24

pa

Have added some

questions.

Ask Brian Griffiths

if that are any more [illegible]

PRIME MINISTER

EUROPEAN EXCHANGE RATE MECHANISM

At the end of your last meeting on whether sterling should join the exchange rate mechanism you said that a further meeting would be needed, but that first the Treasury and Bank should be invited to prepare answers to a number of questions.

I attach a list of questions, which take on board comments from the Policy Unit. Content with the questions?

I suggest asking the Treasury and Bank to complete the examination paper in writing by the end of the month.

The meeting itself is scheduled for 13 November. You said that this should now include a wider group of Ministers than has so far been involved. Please tick Ministers from the list below whom you would like to attend.

- ✓ Mr Tebbit
- ✓ Lord Whitelaw
- ✓ Mr Brittan
- ✓ Mr Wakeham (for backbench reactions)
- Mr Younger (for commonsense comments, though no obvious departmental role)
- ✓ Mr Biffen (bring in later?)
- Lord Young

Any others?

Plus of course the Chancellor ✓, Governor ✓, and Foreign ✓ Secretary. Do you want officials? No [illegible]

Middleton

Burns

Littler

McMahon

George

Loehnis

A conspectus paper will be needed to help ministers coming fresh to the subject.

Content to proceed in this way?

DRN

David Norgrove

9 October 1985

SECRET

Please retype.

ERM QUESTIONS

1. What are the reasons for wanting to take a decision now - one way or the other?

2, 3 →

from end 4 ~~2~~. Would joining the ERM amount solely to an <u>evolution of the policy framework</u> or would it also imply a <u>change in the policy stance</u>?

5 ~~3~~. Are present monetary and fiscal policies tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy? For how long?

6 →

7 ~~4~~. How would the role of the monetary targets change if sterling were to join the ERM?

8 ~~5~~. How much weight would in practice be given to them?

6. In what ways would joining the ERM have a helpful effect on expectations?

7. To what extent would the present level of reserves provide a cushion against temporary <u>downward</u> pressure on the exchange rate, on the basis of past experience here and in other countries?

8. In periods of <u>upward</u> pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?

9. Is it envisaged that interest rates would change more often than they do now?

10. Is there a risk that the decision to abolish exchange controls would be seriously called in question?

SECRET

11. What flexibility would be lost by sterling joining the ERM, in terms of (i) the policy stance
(ii) timing of decisions
(iii) presentation

12. Would a tightening of policy (if that proved necessary) be more easily accepted within Government and by the Government's supporters if sterling were in the ERM rather than outside it? Why?

13. What are the downside risks?

14. Does the UK's position as a major oil producer and exporter mean that it is too risky to join?

15. Are the objections to joining of a fundamental nature or are they questions of timing?

16. How would the decision to join the ERM be presented both to the markets and more widely?

17. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?

18. What are the implications, for the way we conduct and present policy, of sticking to the present arrangements?

2
~~19~~. How would the admission of sterling change the ~~EMS~~ ERM?

3
~~20~~. What turbulence would you expect if we were to join?

6
~~21~~. What rate do you see as the appropriate rate for sterling against the DM? ~~rate against the DM. [No one to say whether it is the market rate on the day - that begs the question.~~

Would a decision on when to join be affected by the rate of sterling against the DM at that particular time?

MJ2BFD

SECRET

MJDBFE

CC DW
DN

file 23

10 DOWNING STREET

From the Private Secretary 7 October 1985

ERM QUESTIONS

I understand that Nigel Wicks agreed to send you informally a list of questions about the ERM which we are putting together here. I now attach a first attempt at them. I intend to put them to the Prime Minister this weekend and would be grateful for any comments before then.

(no BF cleared)

If she agrees, I would aim to circulate them thereafter, asking for written replies by the end of the month.

A more comprehensive piece of work will also no doubt be needed as the basis for the meeting now scheduled for 13 November to put in the picture, among other things, those Ministers who have not been involved before.

David Norgrove

Sir Peter Middleton KCB
HM Treasury

SECRET

cc DW/ DN.

ERM QUESTIONS

1. Would joining the ERM amount solely to an evolution of the policy framework or would it also imply a change in the policy stance?

2. Are present monetary and fiscal policies tight enough to sustain a fixed parity against the DM, bearing in mind the strong performance of the German economy? For how long?

3. To what extent would the present level of reserves provide a cushion against temporary downward pressure on the exchange rate, on the basis of past experience here and in other countries?

4. Is it envisaged that interest rates would change more often than they do now?

5. In periods of upward pressure on the exchange rate what considerations would determine the extent of intervention before the decision to seek a realignment?

6. How would the role of the monetary targets change if sterling were to join the ERM?

7. How much weight would in practice be given to them?

8. In what ways would joining the ERM have a helpful effect on expectations?

9. Would a tightening of policy (if that proved necessary) be more easily accepted within Government and by the Government's supporters if sterling were in the ERM rather than outside it? Why?

10. What policy flexibility would be lost by sterling joining the ERM?

11. Would are the downside risks?

12. How would the decision to join the ERM be presented both to the markets and more widely?

13. Could any benefits from joining the ERM be gained by instead setting a band (published or unpublished) as a non-member?

14. How might macro-economic policy change if sterling does not join the ERM?

15. How would its presentation change?

MJ2BFD

SECRET

22

MR. WICKS

PROFESSOR BRIAN GRIFFITHS

MR. WILLETTS

ERM QUESTIONS

Here is a draft exam paper for the Treasury and Bank to answer in writing before the next meeting on this subject, which very likely will be in the middle of November.

Grateful for comments.

DW

DAVID NORGROVE

4 October 1985

To What extent would [illegible] control over exchange policy, + to

ERM QUESTIONS

F

1. What assurance is there that present monetary and fiscal policies are tight enough to sustain a fixed ~~period~~ parity against the DM, bearing in mind the strong performance of the German economy?

Surely depends

2. ~~How far~~ [illegible] would the present level of reserves ~~prevent~~ provide a cushion against periods of downward pressure on the exchange rate, on the basis of past experience here and in other countries?

3. In periods of upward pressure on the exchange rate what considerations would determine the extent of acceptable intervention before a decision to seek a realignment?

4. How much weight would in practice be given to the monetary targets if sterling were to join the ERM?

5. In what ways would joining the ERM have a helpful effect on expectations? (Is there a risk that it would be seen as an attempt to set an external constraint on growth, based on the general perception of the effect of over-valuation of sterling in the 1960s?)

fiscal + monetary [illegible] ~~macro-economic~~

F

6. Would joining the ERM make the Government's own decisions easier to take and more easily accepted by the country? Why?

both to the markets and more widely

7. How would a decision to join the ERM be presented?

8. If sterling does not join the ERM, will the presentation of macro-economic policy need to change? How?

Why not go as now?

THE TIMES 1/10/85

FINANCE AND INDUSTRY

Executive Editor Kenneth Fleet

Markets' timing is all wrong on EMS entry

The rumour that sterling was finally to join the exchange rate mechanism of the European Monetary System the very weekend before the Opec meeting in Vienna had an engaging dottiness about it. That is about the last moment the Bank of England would advise to the Treasury, it being a week when those who monitor the market are always on their toes. If the markets had their timing wrong, however, there seems little doubt that their thinking was on the right track. Entry into full membership of the EMS is under more active consideration today than at any time since the Callaghan Government opted out at the start and there is a distinct air of immediacy about the issue.

Whatever Dr David Owen, or Sir Terence Beckett at the CBI might wishfully think, it is a contradiction in terms to suppose that we could mesh into the exchange rate mechanism immediately, yet freely choose the (lower) parity at which we enter. The whole point of the mechanism is to stabilize parities at a level the market will accept and industry can live with.

Since mischievous dealers would undoubtedly want to test a new bi-polar EMS if sterling were to join the mark as a central reference currency of world stature, it would be asking for trouble to fix an entry parity markedly out of line with market forces. As last week's exercise on the dollar showed, the markets are prepared to accept determined leadership from central banks if it is offered, but this must go with the grain of the market.

In that sense, the reaction to Friday's rumour was most instructive. The sharp fall in sterling, particularly against the mark, surely reflected a view that the short-term level of sterling as a consistent recent beneficiary of bouts of dollar weakness was not sustainable in the medium term in a European context. Industrialists, for once, would have agreed wholeheartedly with the market's judgement.

Yesterday, the pound dropped again in the morning below $1.40 before recovering most of the ground in the afternoon. The pattern was repeated against the mark, which is more important in terms of the EMS argument. The closing value of DM3.76 is now in line with the central levels shown over the past 18 months of fluctuations. Much the same applies to sterling's rate against the European Currency Unit (ECU), not surprisingly perhaps since sterling and the mark form a hefty proportion of the basket.

Manufacturers who compete with German goods would undoubtedly prefer a parity around DM3.5 or an ECU at £0.63 but these levels were only reached during sterling's winter disgrace. By contrast, sterling's latest central parity for fixing the value of the ECU is £0.55, which looks too high a level for the pound in Europe and compares with yesterday's rate of £0.59.

Pending what happens at Vienna and its market spin-off, the current market rates, as adjusted for the rumour and perhaps with another minor downward adjustment, look the most practical near the time of a British entry into the exchange rate mechanism. If the Treasury wanted a much lower rate, it would have to wait for quite different circumstances since dollar weaknesses should sustain the pound.

The authorities may reckon that they can use the leverage of desired sterling entry into the EMS to persuade the Italians, French and others to make their currency controls more liberal in line with the spirit of the EMS. If so, they may think that a slightly higher entry parity for sterling than some would like is a price worth paying for stability.