

SECRET AND PERSONAL

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PRIME MINISTER

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ERM ENTRY : FOR AND AGAINST

The economic issues over UK entry to the ERM remain unchanged. The case for floating exchange rates is that they allow autonomy in the conduct of monetary policy. And the value of autonomy is that any unexpected developments can be absorbed by changes in exchange rates as well as interest rates. If we join the ERM, the impact will be taken mainly by interest rates.

The immediate danger of being in the ERM is that changes in the exchange market could move the rate to either the top or bottom ends of the band. We have seen how volatile sterling is in the last 48 hours. We would then be forced to intervene and bring interest rates down (at the top end), or raise interest rates (at the bottom end) - even though neither action would be the appropriate policy response to the behaviour of the monetary aggregates and the state of the domestic economy.

X It is sometimes argued that UK interest rates would fall if we entered the ERM. This is most unlikely. The present behaviour of the monetary aggregates, and especially M0, is very worrying. A surge in confidence on entry would have to be taken on the exchange rate - as lower domestic interest rates would be a recipe for inflation.

This leads to one very important point. The intention of the EMS is that a country's exchange rate should move within fixed limits. But what if, shortly after entry and the announcement of good news

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about the economy, sterling hits the top of the band? It is vital that we have the freedom to revalue. If you enter this year it is absolutely critical that, should the circumstances arise, it is possible that we are able to revalue. The argument which might be used in the negotiation for entry would be that given the large differential between sterling and DM interest rates and the disequilibrium in the UK economy at present, we need extra flexibility to ensure that entry is not linked with inflation or deflation. If it was not possible to negotiate such a position, entry to the EMS would run the risk of fuelling inflation, even if only temporarily. But the timing of such a blip in inflation could be extremely embarrassing.

Another area of difficulty is the outlook for German inflation. The EMS is effectively a D-Mark area. Throughout the post-war years the anchor keeping inflation low in Germany was the experience of the 1923 inflation. As the Bundesbank has become more political, and in view of the financial pressures created by the integration of East and West Germany, it would be wrong to be over sanguine about the future course of inflation in Germany.

In terms of the economics of the joining the ERM, my personal view is that the case made for entry is still not very convincing. With a large band ($\pm 6\%$) for the exchange rate and the right to realign our exchange rate should we need to, we could cope in the ERM.

The real case for entry is political.

- You will be seen by the rest of the world as tying our economic future with that of Europe. The City and business will both be pleased and this will almost certainly underpin existing and future direct foreign investment, especially from Japan.
- It will spike Labour's guns;

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- It will also remove one element of division within our own Party.
- It is frequently agreed that we gain more influence in the Community by being in the ERM though I am personally somewhat sceptical about this.

In addition to this your statement at Madrid was seen as the crossing of the rubicon. On the basis of that statement, there is a widespread expectation that the conditions for entry will be fulfilled before the next election and that therefore we will join the ERM. Subsequent statements by yourself and the Chancellor have been perceived as reinforcing this position.

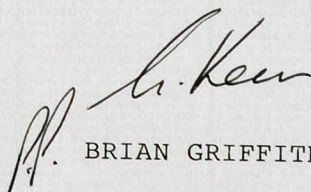
Conclusion

On balance the economic arguments are still against joining; except that it is impossible to quantify the change in confidence which it might inspire (especially on direct investment), and providing we can realign upwards, if the exchange rate surges, we should have no problems in maintaining an anti-inflationary policy.

The political case is strongly in favour of entry and is becoming stronger.

On balance therefore I believe the UK should enter the ERM.

Entry raises many technical questions on which the Treasury are currently preparing a paper. Timing however is important. As the case for entry is political, the timing should be judged to secure maximum political advantage - certainly before the party conference, and probably either in September or July. Given the current buzz in the press and the markets, the Chancellor could well be seeking an early date.


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