

STERLING AND THE EUROPEAN RATE MECHANISM

(Joint Note by Treasury and Bank of England)

Introduction

The public stance of the Government has consistently been that sterling would join the Exchange Rate Mechanism (ERM) when the time was right. Answering Dr. Owen on 31 January this year in the House of Commons, the Prime Minister said:

"We have always said that we shall join the Exchange Rate Mechanism of the EMS when we believe that the time is appropriate. It is kept under review from time to time, but I must make one thing clear. Joining the EMS would not obviate increases in interest rates, it would not obviate the need for financial discipline and, indeed, it might increase it."

2. The subject was last reviewed with the Prime Minister in February of this year. Much of the background material and analysis presented for the seminar at that time remains valid. But key charts and figures have been updated and are attached.
3. Some elements in the balance of argument have changed since February, and there have been important developments in both the substance and the public perception of the UK's financial position.
4. When we discussed the question on 13 February, the dollar had risen sharply, sterling had fallen not only against the dollar but also against European currencies, reflecting market doubts about the Government's commitment to its counter-inflation strategy, and UK interest rates had been forced up sharply. Any move to join the ERM at that time would have been seen as stemming from weakness and might have been interpreted as an attempt to escape from the necessary financial discipline rather than reinforce it.

5. Since then our position has steadily recovered. Inflation is clearly on the way down and is recognised to be so by all shades of opinion. The monetary situation, though difficult to interpret, looks a good deal healthier. We have pursued a cautious policy over interest rates. And our determination to stick to the counter-inflation policy is not being questioned. The dollar has come down substantially from the levels it reached in the winter, though it is still subject to a good deal of variation. Since 13 February, the pound has risen by 8 per cent against the DM and 23 per cent against the dollar.

6. In spite of this stronger position, and the good results we are seeing now in the rate of inflation, we have run into difficulties over the operation and management of monetary targets. Joining the ERM could provide an opportunity not merely to restate our economic and financial strategy, but to reinforce it. It would be no soft option. It would mean linking sterling to the DM, the currency of the strongest economy in Europe, which has an inflation rate of little more than 2 per cent.

Reinforcing the Strategy

7. The MTFS is, and must continue to be, the centrepiece of our financial strategy. Over the past few years we have been operating the policy against a background of currency upheavals overseas and an unprecedented period of decontrol and structural change in the financial markets which is likely to continue. In consequence, the target measures of money have been difficult to interpret, with the various indicators pointing in different directions. For reasons we discussed at the Prime Minister's monetary seminar in July, we have recently had particular difficulty with £M3. Despite these problems

there can be no question of doing without the discipline of monetary targets, though we have to recognise that they have for the present, particularly £M3, become a less reliable guide to the conduct of policy. This has created some difficulties in public presentation and in sustaining the credibility of the policy. Though we receive credit for the results of our policy, this is offset by criticism of the way in which we operate it.

8. We have always acknowledged that, in assessing monetary conditions, the exchange rate has an important role alongside the monetary indicators. The uncertainty recently attaching to our pursuit of monetary targetry has in practice obliged us to place greater emphasis on the exchange rate. And domestic financial markets too have been increasingly influenced by it. It is clear to them what the direction of the interest rate response of a Government committed to low inflation must be, and market interest rates almost always react to sharp exchange rate changes.

9. We have, however, had considerable difficulty in explaining, at any particular time, what weight the exchange rate has in policy decisions. This has itself become a major source of confusion in presenting policy. Markets and commentators continually speculate about the exchange rate level which the Government would like to see; many different exchange rate bands are hinted at. There are of course some advantages in keeping the markets guessing, and in being able to take some part of any pressure on the exchange rate. We certainly would not wish to announce a special target of our own for the sterling index. But greater clarity would simplify some of the problems of day to day conduct of policy, greatly improve its presentation and remove fears that we were exercising too much discretion. The discipline

of an exchange rate regime is more readily comprehensible than money supply targets on their own. Better public understanding would itself be valuable both politically and in influencing economic behaviour. And the only practicable possibility of clarifying this part of our policy would be to join the ERM.

10. It is neither necessary nor desirable that joining the ERM should mean abandoning monetary targets. They would remain a central part of the MTFs. We would need to make it clear that the strategy continued, and that our aim remained to secure a steady and sustained reduction in inflation. Like the Germans, we would continue to set and pursue monetary targets. We would need to consider further whether it would be right at the time of joining to make any changes in the chosen target aggregates in the new context of membership of the ERM. We have in any case to decide how to deal with the present difficulty with £M3. But joining the ERM would support the strategy at a period of some difficulty in both conducting and presenting monetary policy - a difficulty which was recognised at the Prime Minister's seminar on 16 July on monetary control, and which is otherwise likely to persist.

11. Our primary monetary objective would remain to keep monetary conditions firmly in a counter-inflationary direction. We have always recognised that conflicts could arise between sticking to monetary targets and keeping the exchange rate within ERM limits. This might occur, for example, if there were a weakening of German policy; or, if the market came to fear there could be such a weakening, and marked the DM down. Although realignments are permitted within the rules of the system, we would aim to avoid changes, especially in the first year or so, and build credibility in the market. If, however, sticking to the existing parity

required a loosening of policy which was judged to be inconsistent with the aim of keeping downward pressure on inflation our intention - and it would be a mark of strength - would be to raise the value of sterling within the ERM.

Impact on Industry

12. Linking sterling to the DM would be of value in reinforcing industry's determination to control its costs. There have been signs that firms are beginning to ease up on this front, following the strong improvement in their profitability. Manufacturing costs have risen much faster than in other major countries over the past year. Recent statements by the CBI and other industry spokesmen about the need for a lower exchange rate have not been helpful. Such statements both unsettle the markets and encourage firms to believe that they will be bailed out by depreciation.

13. Provided we are satisfied with the realism of the exchange rate at which we join and make it clear that the Government's monetary and fiscal stance remains determinedly counter-inflationary, membership of the ERM would be a valuable discipline. Holding to something like the present £/DM exchange rate would reinforce downward pressure on industrial costs and prices. And we should undoubtedly wish to discourage any idea of periodic devaluations. We should join from strength with the intention of staying strong. The CBI, Institute of Directors and others who in recent months have come to support our joining the ERM, could hardly do anything other than support this stance. They know that this is the philosophy of the ERM, and would have no easy excuse if they found that keeping up with the deutschemark was tough going.

Could we make it work?

14. There is no way in which we can confidently rule out the possibility of bouts of heavy pressure against sterling in the ERM. They could arise from differential movements into or out of the dollar if that currency were under pressure either way; or from a

severe movement of oil prices; or from a weakening of confidence if our inflation performance seemed to be faltering. Given the scale of financial flows through London, the pressure on us might be very large. And particularly in the early months, the markets might well seek to test our resolve.

15. The view that our reserves were inadequate for membership of the ERM was one of the main concerns expressed at the Prime Minister's seminar in February. We have recently strengthened our reserves substantially by borrowing \$2.5 billion on satisfactory terms. But we still have smaller reserves in relation to our volume of trade, and even more so in relation to our potential exposure to international capital movements, than other countries of the Community. We would not want to spend massive reserves, as the French did in late 1982, in defence of the indefensible. We would hope instead to recognise the need for policy change in good time and act on that. But all experience of recent years shows that, even where policies are basically sound, fashions and accidents can induce temporary capital flows on a substantial scale. In such circumstances we would have to be prepared to adjust domestic interest rates vigorously and promptly purely for exchange rate reasons.

16. After a period of achieving a track record and consequent credibility in the ERM we could hope to benefit from the reinforcing effects of membership of a mechanism that has been remarkably successful in limiting exchange rate variations. The fact of being a member could then help to stabilise expectations and to reduce some of the speculative flows. Our best protection would be our own financial strategy and performance. Some commentators have drawn attention to the UK's failure to live within the "Snake"

They claim the full amount but it would

in 1972. But the UK's relative fiscal and monetary position is now quite different from what it was in 1972; then monetary conditions were easy and getting easier, and there was a widespread view that the UK authorities wished to see a lower exchange rate.

Who decides parities?

17. At the discussion in February there was some concern about the influence of other Community countries over our exchange rate. The constitutional position is that initial parities and any subsequent changes are decided by unanimous judgment of all Community Finance Ministers, who meet for the purpose at "realignment conferences". At these there is often a good deal of argument as to whether X should devalue or Y revalue (the same thing in market terms but different in terms of political presentation), and at the margins about the amounts of any changes (with a tendency for resistance against demands for large changes). At the end of the day it is usual for a compromise to be reached, but in practice an individual country only really loses its freedom of action when that country is seeking special financial assistance, in which case attempts may well be made by others to impose policy conditions - an IMF-type situation. There is certainly an in-built pressure in the system against devaluation. But that is what we would want.

Conclusions

18. We are able now to contemplate joining the ERM from a position of some strength, based on our success in reducing inflation and the widespread acceptance of our determination to continue in that direction and the expectation that we shall succeed. But we face difficulties over the conduct and presentation of monetary policy based simply on target monetary aggregates: the exchange rate has increasingly had to be taken into account, and this has also been difficult to handle and present.

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19. Joining the ERM at this juncture would reinforce our basic monetary strategy, simplify its operation in some respects and greatly clarify its public presentation. It would impose a useful discipline to make industry face the need to keep costs down, but would also be well received by a broad range of industrial opinion.

20. There would remain risks of occasional severe difficulties in resisting exchange rate pressures - difficulties which we have not entirely escaped by staying outside the ERM hitherto. Despite these and other problems associated with full membership of the EMS, it is the considered view of the Chancellor and the Governor that the balance of advantage is now clearly in favour of joining at the earliest practicable opportunity.

ANNEX A

QUESTIONS OF PROCEDURE

In the Community

The formal process of joining would be as follows:

- we would notify our intention to the Commission and to our partners;
- a "realignment" conference would be convened, almost certainly over a weekend (notice could be given as late as Friday evening);
- the form of the conference is a preliminary meeting of the Monetary Committee (Treasury and Bank officials), followed by a meeting of Finance Ministers and Central Bank Governors;
- subject to the possible qualifications mentioned below, the sole purpose of the conference would be to settle the rate at which sterling would join, and the consequent complete new grid of cross-parities and ecu rates.

2 There are just two qualifications about the substance of the discussion:

- it would have to cover in addition any special points or conditions we wanted to raise: but this does not arise, because a mark of moving into the system strongly would be that we were not seeking special conditions and, in particular, we would be accepting the standard margins of variation of +/-2.25%;

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- there would be additional but by no means insuperable complications if, at the time of our entry, some other Community country wanted to take ^{the} opportunity of realigning its own currency.

3. The rate at which sterling would join would, in theory, be an open matter for negotiation with and among all the partners. In practice, there would be a strong sense among all concerned, and this would include the UK, that the chosen rates could not be very far from the prevailing market rates: to choose otherwise would risk confusion when markets reopened. This still leaves some room for manoeuvre over the precise rates (which could be such as to give an immediate market effect of sterling being in the middle or upper or lower part of the permitted range). We would want to decide for ourselves within this limited room for manoeuvre. We would have to explain and argue for our choice, but there must be a very strong probability that the general satisfaction of others with our joining at all would give us a strong hand to play.

4. With sterling in the ERM, the relationship between sterling and the DM would be particularly important for the authorities of both countries. Indeed, the ERM would become a different animal: a binary system instead of one with satellites around a single currency. The behaviour of the new system is not predictable - a point which we suspect the Germans and others have not fully recognised. We would want after entry to have some intensive discussions with our German opposite numbers on two main points. First, we would want to explore the possibility of a bilateral "swap" arrangement to be used by agreement in order to meet special DM/£ financial flows. Secondly, we would want to establish very close consultation procedures between our Finance Ministries and Central Banks on any measures or developments in the monetary field.

Parliament

5. The previous Labour administration gave an undertaking to consult Parliament in advance if and when there was a decision by them to join the ERM when it was set up. (Mr. Healey on 29 November, 1978 - the passage is well worth reading and is attached). We cannot trace any such undertaking having been given by the present administration.

6. This means that we could choose between the two options of informing Parliament before or after joining. In either case we would need to move fast in order to minimise the risk of any uncertainty and speculation affecting sterling's position in the market or actually or potentially within the ERM. The two options have different implications and problems:

(1) Undoubtedly best from the point of view of minimising market disruption would be to avoid any hint of our intentions up to Friday night; then arrange a weekend "realignment" conference; and begin to operate within the ERM when markets opened on Monday. A Statement to the House would be necessary on the Monday and a very early full debate would be inevitable. We would want and need to present the whole decision to join including the terms and agreed rates as a package and would have to resist any suggestion that we could adjust the rate at which we joined. We would of course have to

explain at the weekend conference that there would need to be a debate and vote in Parliament which, if lost, would effectively overturn our decision to join; but we would operate in the market as members at once. We see no reason why this should cause problems with other Community countries - or with markets, provided we made it clear that there was no question of the debate affecting our agreement on the rate.

(2) The alternative would be a Statement in the House on a Thursday announcing our intention to join "at the current market rate". The last point would be essential to minimise the risk of heavy speculation. But some speculation would be bound to develop - and it could affect existing ERM currencies in ways which would be unwelcome (rumours that a conference on sterling joining could provoke general realignment). There would certainly be pressure from some MPs for us to seek some different rate and for any rate agreed with other Community countries to be subject to reference back to Parliament. This would have to be resisted but could be embarrassing both in Parliament and in the markets. In any case, Parliament would be unlikely to give authority to the Government to negotiate entry without demanding opportunity for debate when the terms were known; so we would still expect to face that problem after the weekend and in the face of well prepared opposition.

7. The mood of some in Parliament would not be helped by such an important decision being effectively taken before they are told

of our intention. On the other hand, the double dose of the second option is unlikely to be helpful. And the market arguments point pretty strongly to the advantages of the first option. On balance we judge the first option preferable.

Risk of Leakages

8. The decision on handling Parliament - and on timing generally - may be affected by risks of leakages. We should obviously take all possible steps to avoid these risks. But we cannot do anything to prevent an invented story; and the amount of enthusiasm for a decision to join in some quarters of the press makes such a possibility a real one. For the present our response is that the question is of course under regular/continuous review - leaving the implication that nothing has changed. This position should be held for as long as possible: the moment we depart from it we are at risk of market speculation and a build-up of noisy argument: if we wished to enter we would need to move fast into one of the two options indicated above.

9. The worst risk of leakage would arise if we had to talk in advance with other Community countries or the Commission. We have concluded however that this would not be necessary given that our entry must be welcomed and that we would not be seeking special conditions.