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CONFIDENTIAL FILING

Briefing for the Prime Minister by  
Sir Alan Walters

Economic Policy

May 1989

| Referred to  | Date | Referred to | Date | Referred to | Date | Referred to | Date |
|--|------|-------------|------|-------------|------|-------------|------|
| <del>10.5.89</del><br><del>16.5.89</del><br><del>6/6/89</del><br><del>12.6.89</del><br><del>28.2.90</del><br><del>18.5.90</del><br>15.1.91 |      |             |      |             |      |             |      |
| PREM 19/3269   |      |             |      |             |      |             |      |



BP

JAN 18 '91 04:29PM SENT BY PUTNAM, HAYES&BARTLETT DC

Mrs Thagard & Hatcher,

Prime Minister  
Alan Walker forces his message to  
Mr Thatcher via No. 10. Interestingly  
to know what he is thinking.  
could be surprised on X. P.2

A note which might interest you!

Alan

January 15th 1991

### Notes on Sterling

With interest rates at near 14 percent, sterling deposits, as compared with mark deposits at 9.4, are attractive - provided that there is a correspondingly small downside exchange risk. These notes assess that risk.

At present (Jan 15th) sterling is just below its central 2.95 Deutschemark value at 2.9366, after having been well below it at 2.86 or so, only four pfs above its ERM floor. Widely perceived as having a risk only on the downside, the recent appreciation against the mark is largely explained by political events in Lithuania and the USSR depressing the mark and promoting the dollar. Indeed sterling may well rise to a little over its 2.95 level. The underlying economic pressure on sterling is, however still there, while the adjustment for political events tends to be a once and for all movement. One must expect further pressure soon, and it is likely to subside well below its central value.

Will the government hold the 2.95 central value with its six percent limits? For a while I am sure they will. Politically it would be seen as a massive climb-down to ask for a realignment substantial enough to matter. But to hold this, it is unlikely that they will be able to make any much needed reductions in the 14 percent interest rates - especially if the Bundesbank nudges rates up to say 10 percent. It also seems likely that they will not have a very tight budget - that is to say large increases in taxes - in seven or eight weeks time - in order, they would believe, to give them room to reduce interest rates and yet keep the 2.95 value.

The most likely policy is for sterling to be devalued slightly under cover of adopting 2.25 percent limits (rather like Italy did - a move much admired by the ERM enthusiasts). It would be possible to get perhaps a 3 percent devaluation which, proponents will argue, should be enough to mollify the markets, at least in the short term. This may be the tactic for the budget in early March. Such is the pressure for cuts in the 14 percent interest rates that I suspect that the Chancellor would be tempted to bring rates down to 13 percent (even if Germany stays at 10 percent).

As a short term fix this might well succeed. But as the recession deepens, the unemployment soars at fast rates than we have seen in the post war years, and as the crescendo of complaints from industry rises, I believe that there will be overwhelming pressure for something like a 10 percent devaluation. I do not anticipate that this will be conceded until all the other avenues, such as coordinated intervention have been explored. The delay will do great damage to the economy, but the government has boxed itself in.

Finally there is the likelihood, much enhanced by this process of procrastination, that the electorate will turn to the Labour party. This will exacerbate any run on sterling, and so contribute to the pressures both on interest rates and the exchange rate. I would anticipate that this would occur somewhat later in the summer and fall of 1991. Then will sterling really fall.

A warning! Although at present this seems a plausible pattern of events, much could be upset primarily by unforeseen political circumstances. The only part of the story I am reasonably certain of is the next two months - up to the time of the budget. This should provide some reason to hold sterling deposits.

Alan Walker



PRIME MINISTER

MEETING WITH SIR ALAN WALTERS

Alan, Brian Griffiths, Barry Potter and I will be arriving at 1900 on Saturday evening. Alan will be staying overnight and leaving for Heathrow around 0900 on Sunday morning. The rest of us will be returning to London that night.

Brian has provided a useful agenda for the meeting - Flag A. His final item is a discussion of reserve asset ratios. These are discussed in the hefty Treasury paper which will be coming to you this weekend. It is unlikely that you will have had time to read it before the meeting. It may, therefore, be better to hold this over until your meeting with the Chancellor on Tuesday.

Brian has also put in a note on the ERM - Flag B. At X he argues that UK interest rates would be unlikely to fall on entry. I would distinguish between the pressures, ie what is likely to happen without Government efforts, and what ought to happen. The political and economic pressures could well be for lower interest rates; what the economy needs is a strengthening of the exchange rate. The Government might have to work quite hard to secure this in the face of widespread expectations of a windfall on interest rates.

AS

ANDREW TURNBULL

18 MAY 1990

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9a-5 cc Back-up A

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PRIME MINISTER

18 May 1990

MEETING WITH SIR ALAN WALTERS

The following subjects need to be covered at the meeting tomorrow.

Present stance of Economic Policy

1. Is the present stance of policy too loose?
2. MO is now rising at 7.3% or more and has increased since hitting a low of 4.5% in September 1989. Is this a cause for concern?
3. Broader monetary aggregates are growing at 17-18%. Is this a cause for concern?
4. In view of the growth of the monetary aggregates, are interest rates too low?
5. The two other ways of tightening the economy are:
  - (a) public expenditure - how tough should this years PES round be?
  - (b) exchange rates - should entry to ERM at a high rate be used in the fight against inflation?



Entry to the ERM

6. If we were to enter with a wide band, what are the risks to inflation or deflation from joining?
7. What problems do you see in being in the ERM during the run-up to an election? *And what problems about not being in?*
8. What is the inflationary potential of Germany?
9. How important are covert controls in the operation of the ERM at present?
10. What about timing for entry?
11. What impact will sterling have on the ERM?
12. Is it technically possible to realign sterling if we hit the top of the range? If not is this a case for delay?

Other Issues

13. What is the value of reserve asset ratios as a way of controlling the banking system?

*BGr.*

BRIAN GRIFFITHS



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PRIME MINISTER

MEETING WITH SIR ALAN WALTERS

You said you would welcome a chance to talk to Sir Alan Walters in the near future. I have established that he will be coming to Britain on 17 May, leaving for Warsaw on Sunday 20 May. You are in Finchley on Friday afternoon and are seeing Mr de Klerk on Saturday. One possibility would be a meeting on Friday 18 May for an hour at 0930-1030. Content for me to arrange this?

AT

ANDREW TURNBULL

9 May 1990

Prime Minister

I have spoken to Alan. He would like to come to dinner a Saturday evening after Mr de Klerk has left. As he has to be at Heathrow by 8.00 a.m. a Sunday morning, he would very much appreciate being able to stay overnight. I would like to come as well, though not stay. Would you like Brian to be invited also?

Yes no

AT

11/5

I assume that one of our cars

can take them to Heathrow. I will pass  
whether in the car  
no

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PRIME MINISTER

MEETING WITH ALAN WALTERS: 27 SEPTEMBER

You are seeing Alan for 45 minutes tomorrow morning.

I have had a long talk with him this afternoon to brief him on current developments. I suggest the priorities for discussion tomorrow are:

- i. the economy - interest rates, trade figures, M0, etc.;
- ii. electricity privatisation;
- iii. (if time permits) EMU.

Economy

My impression is that Alan feels strongly that the present level of interest rates is right and we should not contemplate any change. He seems reasonably satisfied with the course of the M0 figures, and is relatively sanguine about the continuing high external deficit. As you know, he does not favour significant intervention to prevent the exchange rate falling if that is what the market wants - whereas you have adopted an asymmetrical approach under which you do not favour intervention to stop the pound rising but are content with intervention to stop it falling.

Electricity Privatisation

You may like to take Alan's mind on this in advance of Thursday's meeting. I have reported to him on your recent talks both with John Wakeham and Nick Ridley, and he has seen John Wakeham's latest paper which you started to look at earlier today. This is enclosed at Flag A, in case you wanted to have a full read of it this evening to see the new compromise John Wakeham is suggesting.

My impression is that Alan is most concerned about the extent of the limitations proposed on competition and the sheer bureaucracy of it all. The problem of course is how to increase the competitive element given the constraints of:



- the tight timetable;
- the fact that we cannot force the newly privatised companies to sign contracts they don't want;
- the various aspects of the nuclear problem;
- the coal strike risk.

EMU

Alan missed most of the key meetings of the Peter Middleton group during the summer that prepared the papers leading up to the 'competing currencies' proposal. But I think by the time he sees you tomorrow morning he will have had a chance to touch base with Peter Middleton on this and other issues. I imagine you will want him to do further work on this. But in terms of priorities for the use of the time available tomorrow, the economy and electricity privatisation are both more pressing.

*PAUL*

PAUL GRAY

26 September 1989



SIR ALAN WALTERS

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RAINFOREST PROTECTION

Thank you for your note of 12 July, which I have discussed briefly with Andrew.

Two thoughts:

- on the substance, how confident are you that the administration of this idea could be kept to quite such a slim bureaucracy as you envisage?
- on the handling, might it not be better for you, in consultation with ODA, to do a bit more work - particularly on the quantification - before we float this idea with the Prime Minister?

*Suzanne McGee*

cc PAUL GRAY  
14 July 1989

cc: Professor Griffiths  
Andrew Turnbull  
Charles Powell  
George Guise

EAMAZL



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PAUL GRAY

12 July 1989

RAINFOREST PROTECTION -  
THE GOLDSMITH PROPOSAL

1. Goldsmith proposes that the industrialised countries pay Brazil etc for the service of maintaining their forests - a carbon-absorbing oxygen-producing machine for the world. In his original proposal, the payment would be made in the form of government debt extinction etc. In discussion with him last night, he conceded that this was not really desirable. It would tend to confuse both the forests issue and debt negotiations. We have now a clean slate.
2. A pay-for-forests proposal can be put in the form of the OECD countries agreeing to pay a "service charge" annually for designated acres of forest which remain in some specified "natural" state. The service charge would be fixed so that it is above the value of the forest in any other (agricultural) use, and below the costs of alternative methods of carbon-locking to the same degree as one acre of forest. I suspect that the latter cost level is so high that it can be ignored. The value of the forest in the next best alternative use, however, should be relatively easy to determine - although it will vary greatly according to location. It is important to stress that in principle one would not wish to prevent the destruction of some areas of forest where the alternative use value is suitably large. And we should set our service charge with this firmly in mind (pointing out also the illogical and unscientific nature of the extreme "green" policy which requires all virgin forest to so remain).
3. In order to keep it simple one would probably use a constant service charge per acre. This would over compensate for much of the acreage but it avoids bureaucratic and administrative

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costs involved in a varying charge. I have only a vague idea of the appropriate service charge, but, from the scarce information on such forest land values, I would conjecture that an annual figure between \$0.50 and \$1.50 would be about right. This would be paid at the end of the year with confirmation, probably from satellite photographs, that the forest was intact.

4. Goldsmith suggested that the administration should be in the hands of an international financial institution such as an offshoot of the World Bank. After discussion, however, he agreed that this was not a good idea. In my view the Bank would convert the programme to its own bureaucratic interests. And it is best to separate it from the aid syndrome and bureaucracy. For reasons which are given below I think it would be best if we, in the UK, set up a FORESAVE in London and financed it ourselves, but with the understanding that all OECD countries, if they decide to join, are invited to use FORESAVE in contributing to this initiative for world survival. I would stress that only a very modest staff (about seven to ten professionals) is needed.

Proposal  
5. This is an initiative where the Prime Minister could clearly take the initiative and lead the OECD countries. I would suggest that the Prime Minister, in order speedily to move OECD into recognising their "responsibility for preserving the world's climate", declare that Britain will pay a service charge for 7 per cent of the world's rainforest (roughly our GNP as a fraction of OECD) unilaterally - beginning in 1990. We would hope that the case is so strong that all OECD would follow our lead tout suite.

6. The political advantages of such a declaration are obvious. The Prime Minister will be doing something, not

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convening international meetings, with their endless talk and paper promises, and bemoaning the selfishness of Brazil, Venezuela, etc. This unilateralism will demonstrate the urgency with which we view environmental degradation. She will steal the clothes of the Greens and people will see that there was no Emperor under those green raiments. It will reassure the many supporters who are very worried about environmental degradation.

7. As for the cost, this needs to be worked out in detail. Some of it (and I would argue all, but politically this may be impossible) should be subtracted from the expansion in the budget for aid. In any case, I suggest that we should start work on quantification immediately. It is too good an opportunity to pass up, and I suspect that someone in France will shortly have the same idea.

8. I should add that the proposal outlined above is mine and I have not discussed this with Sir James Goldsmith



ALAN WALTERS

cc Professor Brian Griffiths  
Andrew Turnbull  
Charles Powell  
George Guise

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cc Andrew Turnbull  
Charles Powell a  
Paul Gray  
Brian Griffiths

PRIME MINISTER

16 June 1989

GERMANY'S COVERT EXCHANGE CONTROL

You were interest in FRG's covert exchange controls. Here are three samples:-

1. Restrictions on Insurance Companies holdings of foreign assets.

The law on insurance supervision (VAG) specifies the assets required to meet contractual insurance liabilities:

- (i) The list of prescribed assets does not allow holdings of any foreign currency assets;
- (ii) The law also requires an exact matching of assets and liabilities which implies all Dmark holdings;
- (iii) Severe restrictions apply to equity holdings, eg less than 5 per cent may be in "foreign corporations" and must be traded domestically and denominated in Dmarks;
- (iv) Comparing with insurance companies in the UK in 1984, we find the following portfolio composition:-

|     | <u>Loan Stock</u> | <u>Government</u> | <u>Mortgages</u> | <u>Equities</u> |
|-----|-------------------|-------------------|------------------|-----------------|
|     |                   | <u>debt</u>       |                  |                 |
| FRG | 39                | <u>%</u> 24       | 21               | 5               |
| UK  | 5                 | 27                | 6                | 41              |

In the UK we are entirely neutral between sterling and other currencies.

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2. Restrictions on Foreign Currency Bonds

Section 3 of the Currency Act prevents German residents from issuing and buying domestic bonds denominated in a foreign currency (including ECU).

3. Federal Debt

Although most securities are now open to non-residents, the FRG still does not allow foreigners to buy certain bonds with less than two year maturity (Treasury financing notes and Federal Savings Bonds).

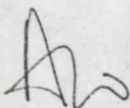
4. Compatibility with Capital Liberalisation Directive (CLD)

The FRG rationalises the insurance company restrictions on the grounds of "prudential" supervision. This is recognised as legitimate in the CLD. But there are clear grounds for arguing that such currency restrictions go well beyond any prudential requirement.

Both the restrictions on foreign currency bonds and on foreign holding of federal debt clearly violate the CLD.

5. CONCLUSION

It would be useful to ask the Treasury to examine the extent and effectiveness of covert exchange controls in all Community countries.



ALAN WALTERS

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*Cole M*

SIR ALAN WALTERS

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**MONEY MARKET ASSISTANCE AND FUNDING POLICY**

The Prime Minister was most grateful  
for your minute of 9 June which she has  
noted.

PAUL GRAY

12 June 1989

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*2*



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Prime Minister<sup>2</sup>

I asked Alan on his return this week to ensure he was contact with the Treasury's

9 June 1989

planned technical changes to market management; you will be pleased to see that he is.

PRIME MINISTER

MONEY MARKET ASSISTANCE AND FUNDING POLICY

A. MONEY, BILLS AND RATES

1. Short term interest rates are controlled primarily by selling and buying bills - supplying money to, or draining money from the market on a daily basis. The money market participants must carry a stock of bills so that, when they are short of money, the Bank can buy them and inject cash into the system. Such money market assistance must also be considered as one element in the funding process.

PRC6

9/6

*Producer  
was not  
mt.*

2. As a consequence of our policy of over-funding up to 1985, the private sector purchases of gilts drained cash out of the system; we were induced to inject cash through buying bills in order to restrain interest rates. Thus we acquired a bill mountain of over £17 bn. From 1985, however, we ceased over-funding and adopted a full funding policy. The idea behind our 1985 policy of full funding was to ensure that public sector financial operations do not have any net effect on liquidity (M3 or M4).

3. This, inter alia, not only reduced the need for these injections of money; but, on balance, since 1985, we sold bills to drain money out of the market. The bill mountain has all but melted away.

B. POLICIES

4. To restore our ability to control short-term interest rates, the Treasury is likely to propose a two-pronged strategy:

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First, we should adjust the funding rule so as to maintain a marginal demand for cash. The market would then supply bills to the Bank, building up a modest bill hill, enabling us to control interest rates. A number of other helpful measures have also already been taken - such as lengthening bill maturities.

Secondly, the Treasury will develop a policy to deal with the Local Authorities subsidised borrowing from the PWLB. The subsidy has induced over-borrowing and the LAs have profited by depositing the money at the higher market rates. They have behaved like financial intermediaries and have increased the cash surpluses on the money markets.

5. Both policies seem to be appropriate. The first policy proposed is about the minimum we need to ensure control of interest rates. The funding change should not affect the term structure of interest rates to any significant extent. The second policy, aimed at reducing or eliminating the subsidised LA borrowing from the PWLB, is desirable in its own terms as well as in its effects on money market operations; but this will take time to explore and implement.

#### C. REJECTING MONETARY BASE CONTROL

6. In their work on funding rules, the Treasury also demonstrated that it would be possible to feed the money markets to produce a target monetary base (M0), leaving short-term interest rates to be determined entirely by market forces. But officials rejected such a rule on the grounds that ministers would never wish to relinquish their powers to control interest rates, even if the target M0 was under strict control.

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D.    CONCLUSION

7.    The Treasury's policies meet the needs of the day.  
I believe they should be supported.    The rejection of MBC,  
if not the rationalization, is also appropriate - at least  
for the foreseeable future. Adopting Treasury's recommendation  
will result in minimum upset to the rather uneasy markets.

ALS

ALAN WALTERS

cc Professor Brian Griffiths

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10 DOWNING STREET

With the compliments of

*Alan Watkins*

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*File*

10 DOWNING STREET

LONDON SW1A 2AA

6 June 1989

Sir Peter Middleton KCB  
Permanent Secretary  
H M Treasury  
Parliament Street  
LONDON SW1

Dear Peter,

The media are currently misrepresenting my views even more than they usually do! For your information (and I would be glad if you would consider passing this on to the Chancellor):

- (a) I believe that the monetary stance is broadly right, and all the signs (except for the recent M0 weekly figures) are auspicious.
- (b) I am fully supportive of the "fully-fund" policy that I argued for way back in 1981/2.
- (c) I am against any broad money target. Broad money is a useful statistic but a misleading target. If we control M0, however, we can prevent any persistent inflation.

Of course, I have made my views known to you before so they come as no surprise. They were also laid out in my book for anyone to read. I suppose that the media misrepresentation serves to sell papers rather than to serve the truth.

I am copying this to Andrew Turnbull, Bernard Ingham, Paul Gray and Professor Brian Griffiths.

Yours,

*Alan*

(Professor Sir Alan Walters)



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CCB/JP

7

PRIME MINISTER

TALK WITH ALAN WALTERS: 17 MAY

You saw various notes from Alan over the weekend, which you are due to discuss with him tomorrow.

I suggest you take them in two groups:

(i) In divider one is Alan's note on the EMS, together with the questions set out in Charles' note.

(ii) In divider two are Alan's two notes on Intervention and Exchange Rate Management, together with my covering note.

PRG.

PAUL GRAY  
16 May 1989

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PROFESSOR SIR ALAN WALTERS

6

**EXCHANGE RATE MANAGEMENT**

I showed the Prime Minister over the weekend your two notes of 11 and 12 May. You may like to see the Prime Minister's comments on them, together with the note I put with them.

As you will see, the Prime Minister would like to talk this through with you before you take action with the Treasury and the Bank concerning explicit constraints on intervention. Amanda is trying to organise a time on Wednesday to discuss this and your thoughts about the ERM.

You may also like to see the attached note I put in the weekend box on the economic statistics due for publication this week.

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PAUL GRAY

15 May 1989

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After we must  
just discuss  
not

PRIME MINISTER

## EXCHANGE RATE MANAGEMENT

You will want to see the attached two notes from Alan Walters, each covering similar issues.

The first note on intervention at Flag A sets out Alan's worries about intervention if there is downward pressure on sterling. He seeks your authority to discuss with the Treasury and Bank the imposition of explicit constraints on intervention activity.

The second at Flag B repeats the worry about intervention in relation to the policy being adopted by the Bundesbank. But Alan goes on also to argue that any external pressure to increase UK interest rates should be resisted.

I would offer two quick thoughts on this:

- in recent months you have adopted an asymmetric view on intervention. You have opposed intervention if the market has been pushing sterling up, but you have been content with modest intervention to prevent sterling going down. Alan favours symmetry, with no intervention in either direction. I continue to see a case for a degree of asymmetry, and would have worries about a completely "hands off" approach if there was downward pressure on the exchange rate.
- on interest rates, I do not dissent from the view shared by Alan and the Treasury that at present the stance of monetary policy in relation to the domestic inflation problem is right. But we need to keep that assessment continually under review and we certainly cannot rule out the possibility of the need for an interest rate increase; the separate note in the box on economic statistics next week points to a surprisingly large



reduction in the latest unemployment figure, and - as we  
discussed when you saw Cecil Parkinson yesterday -  
further upward pressure on wage increases may also  
necessitate offsetting monetary action.

On handling, the issues raised in these two notes by Alan also inter-relate with his note on ERM that Charles has put separately in the box. Perhaps it would be sensible for you to talk through all these issues with Alan, before he discusses the intervention issue further with the Treasury and the Bank.

Content to proceed on that basis?

*Free.*

(PAUL GRAY)

12 May 1989

DA2ABA



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PRIME MINISTER

12 May 1989

CCB/PP

or, as the Treasury would have  
put it, to resist the decline of  
the £. Recg.

INTERVENTION

→ Last Tuesday the Bank intervened about \$185 million in trying to contain the rise of the US dollar. The main rise was against the Dmark which, because of the Bundesbank's past policy, has been particularly weak. No doubt because they have intervened heavily over past months to no avail, the Bundesbank did not intervene at all. Nor did the Bank of Japan. There was certainly no concerted intervention by the G5 countries.

I can see no justification for our intervention. It had no discernable effect on the out-turn of the market. Nor should one expect any substantial effect since, relative to transactions, the sums were trivial. (Incidentally, the media reported it as a \$300 million intervention.) But it may well have given a wrong signal to the market, namely that we have some sort of dollar/Dmark target. I believe it was a mistake.

As far as I can detect, there are no guidelines on intervention. Although there is a clear understanding that a policy of "large interventions" (e.g. over \$500 million) should be cleared with you, apparently there is no policy or strategy on our use of intervention. I suspect that, notwithstanding the "understandings", it could easily get out of control. To the player, intervention has many of the addictions of gambling - the feeling always that one only needs to stake a little more, and a little more, to make a big killing.

I advise that we put more explicit constraints on intervention - similar to those we employed in 1981-83. May I have your permission to explore this with the Treasury and Bank?



ALAN WALTERS

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PRIME MINISTER

11 May 1989

THE Dmark, THE DOLLAR AND STERLING

It is becoming increasingly clear to the Bundesbank (and, I believe I suggested this to you some two months ago) that it (and, above all, Pohl) have greatly misjudged monetary policy. The monetary aggregates are all over the top, inflation is rising (the wholesale price index was over 6 per cent on a year-on-year basis), and there is very large exodus of capital. Per contra, Alan Greenspan has conducted a most responsible monetary policy and has laid the foundations for low and stable inflation for the next two years.

Currencies reflect these policies. The dollar soars, the Dmark sinks.

I conjecture that the Bundesbank will be driven eventually to tighten monetary policy through increases in interest rates. If the increases exceed 100 basis points, this will cause a decline in the Dmark exchange rate of sterling.

I am concerned about the reaction of the Treasury and Bank to these conditions. The immediate reaction is to use intervention to test sterling's decline against the Dmark. As you know, I think that running down our reserves by buying sterling on a market that is falling because of a fundamental change in monetary conditions in Germany is simply a recipe for losing money. If not sterilised, the intervention has the effect of a monetary squeeze. If sterilised, it is useless.

The next reaction is likely to be that we should put our interest rate up pari passu. This, like unsterilised intervention, will increase the severity of our present monetary restraints.

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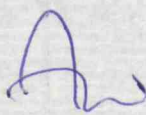


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This would be wrong. Last week the Treasury and Bank agreed that the present monetary squeeze was the right degree of severity for our domestic inflation problem. There is no reason why we should distort our policy and economy in response to the Bundesbank's past mistakes and their present attempts at redress. For example, if the Bundesbank increased rates by 150 to 200 basis points (not beyond the range of the feasible) and we followed with similar rises (to 15 per cent), I believe that such a policy would be very likely to induce a recession - perhaps a severe one - in 1990-1. (It would also create great dissension in the EMS; France in particular would hate to see a rise in interest rates.)

In short, we should stick to our present monetary stance. It is broadly right. And we should take any effects of a putative German squeeze on our exchange rate.

But a small extra  
monetary squeeze to check  
or limit a fall in sterling  
does us no harm at present  
and is meant to indicate that  
we do not want sterling to  
fall. We took in

  
ALAN WALTERS

25 bn to stop it rising - which  
is now causing us trouble  
Very small and to stop it  
falling seems to me helpful.

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file ✓  
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PROFESSOR SIR ALAN WALTERS

cc Mr Gray

EUROPE

I think your idea is ingenious and well worth pursuing. It puts the other Europeans on the spot. We ought to discuss it with the Prime Minister next week. I will look for time in the diary for this.

We have to be ready to deal with a number of counter-arguments, some of which I would expect the Prime Minister to put forward:

- the other Europeans ought to fulfil the conditions set out in paragraph 2 of your note on their merits and without our having to pay a price.
- all our objections to joining the ERM will be just as valid after the others have fulfilled your conditions as they were before. If you take the view that membership is against our interests full stop, then your note does not help.
- there is a risk that, if we set conditions, the other Europeans will set counter-conditions e.g. they might argue that they will free capital movement when we agree to a Community-wide tax on savings.
- if we tie ourselves rigidly to your conditions, then we may actually deprive ourselves of flexibility. Suppose our assessment of the advantages and penalties of membership of the ERM were to change and we decided to go in but our conditions had not been met, it would look like a defeat for us.

I am making these points because I suspect they will come up not because I disagree with you. Indeed your suggestion sits very well with the point which I was trying to make at

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Chequers that we should try to focus the discussion on achieving genuine competition in the Community.

Charles Powell

10 May 1989

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PRIME MINISTER

10 May 1989

WHEN "THE TIME WILL BE RIPE"

1. One of the difficulties in dealing with the EMS issue is that we always appear to be negative, declining a "seat on the bus" etc. This note attempts to set out a positive response, which will, nevertheless, preserve our position.
2. I suggest we say the time is ripe when:
  - (a) all constituent countries have abolished all foreign exchange controls and the legal machinery through which they are imposed. (Note that this condition could be specified as one year without controls. We should ensure that any conditions are satisfied before we enter the ERM. Promises of future reforms are not sufficient.)
  - (b) all domestic banking systems and financial and capital markets are deregulated and open to competitive entry from EEC countries. In particular, cartel arrangements would be regarded as a form of non-competitive behaviour, and
  - (c) any institution, \ corporation, \ partnership or individual would be free to enter any banking or financial business, subject only to minimum prudential conditions. (We need to be very specific about such conditionality.)
3. This would put the ball squarely into our opponents' court. What would they do with it? There are two alternatives:
  - (a) They could say that the conditions are tantamount to rejection of ERM since the other EEC countries could not conceivably liberate their financial and capital markets to the extent of the UK. Then we could reply



b

that EEC ministers had reiterated their view that open, unregulated and competitive financial systems had been the aim; now the reality was that the other countries were backing off their commitments. We have kept the faith: they have not.

- (b) They could accept and carry through the conditionality. Europe's financial systems would then be like ours - free and competitive. Then we would be in honour bound to join.

4. I conjecture that response 3(a) is much more likely than 3(b). For all the talk of deregulation and competition, I cannot see, for example, Italian banks allowing British banks to enter their lucrative and highly restricted mortgage business. The cartelised financial markets of other Common Market countries are part and parcel of their corporatist systems. It is unlikely that, protestations to the contrary, they will be dismantled.

5. But supposing they are so changed into the epitome of competitive and open markets. Then we would have to join the ERM. But surely we would then want to belong fully to this vast liberal market. A free competitive financial system would destroy the corporatism of France, Italy and Germany and set such a dynamic supply-side revolution in train that all countries would gain enormously. (Of course those groups protected by the barriers of corporatism would suffer, at least initially.)

6. None of the arguments against joining the ERM are discredited. They remain as strong as ever. The cost of joining the ERM seem to me to be worth paying if we have open and uncartelised financial markets for us to exploit in the community.

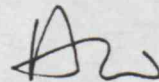
7. But such a cost is likely to be very small since it is most unlikely that the ERM as we know it could remain in a milieu of open and competitive financial markets. There would have



C

to be more room for movements of exchange rates. As the late 1960s showed, the pseudo-fixed exchange rates of Bretton Woods could not be maintained in the face of the, by today's standards, very modest capital movements that fairly free markets then generated.

8. Whether the response is 3(a) or 3(b), I think that this "time is ripe" conditionality should enable us to reverse the negative image and show that we are on the side of the liberal angels. This approach is consistent with various statements of the Government's position. It is also a natural development from your Bruges speech. I suggest that it is worth some consideration.



ALAN WALTERS



FIXED EXCHANGE RATES AND COMMON MARKETS -  
THE CASE OF THE UNITED STATES AND CANADA

1. One Market

- \* Canadian - US trade flows are larger than any other pair of countries in the world.
- \* Both capital and labour are free to move unhindered across the border.
- \* There are no non-tariff barriers and the remaining tariffs are to be abolished under the Free Trade agreement.

2. Exchange Rates and Monetary "Union"

If there were ever a case for an exchange rate fix or monetary union, then it would clearly imply that Canada (a) fix the Canadian dollar against the US dollar, and (b) arrange that Canada's dollar be exchanged for US dollars and for Canada to become an integral part of the US Federation.

3. The History

Canada did, in fact, experiment with two periods when she fixed the Canadian dollar to the US dollar. On each occasion, the Government decided that the costs of pegging were far too large to offset any conceivable benefits. The Canadian dollar has floated with virtually no intervention for fourteen years.

During this period, Canadian dollars have circulated modestly in the border areas of the United States, and US dollars are widely accepted throughout Canada as an alternative medium of exchange.

4. Present Policies

In the wake of the free trade agreement, there is simply no body of Canadian opinion, either academic, political or commercial, in favour of a new bout of fixed exchange rates or a monetary union. The past lessons are not forgotten. And Canada has retained her monetary identity and sovereignty.

AU

ALAN WALTERS



Grey Scale #13



A

1

2

3

4

5

6

M

8

9

10

11

12

13

14

15

B

17

18

19



Inches

1

2

3

1

2

3

4

5

6

7

8

Centimetres

Colour Chart #13

Blue

Cyan

Green

Yellow

