PRIME MINISTER

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Money Policy or EMS?

You cannot have an independent money policy and an exchange rate policy. If you try both, you may achieve neither at considerable cost.

If you choose the exchange rate target, then you are surrendering sovereignty: your policy in part is decided by what foreigners do with their money supply.

If you choose a money target and stick to it, you have more flexibility.

Recent interest rate moves can be presented as a response to clear recent monetary laxity caused by a high PSBR and high private borrowing.

Should we join the EMS?

When Ireland and UK had same money policy, pound and punt had the same value. As soon as Ireland joined EMS and had a different money policy, the punt fell heavily against the pound. It subsequently rose again.

If Germany and UK had the same money policy, DM/£ would be stable. If not, joining EMS means trying to defend the indefensible. There have always been many adjustments within the EMS, and some currencies are costly to defend and consistently crisis ridden. Alan Walters' paper sets this out definitively.

EMS fans want us to match tight German money policy. That means even higher interest rates and a lower PSBR to get there.

I doubt if EMS supporters have in mind a hair shirt of teutonic prickliness. Nor would they wish to be forced into tightening just before an Election because the Germans have.

J. Redwood

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ECONOMIC APPENDIX

STERLING

Has it fallen because the oil price has been weak?

Approx.

OIL per b.	1978	1979	1980	1981	1982	1983	1984	now
$ price	13	27	34	34	33	29	26	29
£ price	7	15	15	16	18	19.5	23	26
SDRs					28	28	29	

(Sources: Esso Hoare Govett & Philips & Drew graphs)

Falling dollar oil price has affected sentiment. Joining the EMS would not change that.

But the sterling oil price has risen sharply.
Real oil price has been stable (measured in international units of account SDRs).
The falling dollar oil price merely shows how strong the dollar has been.

Sterling's fall dates from before a decisive change in trend of dollar oil prices.

Has it fallen because money policy has been lax?

Sources: International Financial Statistics & Simon & Coates

% changes in real money growth

	Real M_1	Real £M_3	Real PSL_2	End	$/£
1979/80	-13.9	-5.8	-7.9	1980	2.4
1980/81	-6.4	2.7	-1.2	1981	1.9
1981/82	0.5	8.2	3.8	1982	1.6
1982/83	8.0	7.0	5.0	1983	1.4
1983/84	9.1	5.1	7.5		
1984/85 (Tsy.est.)	10.1	5.3	8.1		

Change in trend of sterling from rise to fall reflects change from tight to loose money.

ie: When the rapid growth in real pound notes and bank deposits started, the value of the pound fell. The velocity of circulation of money did not fall enough to offset the effect.

Why didn't inflation pick up?

Because:

a. Wage claims remained under some control - attitudes had been affected by the recession and by numbers of jobless.

b. World commodity prices were falling.

c. There was a lot of spare capacity world-wide.

d. The world picture was deflationary, because the crucial US banking system became risk-averse and was short of liquidity.

Where did all the money go?

a. Into consumer spending - new record high.

b. Into profits - much needed increase.

c. Into investment.

d. Flowed overseas - for the purchase of goods, as savings, and for speculative purposes.

a-c were good news, meaning a better balance between output and inflation in response to the stimulus. d meant a sharp decline in our strong balance of trade, pressure against the currency and, for a period, a large outflow of portfolio investment. Only the last of these three was good news.

Profits - are they adequate? (Source: Philips & Drew)

They are now better. Since the 1981 trough, up 70% in cash terms (cf. 20% inflation).

But:

Non-oil rates of return (Net replacement cost)

1960	1964	1968	1973	1978	1984
11.2	10.4	9.0	8.5	6.8	6.9

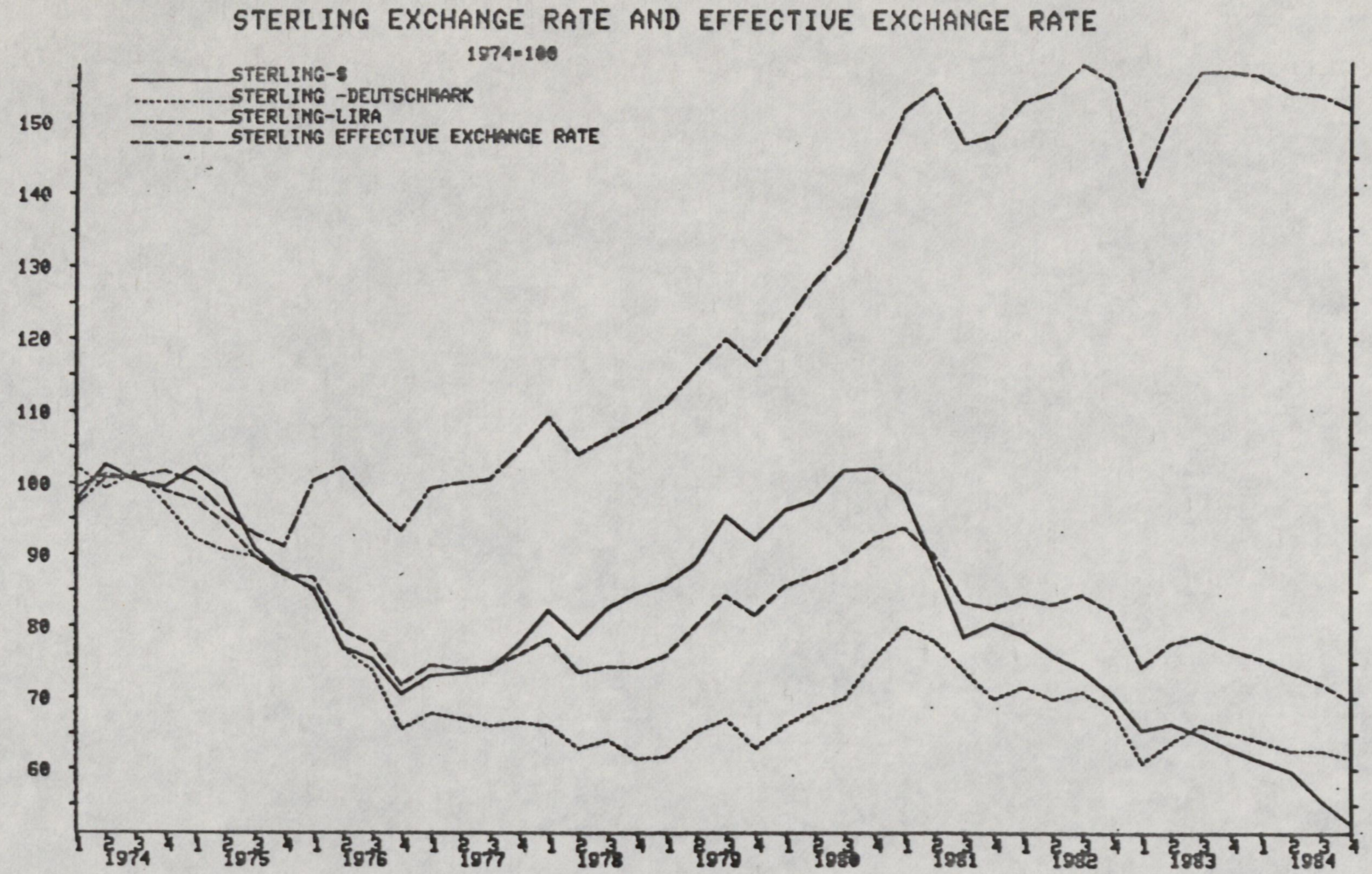
Between 1972 and 1984, efficiency improved so unit wage costs added 3.2% return to profits, but higher employer contributions to National Insurance and pensions subtracted 3.5% from profits.

So better, but still not very good. Long-term downtrend in profits only just reversed.

So here is a paradox: industry now has cashflow and profit sharply better than 3 years ago, but because there are so few attractive additional investment projects to spend it on, it can be partly frittered away in extra wages.

We are still suffering from a shortage of entrepreneurs capable of making good investment opportunities.

ANNEX A



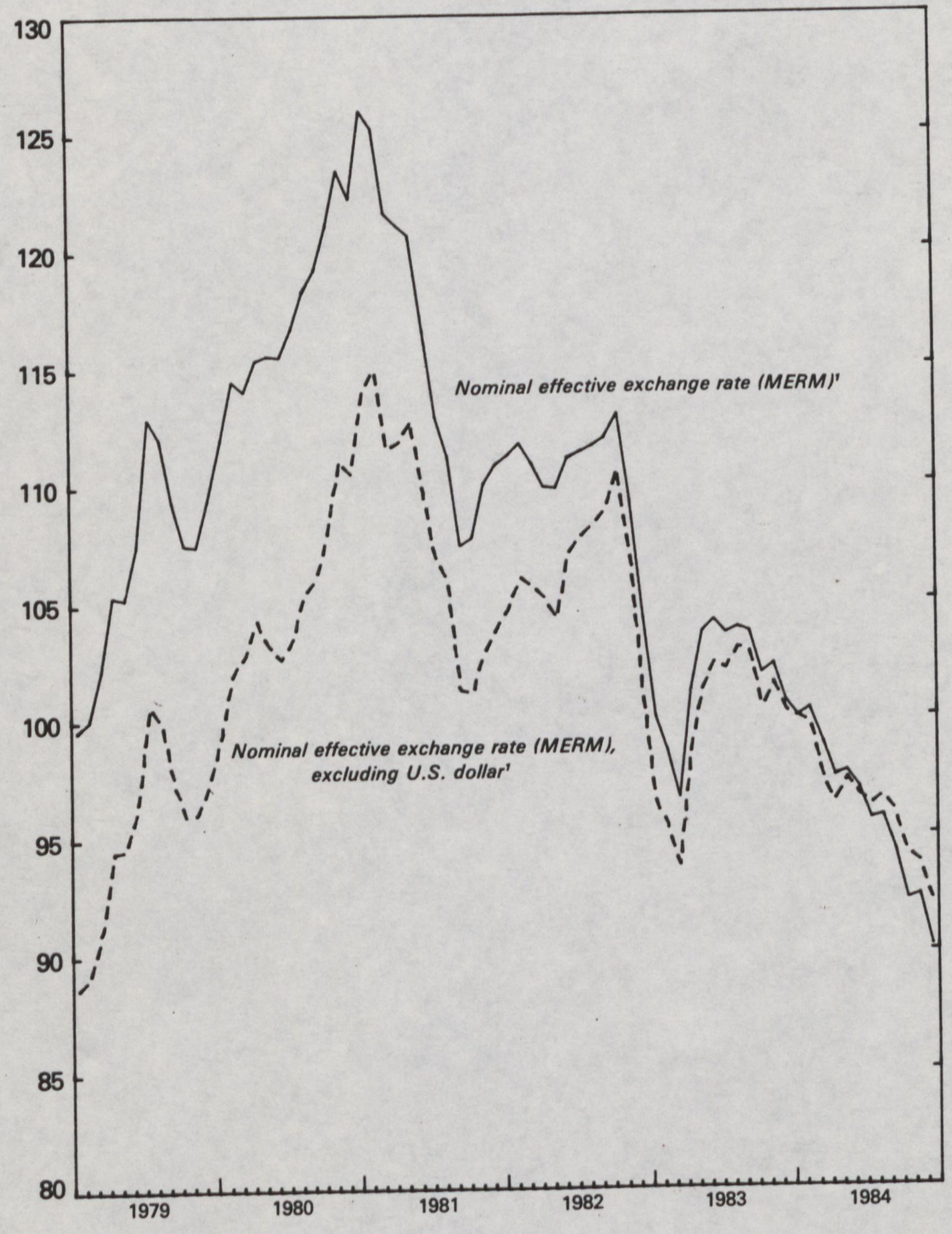
STERLING EXCHANGE RATE AND EFFECTIVE EXCHANGE RATE
1974=100
STERLING-$
STERLING -DEUTSCHMARK
STERLING-LIRA
STERLING EFFECTIVE EXCHANGE RATE
150
140
130
120
110
100
90
80
70
60
1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4 1 2 3 4
1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984

Annex B

CHART 5

UNITED KINGDOM

EFFECTIVE EXCHANGE RATES



Sources: IMF, *Datafund;* and staff calculations and estimates.
[1]January 1984=100.

£ has not just fallen against the $