

SECRET

17

PRIME MINISTER

27 September 1985

SHOULD WE JOIN THE EUROPEAN EXCHANGE RATE MECHANISM?

Brian Griffiths and I are sceptical of the Treasury's case for joining the ERM. They need to offer convincing answers to the following questions.

Why should this financial rule prove to be the true guiding light, any more than the other targets we have picked so far?

We doubt if there is any one financial or monetary indicator which is so good a guide to policy that you can follow it even if all other indicators are pointing in a different direction. Indeed, the Chancellor envisages keeping our monetary targets, which may tell a different story from the exchange rate. Imagine that the inflation rate is coming down, the PSBR is under control and domestic financial conditions look sound but, because of some outside shock, the £/DM rate is weakening. Would you be prepared to see interest rates rise, or to spend the Reserves, in such circumstances?

What will we have to do to maintain Deutschmark parity?

The Chancellor rightly and honestly says that joining the ERM is not an easy option. But how frequently does he think

SECRET

SECRET

we will have to move interest rates, and by how much, so as  
to keep within the mechanism? Will we be drawn into wasting  
large amounts of the Reserves to defend any given parity,  
with the speculators enjoying rich pickings if they succeed  
in driving us off parity? And there might be domestic  
political pressure to impose capital controls to defend the  
rate - as, for example, the French do.

Aren't the UK and Germany very different economies?

If God had intended us to join the Exchange Rate Mechanism,  
we would be as productive and as moderate in our wage  
demands as the Germans. The Chancellor may argue that  
putting us into a German monetary framework will make us  
behave like Germans (the exchange rate may be a better  
discipline for wage bargainers than Sterling M<sub>3</sub>). But if  
the two economies differ deeply, then changes in the  
exchange rate between them are legitimate and normal ways of  
adjusting for that different performance. The opposite  
effect of oil price changes on Britain and Germany is just  
the most vivid example of the difficulty of yoking our two  
economies together.

Applause now and tears later?

One of the Chancellor's cleverest arguments is that the  
moaning industrialists want us to join the EMS. Next time  
we need to raise interest rates, he can point out that it

SECRET

SECRET

has to be done to stay within the ERM - which, after all, was what they wanted. That is logical, but will it actually make rises in interest rates less politically painful? Will the average home-owner happily accept a rise in his mortgage rate once he knows its purpose is to maintain the pound's value against the German Mark?

Will the Europeans want us in?

Joining the ERM would change it fundamentally from a Deutschmark system to a bipolar monetary system. Are the Germans and the French prepared to contemplate this?

Is Germany so stable?

The assumption on which all these arguments for the ERM rests is that, whatever vagaries and uncertainties afflict us, Germany carries on for ever. But the Kohl Government is getting a heavy buffeting. There will be an Election in January 1987, and the SPD - which is less moderate than in Helmut Schmidt's day - is ahead in the polls. It would be a final irony if we found we had linked our financial policy to that of an irresponsible Socialist Government.

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SECRET