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SUBJECT CC MASTER

10 DOWNING STREET
LONDON SW1A 2AA*From the Private Secretary*

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EMS

The Chancellor this morning raised with the Prime Minister the question whether the UK should now become a full member of the EMS. I am sending this record for the Chancellor's and your information.

The Chancellor noted that the Government had for some time maintained that the UK would become a full member when the time was right, and the Prime Minister had said that the first year of a new Parliament would be the right time. The reserves were now much stronger. Membership would give as much exchange rate stability as it was possible to achieve. It would help business confidence and confidence in the marketplace. The Treasury was working to achieve changes in the technical arrangements for the EMS in the autumn and this would provide a good opportunity. The Chancellor said he was not himself a great believer in UK membership of the European Community, but this was one of the few areas where membership had benefits to offer.

The Prime Minister said that the Government had built up during eight years a well-founded reputation for prudence. Membership would amount to saying that we could not discipline ourselves, but we needed the restraint provided by Germany and the Deutchmark. Membership would reduce the room for manoeuvre on interest rates, and it would introduce a new uncertainty because no-one would know how the Government would react when the currency was tested. Interest rates would be higher at times of pressure than they would be if we were outside the ERM. Mr. Edward Heath had said in the early 1970s that membership of the European Community would help to discipline the trades unions. This had not happened and the attempt to use membership of the EMS to influence the expectations of management and workforces would be an equal failure. It would also be difficult for the UK to be seen to be joining at a time when we were criticising other member countries for their failure to exercise discipline over the Community budget. By blocking off changes in the exchange rate membership would tend to lead to higher unemployment. Overall, when things were going smoothly membership of the EMS would add nothing to economic policy making, and when things

were going badly membership would make things worse.

The Chancellor rejected this analysis. Germany had discipline on its own policies and the Government was not in any case a free agent: it was bound by the reactions of business and the markets. Membership had clearly helped France during its difficulties. The Prime Minister argued that business would hate the higher and more volatile interest rates which would come with membership and that France did not enjoy the record for prudence which the British Government had now built up. The fluctuations in oil prices and our open financial system were also relevant factors.

The Chancellor said he would wish to discuss this further with the Prime Minister in the autumn. The Prime Minister said she would not be prepared to hold meetings of the kind which had been held in the autumn of 1985 and that she would not wish to hold a further discussion with the Chancellor until the new year.

DAVID NORRGROVE

Alex Allan, Esq.,
H.M. Treasury.