERM immediately after the AS looks unattractive because of the difficulties of explaining the change of course immediately after a major policy Statement. There might also be problems of inconsistency between the Industry Act Forecasts and the chosen ERM central rate. Joining the ERM on the weekend immediately before the AS has obvious presentational attractions and would provide the focal point of the AS itself. But the strains both on the Chancellor and on the Treasury machine in preparing for, and handling, both simultaneously - with the ERM decision known only to a handful of people - would be very considerable. The Chancellor would have to attend the EC Finance Ministers' meeting the weekend immediately preceeding the Autumn Statement. If we wanted to leave open the possibility of joining the ERM early in November, one possibility would be to decide fairly soon to have the Autumn Statement late this year - though there are public expenditure arguments against this.

(d) Privatisations raise implications for disclosure, if the decision were taken but not announced before publication of the prospectus or pathfinder. These are difficult for the layman to judge, and we would need legal advice. Moreover the timing of the announcement could well bear on the pricing of an issue. Any market uncertainty resulting from the announcement, and particularly any short term adverse effect, could make pricing an issue more difficult or, if the decision were during the offer period, jeopardise the response to the offered price. And, if it were around the time dealings started, there would be criticism if the opening price suffered.

The main dates for the BAA sale are pathfinder 22 June; Impact Day 8 July; offer closes 16 July; allocations announced 20 or 21 July; dealings start 28 or 29 July. This suggests that 27/28 June might be a possible weekend to join if it were thought that markets would have settled sufficiently before 8 July and there were no pathfinder/prospectus difficulties. But 4/5 July would be very close to Impact Day; and the remaining weekends in July either in the offer period or before dealings started.

The main dates for the BP sale are the following (or one week later): pathfinder 21 September; Impact Day 8 October; 21 October UK fixed price offer closes and international tender bids received; 23 October tender striking price fixed and dealings start (unless Stock Exchange insist that dealings cannot start until 3 November). On this timetable a decision on 24/25 October would be straight after dealings had started on 23 October. But 31 October/1 November could be before dealings started if the Stock Exchange are difficult on the timing. 7/8 November would be after dealings had opened on either assumption (unless the whole BP sale were one week later than assumed here).

Summary

3. So the prospects look like this:-

Weekends	Difficult because of:-	No difficulties
13/14 June	Parliament	
20/21 June	Parliament (?)	
27/28 June		No difficulty
4/ 5 July	BAA	
11/12 July	BAA	
18/19 July	BAA	
25/26 July	BAA(?)	
August- 17/18 October	Parliament	
24/25 October	BP (?)	
31/ 1 November	AS (?)	Probably OK if AS were delayed until mid November
7/8 November	AS (?)	OK if AS were delayed until late November.
14/15 November	AS (?)	

DMARK/STERLING EXCHANGE RATE AND THE ERM

This note considers the exchange rate at which it might be desirable for sterling to join the exchange rate mechanism of the EMS, if a choice were available. It does so in three ways:

(a) It considers the behaviour of the "real" DM/£ exchange rate over time;

(b) It looks at the exchange rate which, by implication, we have felt over the last year or so has been more or less appropriate for keeping monetary conditions on track for meeting the inflation objectives;

(c) It examines the exchange rate assumptions made in the Budget forecast, taking into account the balance of payments outlook and discusses subsequent changes in our views.

2. It is likely to be impossible to identify a single "appropriate" level at which sterling should join the ERM. But the above approaches may help to shed some light on the matter. They are discussed in turn. Most of the arguments point to a band no lower than one centred around DM3.00.

a. The Real Exchange Rate

3. Experience suggests that over long periods of time exchange rates tend to adjust in accordance with relative inflation rates. Consequently, although other factors affect exchange rate movements in the short and medium term, it is useful to consider the inflation-adjusted or "real" exchange rate. Chart IA shows the actual DM/£ exchange rate since 1970. Sterling's trend depreciation is not very surprising in the light of the faster inflation rates in

the UK as compared to Germany, shown in Chart IB. The implicit real exchange rate is then shown as in Chart IIA.

4. The question was last looked at in September 1985. Taking 1980 as equalling 100, sterling's real exchange rate against the mark then stood at 110, some 20 per cent above its average level of the last 17 years. The following factors were then thought to be relevant in assessing an appropriate rate for sterling to join the ERM:

(i) at that time, it would be natural for the real exchange rate against the mark to be somewhat above average because of the petro-currency premium which sterling enjoyed. This must be expected to persist for some time; it might, therefore, be unwise to attempt to reduce sterling's rate against the mark by the full 20 per cent needed to reduce the real rate to its average level;

(ii) the UK's inflation rate was still appreciably above the inflation rate in Germany. Again, this was likely to persist for some while. Over time, this meant that the mark must be expected to rise against sterling, pointing in the direction of joining sterling on the low side initially to counteract this effect;

(iii) against this, the very need to eliminate the gap between British and German inflation rates required a period when the real effective rate index was sufficiently high to maintain steady downward pressure on inflation (Chart IIIB displays the real effective rate index over time). The dollar was a complicating factor here. Although the dollar had begun to depreciate against the mark, its real exchange rate was some 40 per cent higher than the average of the last 17 years. Unless the dollar declined further, a "high" sterling rate against the mark was needed to give a satisfactory effective rate index from the point of view of monetary conditions.

5. These considerations pointed in different directions. But on balance the conclusion was that a parity against the mark perhaps 10 per cent lower than the market rate in September 1985 might be appropriate - with a central rate of somewhere between DM3.65 and DM3.75. This would provide continued anti-inflationary pressure and the chance of maintaining the parity for some time to come.

6. Since 1985, there have been material changes in the circumstances:

(a) the sharp fall in oil prices in the Spring of 1986 has reduced any petro-currency premium that attaches to sterling. Arguments for suggesting that the real exchange rate ought on this account to be above average are therefore weakened;

(b) there has been a general appreciation of the D-mark. The dollar's real exchange rate against it - in September 1985 some 40 per cent above average - is now 10 per cent or a little more below its historical average. Sterling's real exchange rate against the mark has fallen by around 25 per cent over the same period to stand about 5 per cent below its average.

7. One factor which has not changed, however, is the relative inflation rates in Germany and the United Kingdom: UK inflation remains about 4 per cent higher.

8. These considerations make it hard to argue for sterling joining the exchange rate mechanism at a rate much lower than the current prevailing rate. Further depreciation of sterling against the mark could lead to insufficent downward

pressure on money GDP.

9. On these grounds there might be a case for sterling joining the ERM at a slightly higher rate than the present market rate. The main argument against would rest on the continued adverse inflation differential compared to Germany. Since this must be expected to persist for some time, and the market recognises this, joining at a higher rate than the current market rate obviously increases the risk of its proving unsustainable, neccessitating an early realignment.

b. **The Rate appropriate for maintaining downward pressure on inflation**

10. The preceding discussion questioned whether joining the ERM at a rate below the present one would be sufficient to maintain adequate downward pressure on inflation. In principle, there can be no clear answer to this question. The exchange rate is only one of the factors which has to be taken into account in assessing monetary conditions. A low exchange rate could be offset so far as the overall stance of policy is concerned by higher domestic interest rates or by a more restrictive fiscal policy. Nevertheless, the exchange rate is of self-evident importance.

11. One way to explore the issue further is to examine the exchange rates which have obtained at the times of the monthly monetary assessments over the last year. Since these assessments record whether monetary conditions were considered satisfactory or otherwise, they are instructive in demonstrating what exchange rates have been judged to be appropriate.

12. Table 1 shows in summary form this information. Broadly speaking, the period since May 1986 falls into 3 parts:

(i) from May to July, there was some feeling that the exchange rate was probably higher than would

032-4553

Table 1

		Exchange Rates			
		ERI	£/$	£/DM	Monthly Monetary Assessment
1986	May	76.1	1.52	3.39	Lower exchange rate desirable on structural grounds. (Base rates fell ½ per cent, 27 May.)
	June	75.9	1.51	3.37	
	July	74.0	1.51	3.24	Exchange rate higher than expected given fall in oil prices
	August	71.4	1.49	3.07	Exchange rate broadly neutral on inflation at this level.
	September	70.4	1.47	3.00	Fall in exchange rate disturbing, given firmer oil prices.
	October	67.8	1.43	2.86	Higher interest rates required to offset exchange rate weakness. (Base rates rose ½ per cent, 14 October.)
	November	68.5	1.43	2.88	Monetary conditions remain loose. Case for a further rise in interest rates.
	December	68.5	1.44	2.86	No case for reducing interest rates unless, for example, exchange rate strengthens.
1987	January	68.9	1.51	2.80	
	February	69.0	1.53	2.78	Exchange rate stability on falling oil prices heartening. But no case for reducing interest rates, unless, for example, exchange rate strengthens further.
	March	71.9	1.59	2.92	(Base rates fell ½ per cent, 10 and 19 March.)
	April	73.2	1.66	2.98	(Base rates fell ½ per cent, 28 April.) Strength of exchange rate justified falls in interest rates.
	May 27	72.1	1.62	2.94	(Base rate fell ½ per cent, 8 May.)

be ideal; either it was placing too much downward pressure on inflation too quickly or that the pressure was occuring in an unbalanced way;

(ii) from August through to January, there was concern at, first, the rapid slide in sterling's effective rate index and then its stability at the lower level. It was felt that this required us to maintain the higher interest rates after October. At times a case was seen for further increases in interest rates to keep monetary conditions on track;

(iii) after February as the exchange rate began to firm, the prevailing view was that a gentle decline in interest rates could be countenanced without forcing monetary conditions off course.

13. There are many complications in interpreting monetary conditions and the level of the exchange rate. Other factors apart from interest rates - the fiscal stance, for example, and the position of the world economy - also have to be taken into account. Nevertheless the overriding impression from the monthly assessments is that we have been comfortable with an effective rate index between about 72 and 74. Lower rates than that have been felt to require higher interest rates to produce the required degree of downward pressure on inflation: higher exchange rates have been viewed as harmful to industrial confidence.

14. There has been no single sterling - mark exchange rate corresponding to this corridor for the effective rate index. As the mark has appreciated against most other currencies, a lower sterling exchange rate against the mark has been consistent with an unchanged effective rate index. But given the mark's current exchange rate against other currencies, maintaining sterling in an effective rate index band of 72-74 would imply an exchange rate against the mark of around DM 3.05 - 2.95. Should there be a further

substantial appreciation of the mark against the dollar, despite the Louvre Agreement, then a lower sterling/mark rate would be consistent with an ERI in this range. But the circumstances of dollar depreciation would have to be considered carefully. If it were to take place accompanied by renewed inflationary pressures in the world as a whole, then a higher sterling ERI might be required to maintain downward pressure on domestic inflation.

c. The Balance of Payments Outlook

15. A further factor bearing on the choice of rate at which sterling might join the ERM is the consequences for the balance of payments. Nearly a half of UK trade is with countries who are members of the ERM, a slightly higher proportion of imports and a lower proportion of exports.

16. At Budget time the current account balance was projected as in the following table. The table also shows the pattern of exchange rates with which these projections were taken to occur.

UK Current Account: FSBR Projections

		Current Surplus (£bn)	Exchange Rates		
			ERI	£/$	£/DM
1987	Q1	-0.8	69.6	1.54	2.78
	Q2	-0.6	70.5	1.57	2.79
	Q3	-0.5	70.5	1.57	2.78
	Q4	-0.8	70.5	1.57	2.77
1987		-2.7	70.3	1.56	2.78
1988		-1.5	69.3	1.62	2.67
1989		-0.4	67.3	1.69	2.52
1990		0.9	65.4	1.72	2.43

17. The current account position projected in the Budget forecast is not an unfavourable one. Whilst there is an assumed current account deficit of £2¾ billion in 1987 (about 0.7 per cent of GDP), this is projected to improve in successive years so that by 1990, there would be surplus of about £1 billion. Two factors underpin this predicted improvement:

(i) in 1987 demand in the UK is liable to grow more quickly than in trading partner countries, producing an appreciable deficit. But in later years, the reverse is the case leading to better trading performance;

(ii) the effects of improved UK competitiveness which became apparent in late 1985 and throughout 1986 increasingly work through to improved net exports, as time progresses.

18. But it should be noted that this satisfactory trade performance is predicated upon an exchange rate substantially below that which has occurred in 1987 to date. In the second quarter, for example, the effective rate index has so far been on average some three percentage points higher than

in the FSBR projections. The exchange rate against the mark has been about 6-7 per cent higher than assumed. Moreover, the FSBR projections incorporate a steady decline in both the effective rate and the rate against the mark after 1987. Clearly, other things being equal, a higher exchange rate must mean a poorer trade position.

19. On the other hand, there are some grounds for thinking that the current account position may remain in a satisfactory state, even with a higher exchange rate path than in the FSBR projections. In the first four months of 1987 imports have been markedly lower than anticipated. Though short run movements are always difficult to interpret, on balance the evidence suggests that the supply response of the economy may be turning out a little better than the Budget projection assumed. So the economy may be able to support a higher exchange rate without an unacceptable current account position.

20. The main conclusion to be drawn, perhaps, is that joining the ERM at rates close to current market rates would probably not give an unduly uncomfortable ride on the current account. Though such rates would be appreciably above those assumed in the FSBR projections, somewhat less favourable trade outcomes than that incorporated in the projections would presumably still be acceptable. Moreover, the basic trade performance may turn out to be better than then expected. But clearly joining the ERM at rates appreciably above those now in the market would increase the danger of a quite unacceptable current account position emerging.

Conclusion

21. There is likely to be no single correct answer to the question of the rate at which sterling should join the ERM. But the three sets of issues considered in this Annex point broadly in the same direction:

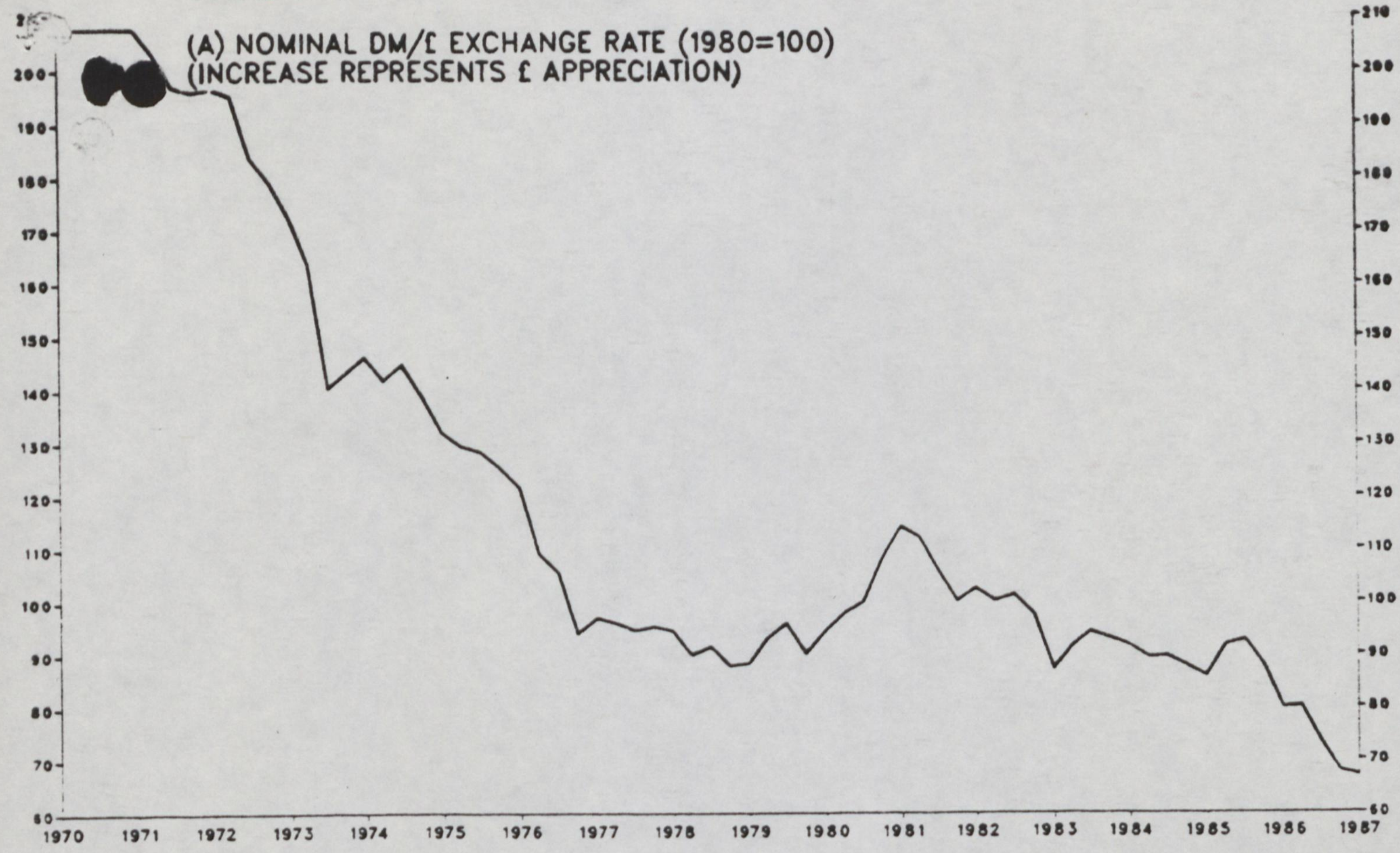
(i) the movements in both sterling's real effective rate index and the real rate against the mark, in relation to their historical averages, suggest that there it would be wrong to look for a substantially lower rate than current market rates for sterling to join the ERM.

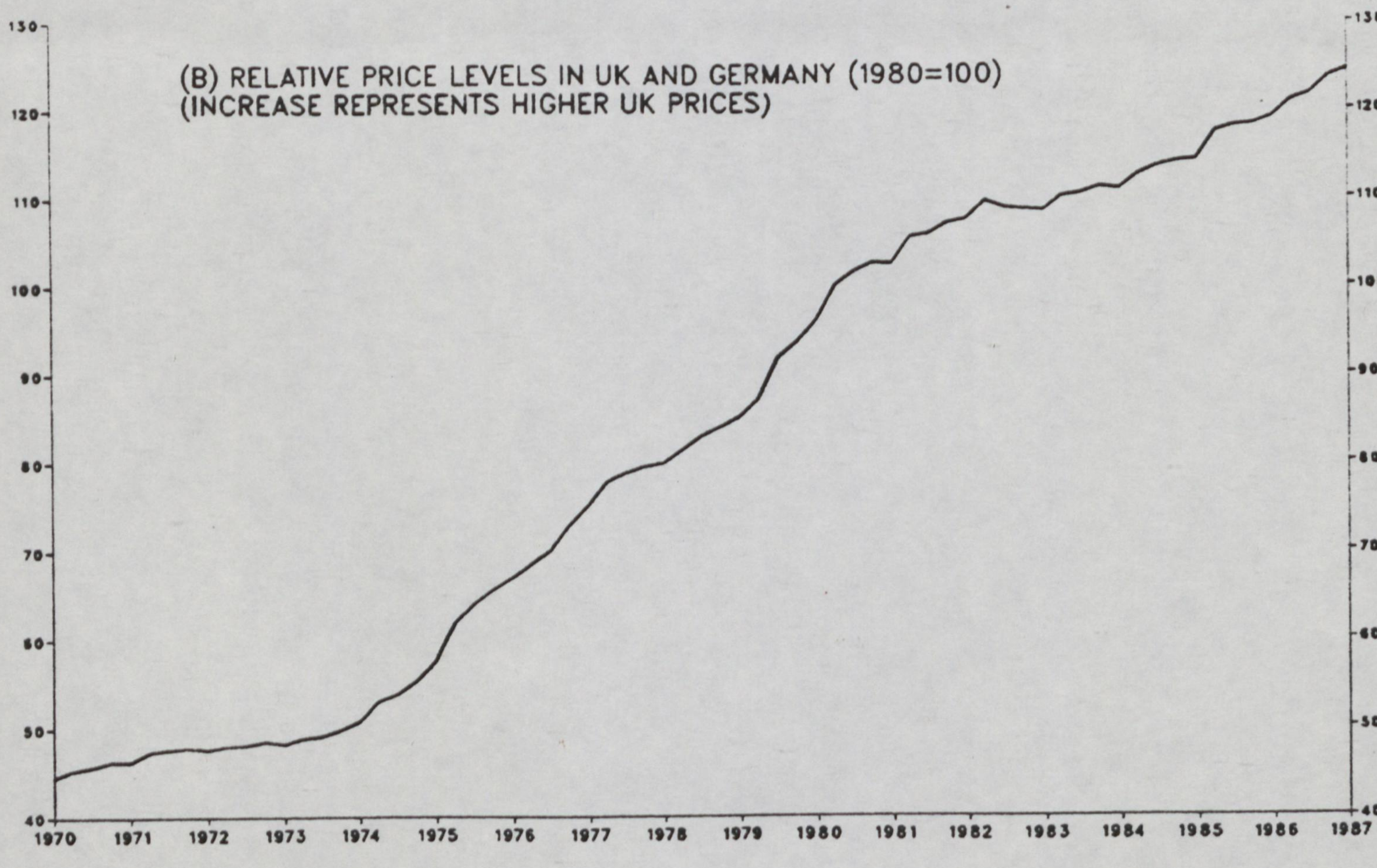
(ii) were sterling to join the ERM at a rate of around DM 3.05 - 2.95, that would appear consistent with the overall exchange rate level which in the last few months has appeared compatible with keeping monetary conditions on track. The situation would have to be reassessed if the mark appreciated further against the dollar and other currencies, in the light of the circumstances accompanying its appreciation.

(iii) joining the ERM at rates close to present market ones would probably not be incompatible with a satisfactory trade performance at least for a reasonable period of time.

22. By contrast, joining at rates appreciably higher or lower than ~~from~~ present market levels would be subject to some dangers. A significantly lower rate would run the risk of allowing a loosening in monetary conditions which would have to be offset by other policy changes if inflation were not to be re-fuelled. But equally joining at a rate much above current market rates would also be risky. There would be an increasing danger of a serious trade deterioration and, with the market perceiving this in advance, the possibility that a high rate for sterling would not be sustainable.

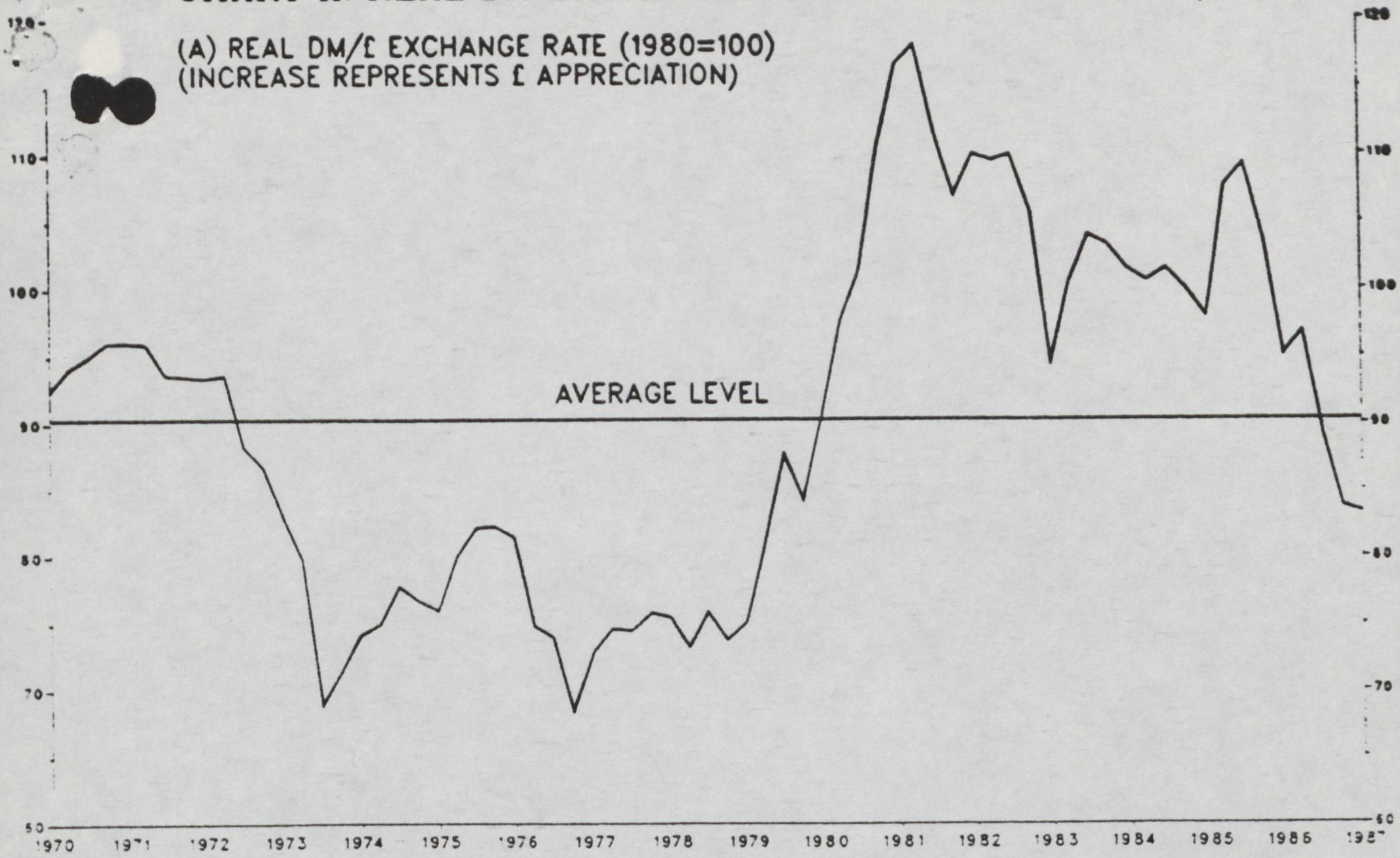
CHART I:

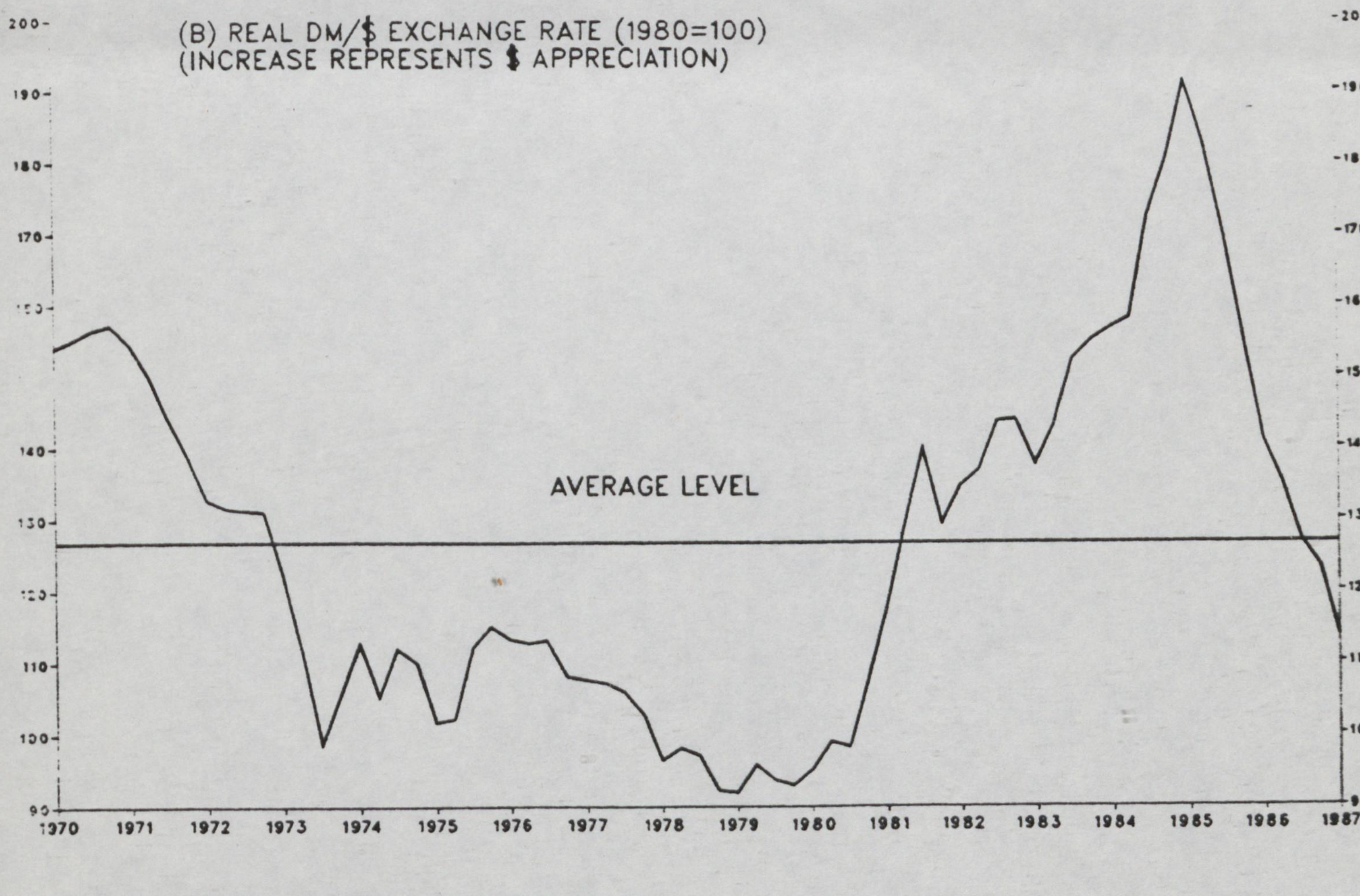




THE PRICE DATA RELATE TO CONSUMER PRICES.

CHART II: REAL DM EXCHANGE RATES AGAINST £ AND $

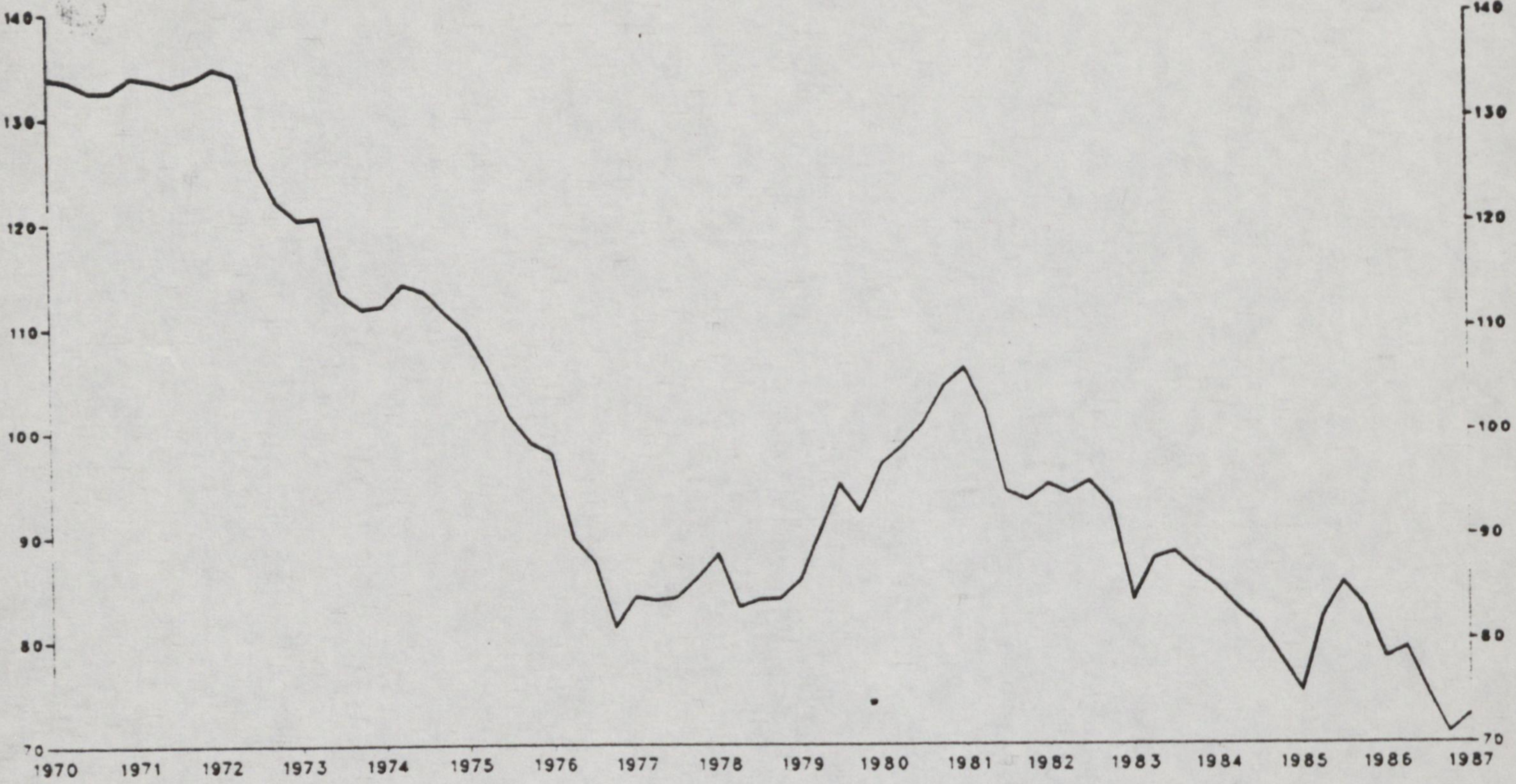


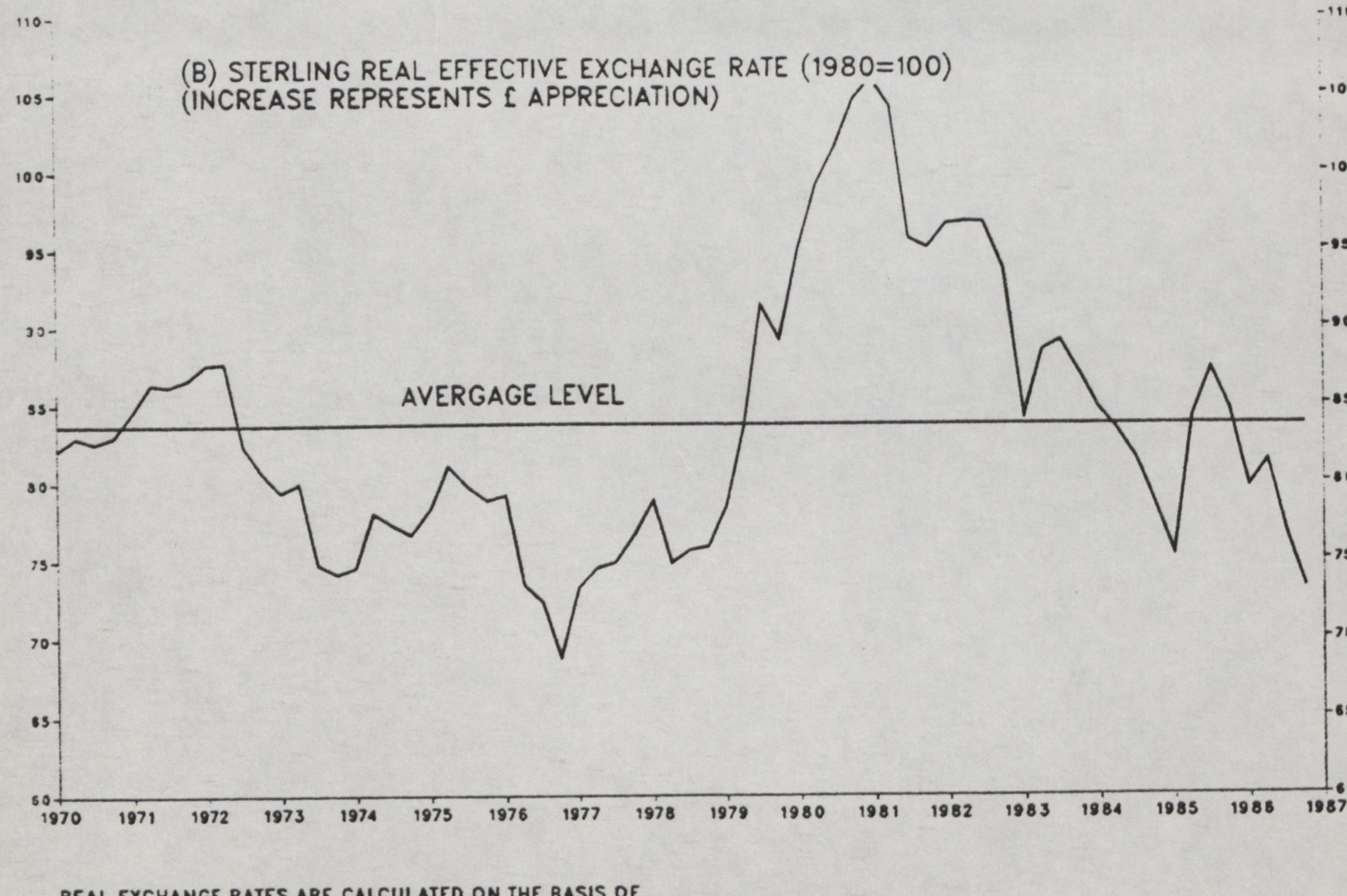


REAL EXCHANGE RATES ARE CALCULATED ON THE BASIS OF
RELATIVE MOVEMENTS IN CONSUMER PRICES

CHART III: STERLING'S NOMINAL AND REAL EFFECTIVE EXCHANGE RATE

(A) STERLING NOMINAL EFFECTIVE EXCHANGE RATE (1980=100)
(INCREASE REPRESENTS STERLING APPRECIATION)





REAL EXCHANGE RATES ARE CALCULATED ON THE BASIS OF
RELATIVE MOVEMENTS IN CONSUMER PRICES