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PRIME MINISTER

ALAN WALTERS AND EMS/EMU

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See overlap
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This story has been running over the weekend. The particular difficulty is that in the article Alan wrote he said he had advised that Britain should

"Stay out of the present arrangements of the ERM."

He then added

"So far Mrs. Thatcher has concurred." - see Flag A.

At Treasury Questions the Chancellor said that these

"are clearly not the views of the Government." - see Flag B.

The Opposition then attempted to set up a fork.

1. Either you agreed with Alan and hence disagreed with the Chancellor; or
2. Alan is mistaken when he says that you concur with his view that we should not join the ERM.

The Lord President gave a very correct reply - also at Flag B - though his "I am not required to answer for every nuance" was rather weak.

An alternative approach would be to argue that Alan's advice "to stay out of the present arrangements for the ERM" was being followed, and that we had stated that the way to join would be clear only when the Madrid conditions had been satisfied, by which time the ERM would be a rather different animal from what it is now. Governments with high inflation rates would be under greater pressure to adjust their monetary policies as they would not be able to deploy exchange controls.

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The problem with this route is that:

- It is a rather complex argument for the House of Commons
- Even after the Madrid conditions are satisfied, Alan might still not favour joining the ERM. He appears to take the line that we should go the whole hog for irrevocably fixed exchange rates, without passing through a phase in which parities are theoretically adjustable, even if in practice they change only rarely. The paper the Chancellor will be presenting for ECOFIN envisages such a phase during which currencies compete.

If Mr. Kinnock asks whether you agree with Sir Alan, or whether he is not telling the truth when he says that you agree with him that we should not join the ERM, I suggest an answer on the following lines:

"Sir Alan's advice, which has been extremely valuable over the past nine years, has been one of the factors taken into account in determining the Government's attitude on the Exchange Rate Mechanism, namely that the time is currently not right to join, but that the way would be clear when our inflation rate has been brought down, when existing exchange controls and other financial restraints have been removed, and when other key aspects of the single market have been achieved."

As the story is still running in Monday's papers it is possible that you could be quizzed on this at your Press Conference tomorrow. It would be helpful to have a clear line on the record ahead of Tuesday's Economic Debate.

Paul has written to Alan - see Flag C - warning him that as an adviser to Government he must be circumspect in what public pronouncements he makes.

AT

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23 October, 1989.

cc. fax to Paul Gray

*What may be all right
"at least on economic grounds"
is NOT all right on political grounds
because of accountability - further
what was the date of
Alan's advice? not*

reduced from an ambient 15 percent in the 1970s to less than 5 percent from 1983 on. It became the accepted view, except among academic economists, that the budget of 1981 together with the adjustment of monetary policy was the foundation of Britain's economic renaissance.

After this auspicious beginning, I acquired a considerable reputation at the Treasury and the Bank of England, and I received their full cooperation during the next three and a half years. We managed to produce a fairly stable monetary policy (the growth rate of M_0 remained in the 3-6 percent range). And from 1981 onwards the British could look forward to tax reform and steady but sizeable yearly reductions in tax rates, at least as long as Mrs Thatcher remained in office. And such tax reductions combined with the transformation from an unmanageable deficit to a budgetary surplus in 1987-8.

In my role as advisor, there was one other major controversy where I found myself in a beleaguered but rather select minority. The issue was exchange rate intervention and in particular the advisability of Britain joining the exchange rate mechanism (ERM) of the European Monetary System. For more than 35 years I have been convinced that the various forms of pseudo-fixed exchange rates, dignified by various names such as crawling pegs, reference zones, etc, had only deleterious consequences - especially encouraging overvaluation and repression (on the part of dependent currencies such as sterling, the French franc, etc.) and massive capital flight or inflow when the 'realignment' was

imminent, which would in turn give rise to proposals for more exchange controls and trade barriers. The pressure from Europe and the British establishment to conform and join the ERM has been enormous. But the arguments have never attained even a minimum level of plausibility. My advice has been for Britain to retain its system of flexible exchange rates and to stay out of the present arrangements of the ERM. So far Mrs Thatcher has concurred. (Of course I would not be opposed, at least not on economic grounds, to the development of a proper European currency administered by a European Central Bank preceded by absolutely fixed exchange rates and appropriate monetary institutions to support that fixity. But that is another story.) It would not be in Britain's or, I believe, Europe's interest to join the present half-baked system.

Conclusion

So far, that is my life. My final reflection must be on my extraordinary luck. My life has been one lucky break after another - although I am reminded of Pascal's dictum that "luck visits the prepared mind". I am reminded that to many people, it seemed positively foolhardy for me to join Mrs. Thatcher at No.10 in 1980 when the chattering classes were confidently predicting that she and her policies were finished. Events did not turn out that way. It was my great privilege to serve as trusted advisor to one of the greatest political leaders who would thrust Britain into the renaissance of the 1980s. As so often the case in Britain, my working class origins were no handicap in attaining