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10 DOWNING STREET

From the Private Secretary

13 February 1985

EMS

The Prime Minister held a meeting today to discuss whether the UK should join the exchange rate mechanism of the EMS. Present were the Chancellor of the Exchequer, the Economic Secretary, Sir Peter Middleton, Sir Terry Burns, Mr. Littler, the Foreign Secretary, Mr. Braithwaite, Mr. Renwick, the Governor of the Bank of England, the Deputy Governor, Mr. George, Mr. Loehnis and Mr. Redwood.

Opening the discussion, the Chancellor said the Government's public position was that the UK was ready to join the exchange rate mechanism of the EMS when conditions were right. A number of factors made it appropriate to consider this question; recent exchange rate developments had brought the EMS to the fore in public debate, and the agreement at Fontainebleau had cleared a major political obstacle in Europe. As time went by the argument of unripe time looked less and less credible. It was for consideration whether the Government should decide one way or the other and say so.

The Chancellor said that whatever view one took of fundamental arguments, it would not be appropriate to enter in current circumstances. The UK's foreign exchange reserves were too low, perhaps even outside the EMS, but certainly for membership of it. In the light of recent developments, entry into the EMS would look defensive; it would be important to enter having re-established confidence in financial markets.

The fundamental arguments against joining EMS remained. Sterling was far more widely held than any of the other EMS currencies apart from the DM; the UK's trade was less integrated with Germany than the other members'; and oil was still a major factor in the markets' view of sterling. If the UK were forced to seek a realignment, possibly in the run-up to an election, the Government would be in an extremely difficult position.

Nevertheless, other arguments had strengthened. The essence of EMS was to provide a financial discipline bearing down on inflation and many people argued that it was easier to present this through the mechanism of fixed exchange rates than through monetary targets. EMS would also help to correct the existing preoccupation with the £/$. Those who advocated entry into EMS would be less able to argue against measures made necessary by adherence to its financial discipline.

The Chancellor concluded that the balance of argument still came down against joining the exchange rate mechanism of EMS, though the Government should not close the door on the option.

The Foreign Secretary recognised that the decision had to be taken on economic grounds. Although Britain's European partners would welcome our entry, this was unlikely to secure any of our major negotiating objectives in Europe. He believed that EMS had benefited the existing members by providing greater exchange rate stability. Realignment had spurred the weaker countries into taking appropriate financial measures. He doubted whether linking sterling and the deutschmark would prove an insuperable problem. If sterling had been in EMS it might have been better placed to cope with recent exchange rate pressures. He agreed that current circumstances were not right but thought the UK should be looking for an appropriate opportunity to join.

The Governor felt that the balance of argument led the Bank to look more sympathetically on membership of EMS. The arguments against entry - that this could destabilise the whole of the exchange rate mechanism and that the link with the deutschmark might prove an excessive restraint on the UK - carried less and less weight. He believed it was easier to present the commitment to stable money in the context of fixed exchange rates than monetary targets, particularly when the credibility of ££ M3, control of which was increasingly dependent upon over-funding, was coming under strain. Though not unanimous, the Bank leant towards joining at some stage though current circumstances were not right. He believed that the Government should make preparatins by raising the level of the foreign exchange reserves by around $5b.

In discussion, the following points were made:-

i) Entry into EMS would not make the conduct of policy easier at the points where it really mattered. Within the EMS it might be easier to cope with minor variations in the exchange rate as there would be no expectation of a change in parity. But where sterling was under major pressure the speculative flows could be aggravated. The worst position of all would be to enter and then be forced to withdraw shortly afterwards.

ii) The present framework of policy had served the Government well and had achieved broadly what had been asked of it. Greater clarity about policy in relation to the exchange rate would be secured only at the cost of more uncertainty about the conduct of monetary policy.

iii) In conditions of turbulence, sterling could be expected to behave differently from the other EMS currencies. Sterling was more widely traded than any currency apart from the DM, and oil and the dollar, plus the interaction between them, continued to exert a significant on sterling. Unless these fundamental factors changed and there was no indication of this happening, conditions would never be right for sterling to enter EMS.

iv) Although the policy framework had delivered lower inflation, there were increasing difficulties in operating it. The more often the authorities were forced to raise interest rates in response to a weakness of the exchange rate, the more the impression would grow that the UK was operating an exchange policy. Against this it was argued that the increases in interest rates had been the response, not to the fall in the exchange rate per se but to what the exchange rate was signalling about excessively loose domestic financial conditions.

Summing up the discussion, the Prime Minister said it was agreed that conditions were still not right for sterling to join the exchange rate mechanism of EMS. The existing public line should be maintained. The Treasury and the Bank of England should consider how best to augment the foreign exchange reserves.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and John Bartlett (Governor of the Bank of England's Office).

(Andrew Turnbull)

Mrs. Rachel Lomax,
HM Treasury