SECRET

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister 2.
You said that this should go to OD, but you first wanted to discuss with the Chancellor, the Governor and the Foreign Secretary.
Shall I -
i) send copies to the Governor and Lord Carrington,
ii) arrange a meeting for as soon as the Chancellor returns from Belgrade?
(Perhaps I could do this and then return the paper to you for w/end reading).
TL 25/9

PRIME MINISTER

Yes please

EMS

The letter of 12th July from your Private Secretary to mine set out the procedure you wished us to follow for considering further our position on the EMS.

2. I now attach a paper which has been prepared after meetings at which the Cabinet Office, FCO, Departments of Trade and Industry and the Bank of England were represented under Treasury chairmanship. As you proposed, it has also been discussed in a meeting of Permanent Secretaries under Sir John Hunt and some changes have been made in the light of that.

1 copy to MO/BA

3. You will wish to consider when we should discuss this paper. I would then like to circulate it under cover of a short note of my own. Our experience with the Belgians last week shows that the question of our position on the EMS is likely to come up with increasing frequency in the weeks ahead; perhaps the next really important stage will be at your bilateral meeting with Chancellor Schmidt at the end of October.

4. I am copying this letter at this stage only to Sir John Hunt.

(G.H.)

24 September 1979

SECRET

THE UK AND THE EMS

Form of Paper

1. The first part of this paper (paragraphs 2-10) is a brief history of the EMS and description of the present UK relationship to it. The second part (paragraphs 11-43) identifies and discusses three main issues which Ministers will wish to consider in deciding whether to put sterling fully into the EMS. They are first, the international monetary environment and its bearing on managing sterling in the EMS; second, the relationship of EMS obligations to domestic economic policy, especially to the money supply and thirdly, the Community factor - the significance of the EMS for our relations with the Commun ity. A final part of the paper (paragraphs 44-52) deals with certain specific questions which require a Government view, or would require a decision if Ministers decided to join the EMS: the relationship to the budget problem, the present low-key review of parts of the EMS, the question of "travelling alongside" and the possible use of a 6% margin. The conclusions list the options which we think are effectively open to the Government and also lists again the main considerations bearing on the choice.

HISTORY OF EMS AND PRESENT UK POSITION

2. The European currency system which became known as the "snake" began to operate on 24 April 1972. For the then six members of the EEC it linked currencies with 2¼% margins and was seen as part of the movement towards European Monetary Union. Britain joined the "snake" in May 1972 but left again after 6 weeks. France left in 1974 and again, after a second period of membership, in 1976. Italy, Sweden and Norway also had periods of membership or association, but felt obliged to leave in periods of balance of payments difficulty. By 1977/78 the "snake" consisted of Germany and the smaller countries economically closely linked to her - Benelux and Denmark.

3. In 1978 several economic and political factors combined to give rise to proposals for a European Monetary System. The Germans were concerned about the upward pressure on the German mark produced by a weak dollar; and felt that it could be mitigated if the mark formed part of a larger block less readily moved by dollar weakness. That would protect German competitiveness and make for more currency stability in Europe, which accounted for more than half of German trade. President Giscard was a believer in fixed rates and their value as a counter inflationary discipline to the French economy. Other factors were some general disenchantment with floating exchange rates, a distrust of the future of the dollar and a desire to restore momentum to European integration.

4. The discussion between April and December 1978 for the formation of the EMS, on the basis of an outline agreed between Chancellor Schmidt and President Giscard, repeated elements of earlier arguments in the IMF about the operation of fixed exchange rate systems. The potential new members (France, the UK and Italy) argued that the system should be constructed so as to place on the strong members (ie Germany) an obligation to play a full part in keeping exchange rates together through domestic policy measures and intervention; and that if all the

obligation fell on weaker members, the effect would be deflationary. The Germans resisted what they regarded as inflationary proposals. The UK, Italy and Ireland also argued for better treatment of the weaker member countries through the Community Budget. They said this was necessary to the "convergence" of EEC economies without which such an exchange rate system would not succeed.

5. As agreed in December 1978 the EMS included the following elements:-

i. a parity grid of exchange rates with 2¼% margins as in the snake, but with a 6% option for new members (France, Italy, UK, Ireland);

ii. within the parity grid, a "divergence indicator" which could lead to policy measures when a currency was diverging significantly from its partners. Divergence is measured against a basket of Community currencies (the ECU);

iii. enlarged short term and medium term credits to assist intervention and balance of payments adjustment;

iv. a revolving swap of reserves against ECUs, which would then be the unit for accounting between EMS central banks.

There was provision for creating a European Monetary Fund after 2 years with a full transfer of reserves, further development of the ECU and absorption of existing credit arrangements.

6. The "divergence indicator" was the main concession in the working of the exchange rate mechanism to the arguments of the "candidate members" described in paragraph 5. Its working has been reviewed this autumn. Such imperfections as the review has revealed have not been considered sufficient to justify any changes in its mechanisms, at least on the basis of experience so far. It is not clear that the indicator has so far had any notable extra effect in triggering policy reviews.

SECRET

7. Italy and Ireland reserved judgement at the December 1978 European Council but agreed to join the EMS shortly afterwards when given certain assurances about resource transfers. Italy alone used the 6% margin. France delayed the start of the EMS from January 1979 until 13 March 1979 by seeking assurances about "green rate" changes in countries whose currencies appreciated within the EMS ie Germany. A specific assurance was not obtained. The then UK Government decided not to participate in the EMS exchange rate arrangements on the ground (as Mr Callaghan said to the House of Commons) that they were too "close to the original snake" and that "it would be imprudent to join the exchange rate mechanism" when the EEC economies had in recent years not converged.

Present UK Position

8. The UK already has links with the EMS:-

i. sterling is included in the European Currency Unit (ECU);

ii. we participated in the EMS expansion of the Community medium term credit;

iii. we are entitled to join the exchange rate arrangements at any time under the conclusions of the December 1978 European Council;

iv. there is provision for mutual consultation on changes of exchange rate policy between ourselves and full EMS members;

v. at the Strasbourg European Council in June 1979 the Prime Minister announced that we would participate in the "swap" of reserves for ECUs. She made it clear that this was without prejudice to our decision on the EMS exchange rate mechanism, but reflected our interested in the development of the ECU and the European Monetary Fund;

vi. we participate in Community discussions about the closer co-ordination of economic and financial policies which is intended to provide the underlying conditions for the successful operation of the EMS.

9. On 26 June the Prime Minister said in answer to a Supplementary Question in the House that we should not make a final decision on whether to join the EMS for some time. She made a reference to the review of the EMS "divergence indicator" after 6 months working which was scheduled to begin in September, saying that "we would be in a position to make some preliminary observations when this matter was dealt with again in September".

10. On 16 July the EEC Finance Council agreed that the review should be conducted by the Monetary Committee and Committee of Central Bank Governors in an "undramatic way" and should be limited in scope. The review has now been terminated by the Finance Council on September 17. This was primarily at the instance of the Germans. They argued that, since the specialist committees in Basle and Brussels had reported that, on the basis of experience so far, there was no need to change the mechanisms of the system, and since the markets appeared to be nervous in expectation of some change, it would be advisable to express satisfaction at the Committee's reports and to declare the review completed. Although the UK expressed doubts, the participants all decided to approve the German proposal. The conclusion of the review (though it was only of "certain aspects" of the EMS) could be said to remove one answer to those who might press for an early decision on whether or not the UK will join. But the mere conclusion by the participants that, on experience to date, the mechanisms do not at present need to be changed does not in itself greatly affect the more fundamental considerations underlying the UK's choice.

THE MAIN ISSUES

11. The main considerations raised for the Government by the decisi[on] whether or not to join the EMS exchange rate mechanism are:

i. first, whether an attempt to hold sterling to a fixed but adjustable rate (within a 2¼% or even a 6% margin) is likel[y] to succeed in the present international monetary environment. This includes the special problems of sterling as a "petro-currency". ("The International Monetary Environment");

ii. second, how far there is a conflict between giving priority to an exchange rate target and the present economic policy of the Government, with the priority it gives to control of the monetary aggregates. ("Relationship to Domestic Economic Policy");

iii. thirdly, the relationship between our decision on the EMS and the whole complex of our relations with our partners in the EEC. This includes the clarity of our political commitment to the Community and any impact on the argument about our net budgetary contribution. ("The Community Factor").

The following paragraphs examine these in more detail.

THE INTERNATIONAL MONETARY ENVIRONMENT

12. This section discusses the situation and prospects of the dollar, the EMS group of currencies and sterling as the main factors bearing on our ability to manage sterling in an EMS fixed but adjustable system, and on the likely costs of doing so.

13. There have been two important policy moves towards greater exchange rate stability in the past 12 months. The first was the change of policy by the US on 1 November 1978 towards a much more deliberate effort to maintain the value of the dollar, enlisting at the time German, Japanese and Swiss help. The second was the establishment of the EMS, which has now functioned for 6 months witho major crisis or realignment.

14. Nevertheless, because the world economic situation, including oil supply and price, is uncertain, the foreign exchange and gold markets remain uneasy and volatile. The dollar, as the principal reserve and trading currency, reflects these uncertainties as well as the uncertainties of US domestic policy. Movements of the dollar affect both sterling and the present EMS.

15. The key dollar-deutschemark rate moved from 1.73 (marks to the dollar) in October 1978 to nearly 2.00 (+ 16%) in November 1978. After 1.81 in January 1979 and 1.92 in May it was again at 1.81 (10% below the peak of 2.00)on 7 September. The scale of exchange market intervention remains large. Central bank purchases of dollars were $33 billion in 1977 and $36 billion in 1978. In the first 5 months of 1979 the 7 most important countries sold $19 billion net and in June and July they bought about $11 billion. It is the scale of intervention involved in limiting currency movement which makes it important for money supply and credit conditions in the countries whose currencies are involved in it.

16. There will be factors operating in both directions on the dollar in the next 12 months. The US economy may move into recession; interest rates could be held tight or tightened; the real oil price might fall a little; the US current account deficit may be reduced. These factors could produce some dollar recovery. On the other hand inflation remains high; an election in 1980 may inhibit tough policies and create uncertainty; there could be more trouble over oil supply and prices, or disturbance in the Middle East; and Saudi Arabia could decide to sell its surplus dollars for other currencies instead of investing them in dollars. The most one can say is that change is at least as likely as stability.

17. The EMS has been influenced by the fortunes of the dollar and German reactions to them. In March, April and May when the dollar was firm the Germans sold dollars in order to hold up the mark and reduce domestic money supply, offsetting 1977/8 dollar purchases. By holding up the mark this policy put strain on the weaker EMS currencies.

when the dollar weakened in June the Germans began to buy dollars, but they also put up domestic interest rates, enforcing similar interest rate increases in Denmark, Holland, Belgium and France.

18. The Danish krone and Belgian franc have come under pressure on several occasions and there have been rumours about realignment, but this has so far been resisted by intervention and domestic policy measures. France has not wished to see any early realignment, no doubt partly because any change might raise questions about the French franc. All 3 countries have complained that the Germans have paid too much attention in their dollar intervention and interest rate policies to countering domestic inflation and not enough to obligations to other EMS members.

19. We cannot be sure how smoothly the EMS will operate later this year and in 1980. It is likely that after 9 months or a year market expectations of a realignment will grow stronger, if only because of the inflation differentials between partners. That could lead to speculative pressures. But the performance of the dollar is likely to be important. If it moves sharply in either direction there are risks to the EMS because the impact on EMS member currencies is likely to differ. Again, the German reaction to such movements, and German monetary policy generally, could be critical.

20. Despite the recent dip in the market, sterling retains most of the strength that has been manifest since March as a result of international oil developments and of the Government's monetary and fiscal policies. There might have been some check to this rise if we had been EMS members from 13 March 1979. But even with such a check, it is likely that we should have reached either a 2¼% or a 6% limit within a few weeks. We would have had to intervene to hold the exchange rate and accept the risks to the monetary targets and to inflation; or there would have had to be an early realignment of rates, which our partners would have regarded as unwelcome so early in the scheme. They would also have criticised us if we had made an interest rate increase like that announced in the Budget. Indeed, it is very possible that we should have had to take a congé, or temporary period of leave, from the EMS.

21. Sterling tends to be a more exposed currency than any in the EMS other than the deutschemark because it is still widely used in trade, because of London's importance as a financial market and because as a currency it is easily accessible. It has been a relatively volatile currency recently. For example, in 1978 the sterling-deutschemark rate fell from 4.10 in January to 3.70 in October (-10%); by July 1979 it rose to 4.13 (+12%). In the next few months sterling will be exposed to a number of special uncertainies. They include the oil situation; the impact on the economy of the new monetary and fiscal policies of the Government, which will take time to show their effects; and also, very importantly, the effects after 40 years of control of the exchange control relaxations already announced or in prospect. In addition, the markets will watch closely the development of pay increases during the winter.

22. Taking the international monetary environment as a whole, it is difficult to be confident that the next 12 months will be a period of relative stability for the dollar, for the EMS or for sterling. There are sets of circumstances which could make that 12 months more stable than the last - a quieter period on oil prices, some dollar recovery, smaller balance of payments differences between major countries. But plenty of other scenes are possible.

RELATIONSHIP TO DOMESTIC ECONOMIC POLICY

23. The essence of the EMS exchange rate mechanism is that it requires certain exchange rate objectives to be maintained at least until the members of the system agree that they should be changed. This implies a high priority for exchange rate policy, and some subordination of other policy objectives to it.

Benefits of the EMS

24. The possible benefits of such a policy can perhaps best be seen through the eyes of present members of the EMS. There is first a general benefit of greater stability which is seen as helpful to business confidence, especially for small firms. Much of industry in the UK would also see benefits in greater stability. It means greater predictability of returns and greater stability of profits if significant exchange rate changes happen only every year or two years. A more stable profit level may make credit easier to obtain. These are helpful factors, even if long term investment decisions still have to cope with the likelihood of relative exchange rate changes.

25. However the costs and benefits of exchange rate stability are different for Germany and for most of her EMS partners. For Germany the trading and industrial benefits of stability in the EMS are reinforced by benefits to competitiveness, and her objective is naturally to get these benefits with least damage to her inflation rate. Her currency is held down, those of her partners are held up, and the system requires the partners to join through intervention and domestic policy in achieving this result. Germany gets greater exchange rate stability in her most important trading area. But there is an inflation cost through a lower mark rate, more intervention, the giving of more credit and pressure to relax domestic policies.

26. For most other partners the benefits lie in countering inflation. This is how Holland, Denmark, Belgium and France see it. For them there is a price in lost price competitiveness in keeping their exchange rates higher than would otherwise be the case. But all these see the system as a counter-inflationary discipline imposing restraint on other policies and for several of them indexation of pay and benefits much reduces the competitive gains from devaluation.

27. On entering the EMS the UK could look for the benefits of stability for industry described in paragraph 24. In addition, at different times the UK might see advantage in holding its rate down for competitiveness or holding it up to counter inflation. If this were so, it could try to do this unilaterally and remain free to change policy at any time; or it could enter the EMS in order to carry more conviction because that would make the commitment more permanent and because we could seek help from our partners in holding our rate. We could not expect to gain much "advantage" in either direction on first joining the EMS because our starting rate would be agreed with our partners, but the system could act as a drag on our rate in either direction over a period. The first question this raises is however whether a fixed exchange rate can be held, with periodic agreed adjustments, in the volatile world described in the preceding section, and with a currency as volatile as sterling has recently been. The second question, discussed in the next section, is how far there is a potential conflict with present economic policy.

The Exchange Rate and Money Supply Targets

28. Joining the EMS could produce a conflict with the Government's approach to combating inflation through strict adherence to money supply targets and a progressive reduction in monetary growth.

29. Small self-balancing exchange market interventions are not likely to create serious problems for money supply targets, but they presuppose a rate which is naturally stable, perhaps in a rather stable world environment. That is not the situation of sterling. Large scale net intervention in either direction (like any unpredictable capital flows) makes it difficult to stick to a pre-stated monetary target. The scale of its effects on the money supply is uncertain and it is rarely possible to bring about adjustments in domestic monetary conditions to compensate in such a way that the target is met. The effect of gaining greater exchange rate stability in these circumstances is to push the instability back into the money supply. The possibility of meeting a target rather than overshooting or undershooting it is correspondingly reduced.

30. Substantial intervention to hold sterling down so as to keep within an EMS margin would almost certainly inflate our money supply.

The essence of this case is that we are creating (ie printing) sterling in order to sell it and thus making it cheaper by making it more plentiful. The effect is much the same as an increase in the PSBR: the intervention is in fact financed by borrowing from the National Loans Fund. After a while the extra sterling so created tends to find its way into the UK credit base. The previous Government changed its intervention policies in the autumn of 1977, and again to a lesser extent in the spring of 1979, because they considered that intervention was making it difficult to meet monetary objectives.

31. This has also been the experience of Germany and Switzerland. It was the classic German complaint in the three or four years before the dollar was floated in 1973 that the obligation on Germany to buy dollars at a fixed over-valued rate forced her to import inflation. More recently Germany has had a rate of monetary growth in the 11% to 12% range (much in excess of target) during the period of heavy intervention from mid 1977 to end 1978. Switzerland was obliged to abandon her monetary target altogether when she decided in 1978 to intervene massively to hold down the Swiss franc.

32. The other possibility is that we might need to intervene heavily to hold sterling up in order to keep within EMS margins. The direct effect of that would be to reduce the growth of the money supply. We would be using our foreign currency reserves to buy back sterling (and repay the National Loans Fund).

33. However the monetary consequences of intervention to defend a rate against heavy attack may differ from those where intervention holds up a rate which is not under severe pressure. The Germans sold large amounts of dollars in the spring of 1979 to hold up their rate and reduce their money supply. But they were not at their EMS margin. Intervention when downward pressure is heavy becomes unpredictable (it is not part of policy to undershoot a monetary target any more than to overshoot it). And if the market concludes that a devaluation is inevitable, holding a fixed rate can encourage speculators by offering them a one-way option. If then people borrow sterling in order to

speculate against it, that borrowing inflates the money supply. The reserves are used to buy back sterling created by our own banking system. Companies can lead and lag, and back this by extra resort to bank credit. This happened to the UK in 1976, and can become an important offset to the monetary contraction normally associated with selling reserves.

34. It may be argued that the conflict between money supply policy and a fixed exchange rate can be greatly mitigated by taking full advantage of the ability to change central rates which is an integral part of the EMS. But the EMS does not provide for, and could not work with, unilateral changes of rates. Frequent realignments are expressly not welcome because they undermine the stable currency zone and diminish exchange rate discipline on domestic policy. Rates tend to move together after countries concerned have put up a fight to defend their rate, and with due regard to the effect on competitiveness. Appreciation may be somewhat easier than depreciation in the system but the inhibitions on the frequency and timing of movement still apply. We cannot expect special terms on this point. The Italians wanted a "crawling peg" system. The answer to them was a 6% margin and we would no doubt get the same answer.

35. So long as strict adherence to monetary targets is an important part of Government policy, the risk of conflict with an EMS fixed rate obligation remains. However, this need not mean that the UK must remain indefinitely in a state of isolation from the exchange rate arrangements in the system, if, for example, there were a period of greater natural exchange rate stability and as it becomes clearer that the Government is succeeding in its monetary objectives.

The Exchange Rate and Community Economic Integration

36. There is an important argument that EMS membership obliges Community partners to align their domestic economic policies over a period and thus contributes to the closer economic integration of the Community.

37. It is certainly part of present Government policy to aim to match German rates of inflation and ability to compete, and generally to

enable the performance of our economy at least to match the Community average. The question is whether, given our starting point, entering an exchange rate system like the EMS in the near future would help us to do so. The Government have taken the view that the right way to make progress, given our inflation rate and the weakness of the supply side of our economy, is through strict control of the money supply and the restoration of market disciplines. There has been much acceptance of this economic approach by our Community partners, especially Germany. But under these policies the exchange rate responds to the money supply objective and is an instrument of it, whereas in a system like the EMS money supply control tends to be an instrument for supporting an exchange rate objective. We are back to the potential conflict of objectives discussed in earlier paragraphs.

38. It may be asked: why cannot we now accept the EMS if our 8 partners can, most of whom give a high priority to countering inflation? From an economic standpoint, the answer is probably that their situations differ. Germany can afford to pay some inflationary price for a major trading and political benefit. The circumstances of the smaller countries (some of whom are now in difficulty) are not comparable with ours. France is the most comparable case to the UK, though with a stronger industrial economy and a less exposed currency. It is too early to say how she will fare in the EMS : she left the "snake" twice.

39. As to the UK, it can certainly be argued that the implication of the Government's present economic policy is that we should apply the present policy strictly, especially in this first stage, in order to make progress on "the fundamentals". If this argument is right we would make better progress towards economic integration with Europe by reducing the inflation differential first than by an early linking of exchange rates.

THE COMMUNITY FACTOR: RELATIONS WITH THE EEC

40. Joining the EMS in full would obviously be seen as a significant step in reaffirming our commitment to the EEC. Our joining would be welcomed politically, especially by Germany, Italy, Benelux and Denmark, and might help some of these countries to justify in domestic political terms their share of the cost of resolving our budget problem. Conversely, our standing aside is often represented as casting doubt on our commitment to the EEC, and this doubt would clearly be intensified if we were to go so far as to declare an intention not to join (as distinct from saying "not now, but later").

41. This does not mean that we are not free to choose the moment when to join or that we are under special pressure to do so immediately. Present indications are that a number of countries would prefer us to wait for a moment to join when there was less risk that we would disrupt the system. They are very conscious of the existing pressures on it and of the strength and volatility of sterling.

42. This situation could change if the dollar stabilised and the pressure on oil prices abated; and if sterling also looked stable. However, when assessing the stability of sterling, some of our partners will look not only at the international oil and monetary situation, but at the industrial and pay situation in the UK during the coming winter. So there may be uncertainty until the end of the year or beyond.

43. It is clear, at all events, that unless or until circumstances change radically we should be careful as a minimum not to rule out eventual full membership for the UK, and should keep the question open. And we should also be careful to continue to make it clear that we wish the system well.

SOME SPECIFIC QUESTIONS

Relationship to our EEC Budget Problem

44. Given their present cautious attitude to our early membership of the EMS, it seems unlikely that the majority of our partners would want to link the solution of our budget problem with our full participation in the EMS. Attempts might be made in various ways to use the question as a debating point or delaying tactic, or perhaps even as an excuse for not making concessions which those concerned were determined to refuse anyway. But if there were such manoeuvres it ought to be possible to deal with them.

45. If nevertheless, on a balance of all the considerations, the Government decided to join by about the end of the year, we would obviously want to get all the leverage we could out of this decision in the budget context. Joining would not negative any of the particular arguments which our partners are likely to use against us on the budget and would not change the real interests in the debate. Its real bargaining value is therefore likely to be limited. Its contribution would be to the general atmosphere, mainly perhaps in the Benelux countries and Denmark: one or two of them might see our entry as an opportunity for an EMS realignment which they see as desirable or inevitable.

46. Joining would also enable us to argue for interest rate subsidies like those extended to Ireland and Italy. This would be unlikely to make more than a modest contribution to our budget problem however and we shall need to go on arguing that the loans themselves do not score at all for that purpose.

47. If the Government decided against early adherence, it would be important to state our position in terms most helpful, or least damaging, to our budget case. The line could be that we were for the moment exposed not only to the uncertainties of a "petro-currency",

but also to the exchange rate effects of the Government's radically new structural approach to the UK economy. That included the relaxation (perhaps abolition) of exchange controls in accordance with our Community obligations, after 40 years of tight control. We hoped that the new policies would bring us before long to the point where we could join the EMS with advantage to ourselves and our partners, but we had first to let sterling settle down to a level which reflected the new situation and where we could reasonably look forward to greater stability. It seems likely that in present circumstances this line would be accepted by our partners, especially if explained to them (notably to Chancellor Schmidt) in advance of the Dublin European Council.

48. Our partners might become more interested in early sterling membership of the EMS if the currency situation became more stable. One would have to look at all the circumstances at the time to assess the implications of that. At present however it seems best to assume that going beyond the formula in paragraph and announcing early adherence to the EMS would not have a really important bargaining value on the budgetary issue.

Travelling alongside

49. One possibility mentioned at Strasbourg is that we might behave for an experimental period as if we were in the EMS exchange rate mechanism (either at 2¼% or 6%) without actually joining. It is not a possibility that need be ruled out in all circumstances But it is best seen as a short prelude to joining, subject perhaps to extension if things go wrong in the trial period. As an arrangement for an indefinite period it offers few advantages. At worst it would involve us in policy constraints and intervention obligations without the benefits of full membership. At best, if it involved us in no greater constraints than we shall in any case face outside the mechanism, our partners would be less impressed by our gesture of co-operation than by our refusal to commit ourselves.

A 6% Margin

50. If Ministers decided to join, they could choose between a 2¼% and a 6% margin. Given the circumstances in which Italy argued for a wider margin (desire for a "crawling peg") it was widely feared that a 6% margin might be regarded as a sign of weakness and invite speculation. In fact the lira has been strong and in present circumstances no such suspicion would attach to sterling. In view of volatility of sterling it might be wise to opt for the 6% margin. This might require close thought if we were joining at a time of sterling weakness however.

51. The wider margin gives some extra time and room for manoeuvre if the rate comes under pressure in either direction. However once the margin is reached, the position is the same with a 6% as with a 2¼% margin and all the earlier arguments about speculation and intervention apply.

CONCLUSIONS

52. The options which we think are effectively open to the Government on the EMS this autumn are:-

i. to announce a firm intention to join the EMS at an early date. An "early date" for this purpose might be anywhere between the date of the Dublin Council (29-30 November 1979) and say, the date of the Spring Budget (probably April 1980). There would be a choice, which could be left open until the date of adherence, between a 2¼% and a 6% margin;

ii. to say that while we expect in due course to join the EMS, we think it is/in everybody's interest that we should first let the structural changes affecting sterling under the new Government work themselves out: the adjustment to oil self-sufficiency, the new monetary and fiscal policies and, as a very immediate and important point, exchange control relaxation. Meanwhile we would play a full part in work on the evolution of the system and of the European Monetary Fund.

53. The main considerations bearing on the Government's choice are:-

i. the risk that we might run into serious difficulty in holding a "fixed but adjustable" exchange rate obligation in the EMS, if it is undertaken in an uncertain international monetary environment, as with the snake in 1972;

ii. the benefits for industry of an exchange rate which fluctuates less, if we can achieve that in the EMS;

iii. the risk of conflict between the Government's policy for the monetary aggregates and an EMS exchange rate obligation;

iv. the bearing of the choice made on the clarity of our commitment to the EEC, on our relations with our Community partners in general and on the budgetary question in particular.

54. On procedure, the questions are:

i. whether any further statement, either for or against early entry, should be reserved for the Dublin Council; or made earlier;

ii. whether Chancellor Schmidt and President Giscard should be given advance warning of our position;

iii. what should be said to the House of Commons.

These questions can perhaps best be considered separately in the light of the main decision.

24 SEP 1979

CONFIDENTIAL

Euro Pol
File B
bc Mr Sanders

10 DOWNING STREET

From the Private Secretary

26 September 1979

EMS

I have shown the Prime Minister the Chancellor's minute of 24 September and the enclosed paper on the EMS. She will be considering the paper further, but in the meantime she has asked me to say that she would like to discuss it with the Chancellor, the Foreign and Commonwealth Secretary and the Governor as soon as possible in advance of its being considered in OD Committee. The Prime Minister would like the Chancellor to circulate the paper to OD - under cover of a note as he has suggested - after this small meeting has taken place. We will be in touch with you to arrange a time.

I would be grateful if you could arrange for the Governor to receive a copy of the paper if he has not done so already. I will ask Sir Michael Palliser's office to let the Foreign and Commonwealth Secretary have a copy.

I am sending a copy of this letter to Martin Vile (Cabinet Office).

T. P. LANKESTER

M.A. Hall, Esq.,
HM Treasury.

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