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PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

This is likely to be a difficult meeting: higher interest rates and the EMS are the two items on the agenda.

The Chancellor wishes to raise interest rates by $\frac{1}{2}\%$. He argues that this might pre-empt a larger increase later, which might be caused by another bad set of trade figures (if they are) and probably bad money figures. (The weekly bank lending figures are apparently high and M0, three months on three months, is growing at an annual rate of $7\frac{1}{2}\%$.) Mortgage rates would be unlikely to rise, though others would then be unlikely to follow Nat West down to $10\frac{1}{2}\%$ from the present 11% or so.

There is undoubtedly a good deal of unease at present about the monetary stance. However, perceptions of the economy swing markedly within the space of a few months, from gloom about the lack of growth to concern about excessive growth. We should not be panicked. There is also a clear risk that an increase now would simply create a higher base for a further increase when and if bad figures emerge.

I have included a separate note on EMS arguments. There is time in the diary before your meeting with the Chancellor to go through this so that you can sharpen them up.

Vanessa

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VC2APC

EMS ARGUMENTS

THE CHANCELLOR'S ARGUMENTS

1. Full membership would provide an anchor for Government economic policy and give assurance that policy would continue to be operated responsibly and prudently.

A: Just because the monetary aggregates are no longer so useful, we should not fix ourselves into an arrangement which will tie us down and may itself have damaging effects. The real answer is to continue to follow a prudent fiscal policy and to be prepared to put up interest rates when it is clearly right to do so (and that is not the case at present). We have a reputation already for prudence and responsibility and this needs no reinforcement from outside. The achievements of the past 8 years have been brought about by self-discipline.

2. The obligations of membership would be understood by management and workforce alike and would influence pay and price expectations.

A: This is all too trusting. People would not believe that the Government was serious about holding the exchange rate within the band until it was really biting on them. The effect would be higher unemployment and lower output.

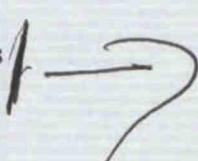
3. There would be lower interest rates on average.

A: This might be the case during periods when there was no pressure. But, as Eddie George argued in 1985, when the exchange rate came under pressure the speculative flows would probably be larger than outside the EMS and interest rates would have to be raised still more if the Government wanted to prevent a re-alignment. So average interest rates might be higher, not lower. And there would certainly be greater volatility of interest rates.

4. A more stable exchange rate would help business.

A: Yes of course. But they would scream the moment it began to bite and they would not welcome bigger swings in interest rates.

5. The oil factor is now much less important.

A: Possibly, but they have doubled from their low point and could again move much higher or much lower. And oil is not the only reason why sterling moves differently from other currencies. The size and openness of our financial markets also mark us out. 

6. Foreign exchange reserves are in a healthy state.

A: Yes they are higher but at 9 weeks equivalent in terms of imports they are less than those of Italy (10 weeks), France (13½ weeks) and Germany (14 weeks).

7. Other countries have removed many of their exchange controls.

A: Yes to some extent, though the process seems to have stopped in France and Italy.

8. The Government is committed to holding the exchange rate at its present level and has been very successful at it in recent months.

A: This cuts both ways: if we can achieve stability outside the EMS, there is less need to join. By joining we lose the Chancellor's claimed advantage of the full commitment, but we get the more than offsetting advantage of keeping flexibility for the exchange rate if that becomes really necessary.

9. The IMF have shown that the EMS countries have had less exchange rate volatility and lower inflation than those outside it.

A: This is not at all surprising if you take, as they did, all countries outside the EMS together; of course countries as widely different as Australia, Canada, the US, Japan, the UK and others, when you lump them all together will tend to show greater dispersion than the group of EMS countries which are next to each other, and have close trading links.

ARGUMENTS AGAINST JOINING

These are mostly set out above in reply to the Chancellor. But to summarise they are:

1. The Government should not rely on an external discipline as the basis of its economic policy; policy should be based on self-restraint.
2. EMS membership would cede to other countries, particularly Germany, a major role in Britain's economic policy; this would be in many ways a sign of weakness, not strength.
3. The entry of sterling into the EMS would have unpredictable effects, both because of the size and openness of our financial markets, and the continuing importance of oil.
4. The uncertainties for business might be increased rather than reduced because they would fear periodic major crises.
5. Full membership would reduce flexibility, causing the entire weight of exchange rate pressures (in either direction) to be taken on the reserves and interest rates; less volatility in the exchange rate is likely to

mean greater volatility of interest rates.

6. The influence of EMS membership on pay bargainers is likely to be slight; with cost pressures higher here than in Germany and less scope for exchange rate depreciation, the strain would be taken sooner or later in higher unemployment.
7. We should not tie ourselves still more closely into Europe at a time when we are in major disagreement with them and criticising them for financial irresponsibility, whatever the strength of economic management in Germany.

LESS GOOD ARGUMENTS

Alan Walters is not here to defend the points he made, but I am doubtful about two of them:

- (i) He argued that the City would like the EMS because it would allow them to make greater profits: arguably, the reverse is true because they make money when exchange rates are moving; membership of the EMS might cause them to make their profits spasmodically rather than continuously; in any case, those who argue for the EMS are not I think motivated in this way.
- (ii) Alan also argues that EMS membership has been a factor in EMS members growing more slowly than us; this may or may not be true but it would be extremely difficult to prove; our fastest period of growth since the War was during Bretton Woods.

follow market

It would also not be right to place too much emphasis on the size of our foreign exchange reserves or exchange controls elsewhere: either of these factors could change in the next year or two.