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PRIME MINISTER

TALK WITH ALAN WALTERS: 17 MAY

You saw various notes from Alan over the weekend, which you are due to discuss with him tomorrow.

I suggest you take them in two groups:

(i) In divider one is Alan's note on the EMS, together with the questions set out in Charles' note.

(ii) In divider two are Alan's two notes on Intervention and Exchange Rate Management, together with my covering note.

PA.G.

PAUL GRAY
16 May 1989

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PROFESSOR SIR ALAN WALTERS

EXCHANGE RATE MANAGEMENT

I showed the Prime Minister over the weekend your two notes of 11 and 12 May. You may like to see the Prime Minister's comments on them, together with the note I put with them.

As you will see, the Prime Minister would like to talk this through with you before you take action with the Treasury and the Bank concerning explicit constraints on intervention. Amanda is trying to organise a time on Wednesday to discuss this and your thoughts about the ERM.

You may also like to see the attached note I put in the weekend box on the economic statistics due for publication this week.

AG

PAUL GRAY

15 May 1989

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After we must
just discuss
not

PRIME MINISTER

EXCHANGE RATE MANAGEMENT

You will want to see the attached two notes from Alan Walters, each covering similar issues.

The first note on intervention at Flag A sets out Alan's worries about intervention if there is downward pressure on sterling. He seeks your authority to discuss with the Treasury and Bank the imposition of explicit constraints on intervention activity.

The second at Flag B repeats the worry about intervention in relation to the policy being adopted by the Bundesbank. But Alan goes on also to argue that any external pressure to increase UK interest rates should be resisted.

I would offer two quick thoughts on this:

- in recent months you have adopted an asymmetric view on intervention. You have opposed intervention if the market has been pushing sterling up, but you have been content with modest intervention to prevent sterling going down. Alan favours symmetry, with no intervention in either direction. I continue to see a case for a degree of asymmetry, and would have worries about a completely "hands off" approach if there was downward pressure on the exchange rate.
- on interest rates, I do not dissent from the view shared by Alan and the Treasury that at present the stance of monetary policy in relation to the domestic inflation problem is right. But we need to keep that assessment continually under review and we certainly cannot rule out the possibility of the need for an interest rate increase; the separate note in the box on economic statistics next week points to a surprisingly large

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reduction in the latest unemployment figure, and - as we discussed when you saw Cecil Parkinson yesterday - further upward pressure on wage increases may also necessitate offsetting monetary action.

On handling, the issues raised in these two notes by Alan also inter-relate with his note on ERM that Charles has put separately in the box. Perhaps it would be sensible for you to talk through all these issues with Alan, before he discusses the intervention issue further with the Treasury and the Bank.

Content to proceed on that basis?

Paul.

(PAUL GRAY)

12 May 1989

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PRIME MINISTER

12 May 1989

or, as the Treasury would have
put it, to resist the decline of
the £. Acc.

INTERVENTION

Last Tuesday the Bank intervened about \$185 million in trying to contain the rise of the US dollar. The main rise was against the Dmark which, because of the Bundesbank's past policy, has been particularly weak. No doubt because they have intervened heavily over past months to no avail, the Bundesbank did not intervene at all. Nor did the Bank of Japan. There was certainly no concerted intervention by the G5 countries.

I can see no justification for our intervention. It had no discernable effect on the out-turn of the market. Nor should one expect any substantial effect since, relative to transactions, the sums were trivial. (Incidentally, the media reported it as a \$300 million intervention.) But it may well have given a wrong signal to the market, namely that we have some sort of dollar/Dmark target. I believe it was a mistake.

As far as I can detect, there are no guidelines on intervention. Although there is a clear understanding that a policy of "large interventions" (e.g. over \$500 million) should be cleared with you, apparently there is no policy or strategy on our use of intervention. I suspect that, notwithstanding the "understandings", it could easily get out of control. To the player, intervention has many of the addictions of gambling - the feeling always that one only needs to stake a little more, and a little more, to make a big killing.

I advise that we put more explicit constraints on intervention - similar to those we employed in 1981-83. May I have your permission to explore this with the Treasury and Bank?

ALAN WALTERS

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PRIME MINISTER

11 May 1989

THE Dmark, THE DOLLAR AND STERLING

It is becoming increasingly clear to the Bundesbank (and, I believe I suggested this to you some two months ago) that it (and, above all, Pohl) have greatly misjudged monetary policy. The monetary aggregates are all over the top, inflation is rising (the wholesale price index was over 6 per cent on a year-on-year basis), and there is very large exodus of capital. Per contra, Alan Greenspan has conducted a most responsible monetary policy and has laid the foundations for low and stable inflation for the next two years.

Currencies reflect these policies. The dollar soars, the Dmark sinks.

I conjecture that the Bundesbank will be driven eventually to tighten monetary policy through increases in interest rates. If the increases exceed 100 basis points, this will cause a decline in the Dmark exchange rate of sterling.

I am concerned about the reaction of the Treasury and Bank to these conditions. The immediate reaction is to use intervention to test sterling's decline against the Dmark. As you know, I think that running down our reserves by buying sterling on a market that is falling because of a fundamental change in monetary conditions in Germany is simply a recipe for losing money. If not sterilised, the intervention has the effect of a monetary squeeze. If sterilised, it is useless.

The next reaction is likely to be that we should put our interest rate up pari passu. This, like unsterilised intervention, will increase the severity of our present monetary restraints.

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This would be wrong. Last week the Treasury and Bank agreed that the present monetary squeeze was the right degree of severity for our domestic inflation problem. There is no reason why we should distort our policy and economy in response to the Bundesbank's past mistakes and their present attempts at redress. For example, if the Bundesbank increased rates by 150 to 200 basis points (not beyond the range of the feasible) and we followed with similar rises (to 15 per cent), I believe that such a policy would be very likely to induce a recession - perhaps a severe one - in 1990-1. (It would also create great dissension in the EMS; France in particular would hate to see a rise in interest rates.)

In short, we should stick to our present monetary stance. It is broadly right. And we should take any effects of a putative German squeeze on our exchange rate.

But a small extra
monetary squeeze to check
or limit a fall in sterling
does us no harm at present
and is meant to interfere - that
we do not want sterling to
fall. We took in
25 bn to stop it rising - which
is now causing us trouble
Very small amount to stop it
falling seems to me helpful.

ALAN WALTERS

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PROFESSOR SIR ALAN WALTERS

cc Mr Gray

EUROPE

I think your idea is ingenious and well worth pursuing. It puts the other Europeans on the spot. We ought to discuss it with the Prime Minister next week. I will look for time in the diary for this.

We have to be ready to deal with a number of counter-arguments, some of which I would expect the Prime Minister to put forward:

- the other Europeans ought to fulfil the conditions set out in paragraph 2 of your note on their merits and without our having to pay a price.
- all our objections to joining the ERM will be just as valid after the others have fulfilled your conditions as they were before. If you take the view that membership is against our interests full stop, then your note does not help.
- there is a risk that, if we set conditions, the other Europeans will set counter-conditions e.g. they might argue that they will free capital movement when we agree to a Community-wide tax on savings.
- if we tie ourselves rigidly to your conditions, then we may actually deprive ourselves of flexibility. Suppose our assessment of the advantages and penalties of membership of the ERM were to change and we decided to go in but our conditions had not been met, it would look like a defeat for us.

I am making these points because I suspect they will come up not because I disagree with you. Indeed your suggestion sits very well with the point which I was trying to make at

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Chequers that we should try to focus the discussion on achieving genuine competition in the Community.

Charles Powell

10 May 1989

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PRIME MINISTER

10 May 1989

WHEN "THE TIME WILL BE RIPE"

1. One of the difficulties in dealing with the EMS issue is that we always appear to be negative, declining a "seat on the bus" etc. This note attempts to set out a positive response, which will, nevertheless, preserve our position.

2. I suggest we say the time is ripe when:

- (a) all constituent countries have abolished all foreign exchange controls and the legal machinery through which they are imposed. (Note that this condition could be specified as one year without controls. We should ensure that any conditions are satisfied before we enter the ERM. Promises of future reforms are not sufficient.)
- (b) all domestic banking systems and financial and capital markets are deregulated and open to competitive entry from EEC countries. In particular, cartel arrangements would be regarded as a form of non-competitive behaviour, and
- (c) any institution, } corporation, } partnership or individual would be free to enter any banking or financial business, subject only to minimum prudential conditions. (We need to be very specific about such conditionality.)

3. This would put the ball squarely into our opponents' court. What would they do with it? There are two alternatives:

- (a) They could say that the conditions are tantamount to rejection of ERM since the other EEC countries could not conceivably liberate their financial and capital markets to the extent of the UK. Then we could reply

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that EEC ministers had reiterated their view that open, unregulated and competitive financial systems had been the aim; now the reality was that the other countries were backing off their commitments. We have kept the faith: they have not.

- (b) They could accept and carry through the conditionality. Europe's financial systems would then be like ours - free and competitive. Then we would be in honour bound to join.

4. I conjecture that response 3(a) is much more likely than 3(b). For all the talk of deregulation and competition, I cannot see, for example, Italian banks allowing British banks to enter their lucrative and highly restricted mortgage business. The cartelised financial markets of other Common Market countries are part and parcel of their corporatist systems. It is unlikely that, protestations to the contrary, they will be dismantled.

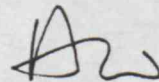
5. But supposing they are so changed into the epitome of competitive and open markets. Then we would have to join the ERM. But surely we would then want to belong fully to this vast liberal market. A free competitive financial system would destroy the corporatism of France, Italy and Germany and set such a dynamic supply-side revolution in train that all countries would gain enormously. (Of course those groups protected by the barriers of corporatism would suffer, at least initially.)

6. None of the arguments against joining the ERM are discredited. They remain as strong as ever. The cost of joining the ERM seem to me to be worth paying if we have open and uncartelised financial markets for us to exploit in the community.

7. But such a cost is likely to be very small since it is most unlikely that the ERM as we know it could remain in a milieu of open and competitive financial markets. There would have

to be more room for movements of exchange rates. As the late 1960s showed, the pseudo-fixed exchange rates of Bretton Woods could not be maintained in the face of the, by today's standards, very modest capital movements that fairly free markets then generated.

8. Whether the response is 3(a) or 3(b), I think that this "time is ripe" conditionality should enable us to reverse the negative image and show that we are on the side of the liberal angels. This approach is consistent with various statements of the Government's position. It is also a natural development from your Bruges speech. I suggest that it is worth some consideration.



ALAN WALTERS

FIXED EXCHANGE RATES AND COMMON MARKETS -
THE CASE OF THE UNITED STATES AND CANADA

1. One Market

- * Canadian - US trade flows are larger than any other pair of countries in the world.
- * Both capital and labour are free to move unhindered across the border.
- * There are no non-tariff barriers and the remaining tariffs are to be abolished under the Free Trade agreement.

2. Exchange Rates and Monetary "Union"

If there were ever a case for an exchange rate fix or monetary union, then it would clearly imply that Canada (a) fix the Canadian dollar against the US dollar, and (b) arrange that Canada's dollar be exchanged for US dollars and for Canada to become an integral part of the US Federation.

3. The History

Canada did, in fact, experiment with two periods when she fixed the Canadian dollar to the US dollar. On each occasion, the Government decided that the costs of pegging were far too large to offset any conceivable benefits. The Canadian dollar has floated with virtually no intervention for fifteen years.

During this period, Canadian dollars have circulated modestly in the border areas of the United States, and US dollars are widely accepted throughout Canada as an alternative medium of exchange.

4. Present Policies

In the wake of the free trade agreement, there is simply no body of Canadian opinion, either academic, political or commercial, in favour of a new bout of fixed exchange rates or a monetary union. The past lessons are not forgotten. And Canada has retained her monetary identity and sovereignty.

AW

ALAN WALTERS