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SC. NLW
Dr. D.

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

PRIME MINISTER

EUROPEAN CURRENCY ARRANGEMENTS

I attach 2 papers for your seminar on this subject on 29th June. One of them outlines schemes which have been canvassed and assesses their possible implications for the UK. The other is concerned mainly with tactics, timing and handling but has also a section about what membership of any scheme of this kind could involve for the UK.

2. Paragraph 2 of the paper about handling, records the UK pre-conditions for a new scheme which, as agreed, I rehearsed at the Luxembourg meeting of the Finance Council on Monday, 19th June. The essence of these conditions is that any scheme which we are to join should promote growth rather than reduce it, and that it should embody convergence of policies, in the economic field as well as the currency field, from the side of the stronger countries as well as by the weaker. Without this symmetry of obligations as between surplus and deficit countries, a scheme would have a built-in deflationary tendency. Our views on this are now on the record, but in a context which makes it difficult for anyone to argue that our approach is a negative one.

3. It became clear from my discussions with M. Monory in Paris on 15th June and from what M. Monory said in Luxembourg on

/19th June

19th June that there is likely to be scope for us to act quite closely with the French in this matter in the months ahead. It looks as if M. Monory had the authority of President Giscard for saying in Luxembourg that we ought not to be too hasty in this matter and to avoid solutions which required transitional arrangements precisely because they were too hasty. It seems clear that the French approach is that they should defer entry to any scheme at least until next year.

4. An interview given by M. Barre to British and American journalists which was reported in the "Financial Times" for 21st June is consistent with this. He is reported as saying that he did not expect much progress to be made at the Bonn Summit towards closer monetary co-operation. Any moves in this direction were conditional on a greater convergence of the economic situations in the countries concerned. M. Monory also said that economic convergence was needed to help efforts in the monetary field.

5. The present Snake countries have said that they wish to preserve their present currency arrangements unchanged within any wider EEC currency reform. The French, no doubt partly for tactical reasons, said for their part in Luxembourg that they were opposed to a 2-tier scheme which would encourage speculation against the weaker partners. If all EEC members were joining, all member countries must be on the same footing. If one accepted both these positions at face value, it would mean that the only options available to us were to join the existing Snake or to stay as at present. It is difficult to believe that these positions would not change in negotiation if they came under pressure but so long as they are held they rule out an early solution, and do so without placing any onus on the UK. It may be that the implications of the line being taken by the Snake countries and the French will appear at Bremen. My conclusion is that a part of our tactics should be to keep reasonably close to the French in the coming months both on the merits and in order to reduce

/the risk

the risk of our becoming isolated or cast in the role of the principal opponent of Chancellor Schmidt's aspirations for European currency reform.

6. I should repeat also the point which I know was taken at an earlier stage: we do not want the markets to think both that we are likely to enter a new currency scheme before long and that we or the French or both will have to devalue on entry. If that idea gained currency there could be pressure on our exchange rate.

7. The Finance Council agreed to send forward to Bremen both the report of the Monetary Committee, which is at Annex 2 of the "Assessment" paper attached; and a report from the last Basle meeting of Central Bank Governors. You will wish to see the report by Central Bank Governors and I am attaching that also.

8. I am copying this minute and enclosures to the Foreign Secretary and Chancellor of the Duchy of Lancaster; to the Governor of the Bank of England, Sir John Hunt, Sir Michael Palliser and Sir Douglas Wass.

DWH

(D.W.H.)
22 June, 1978

SECRET

# EUROPEAN CURRENCY ARRANGEMENTS

## HANDLING, TIMING AND TACTICS

1. We have made an assessment in a separate paper of the relationship between United Kingdom interests and new European currency arrangements. This paper is concerned more with the handling of this question in coming months, with the relationship to the Bonn Summit and with the attitudes of other countries. It touches also however on the scope for making gains for the United Kingdom economy out of the right sort of European currency scheme, both in our dealings with our Community partners and in domestic economic management.

UK pre-conditions

2. The Chancellor of the Exchequer made clear the UK pre-conditions for a new European currency scheme in the EEC Finance Council on 19 June:-

i. nothing the Community did must weaken the dollar or the yen;

ii. the Community must not commit itself to a strategy it could not sustain. The scheme must be of a durable character;

iii. the scheme must assist growth by reducing excessive currency fluctuations without attempting to prevent market pressure from making adjustments made necessary by underlying economic relationships;

iv. the scheme must make available the necessary resources of credit to sustain the agreed level of intervention;

v. there must be improved convergence of policies, but the convergence must be by the stronger as well as the weaker countries. There must be symmetrical obligations as well as rights as between surplus and deficit countries;

vi. in a scheme progressing towards currency union, there must be proper arrangements for the right transfer of resources to the weaker units in the medium term. Too often at present transfers (eg the CAP) were from the weak to the strong.

3. It is easier to visualise machinery to meet some of these conditions than others. For example, the credit conditions could be met if the Germans were prepared to be sufficiently forthcoming, though we can expect some reluctance from the Bundesbank. It would be possible to visualise arrangements which gave us a better deal on resource transfers within the Community, for example by some restriction on the cost to us of the CAP or by increases in offsetting transfers. It is less easy to see how we could assure ourselves of a satisfactory degree of influence over German economic management, at any rate so long as Germany were in persistent current account surplus. It has after all been a central problem of the IMF to find ways of balancing its restraints on deficit countries with pressures on surplus countries to grow. This has been the central argument in the developed economies in the past year. Every effort would have to be made to keep this point in the forefront of discussion of a European scheme and to devise at least some mechanisms to support it.

## Position of other countries

4. Although other motives may play a part, it seems almost certain that the main German objective in advocating a scheme of this sort is to keep down the mark and to insulate it more against pressure from a falling dollar by linking other currencies with the mark. If other EEC countries stick with the mark more and with the dollar less, that helps intra-EEC German trade and also helps Germany in competition with its EEC partners in other markets. The scheme might also increase the resources available to intervene to hold up the dollar against European currencies as a group. The Germans have been much preoccupied with maintaining the competitiveness of their exchange rate and the German Government has been under strong pressure from industry on this; although that has not stopped the Germans from suggesting that any preoccupation by deficit countries with the competitiveness of their exchange rate was misguided inflationary Keynesianism.

5. A second German objective may have been to direct some of the pressure away from their own economic policies by making proposals in a different field to which others, notably the British, would have to respond.

6. If the main effect of the scheme were to keep the mark cheaper in relation to German costs, that might make life easier for German industry but it would tend to generate bigger German surpluses. Those could damage world growth and tend to put the mark up again. That would be destabilising, rather than helpful to the Chancellor's condition of durability. To avoid this result there would have to be higher growth than otherwise of German domestic demand; an improvement in the relative inflation rates of other countries; more resource transfers from Germany; wider availability of the mark as a reserve and trading currency; or some combination of the four.

7. The Germans probably accept, at least at government level, that any scheme requires substantial credit from them. They have begun to take on board our other conditions but it is less clear whether they are prepared to respond to them.

8. In France most Ministers and officials, while favouring the objective of greater currency stability, would prefer to defer French entry to a new scheme until next year. They hope that by then the inflationary surge produced by the ending of price control and the raising of nationalised industry prices will have passed. They do not contemplate getting over this difficulty by entry now with an initial devaluation. It is not yet clear however whether this majority has persuaded President Giscard. The French attach importance to generous credit, and would agree with us about the need to influence German economic policy.

9. Italy would support our condition for entry and, on political grounds, would probably wish to join if Britain and France joined also. Unlike the UK, they might also reckon, consciously or unconsciously, that if participation drove them into medium term borrowing, they need not take any conditionality attaching to it

too terribly seriously. The need for credit would certainly be increased if Italy were included in a scheme, and there might be some reduction in the credibility of the whole scheme in the eyes of the market. We could in some circumstances find ourselves in competition with Italy for credit. At present Italy is in surplus, but the underlying state of the economy looks unsatisfactory and the rate of inflation of at least 12 or 13% seems to persist. The Germans and the French will probably conclude that on political grounds Italy would have to be included in any scheme but they do not seem yet to have faced the implications of this or addressed themselves to the details.

10. The smaller snake countries seem to favour a wider scheme which might have the effect of giving them rather more influence on German economic policy, but they wish to retain the present snake arrangements within any wider scheme.

11. The United States showed signs at first of wishing to urge a currency scheme on Britain and France, possibly on the rather simple view that it would strengthen the ability of the European economies to stand on their own feet. They have recently taken a rather more reserved line. In particular, Mr Solomon has said that if a European currency scheme led to reduced growth in Europe, that would be contrary to US interests; and has sought assurances that any new European reserve asset would not be available as a substitute for dollars to non-Community countries like Saudi Arabia. The Americans have now said that they do not want to discuss European currency questions at the Bonn Summit. That looks helpful to us because it removes a possible diversion and a risk of international pressure on the UK, though it may mean there is little scope for progress on currency stability generally on this occasion.

Timing

12. It now seems less likely than immediately after the Copenhagen Summit that we shall come under pressure to reach an early decision on entry to a new currency scheme or see the French enter it without us. Both the Prime Minister and the Chancellor have said publicly that they do not expect an early resolution of Chancellor Schmidt's proposals. It now seems likely that the French will not wish to be hurried. The UK from its side is able to say that with the possibility of an election in the autumn, it could not reach a decision in the next few weeks. We could, for example, hardly accept the risks of entering into a fixed rate relationship in the run-up to an election and it could be argued that it would be better as a constitutional matter to defer a decision on such a major issue until after the election. The indications are that the Germans as well as the French accept that we cannot reach a decision during this period.

13. On the other hand, whatever view Ministers take of the merits, they will probably prefer to continue with the cautious but constructive attitude they have followed since Copenhagen. It seems better not to adopt a wholly negative attitude or to risk isolation on this subject, at least until the Bonn Summit is well our of the way. It also seems desirable to associate the UK firmly with any further discussions on a scheme. We could easily find that our pre-conditions cannot be satisfied and the discussions might run into the sand as a result of some change of position in Germany or France. But meanwhile we can try to establish just what is on offer, so long as we are not drawn into a commitment.

14. It is possible to visualise French entry without us. That could expose us to some economic and political pressures, unless it soon transpired that the French could not stay in the scheme or that the price of doing so was high. If however the French defer entry, nobody would expect us to enter a scheme in advance of them. If there were pressure for progress, it would have to be applied to the French.

15. Against this background the Germans might still like to obtain a commitment in principle to a new European currency scheme from France, Britain and perhaps Italy at Bremen but they are not likely to be surprised if that is not forthcoming. The most that would be possible would be for Heads of Government to ask Finance Ministers and other responsible authorities to join in working out a scheme for their further consideration based on a few named principles of a broad kind. There could be no commitment, even in principle. Even this course could rouse expectations which might in the end have to be disappointed.

16. If the time did come for entry to a new scheme by Britain or France, both countries would obviously have a strong interest in entering the scheme at an exchange rate which they could hold for at least the better part of a year, notwithstanding that there would still be a gap between the German rate of inflation on the one hand and that of Britain and France on the other. That could involve the possibility of devaluation on entry, according to what has been happening to rates in the preceding period. However, devaluation on entry might make the scheme look less attractive to German industry in the short term and it could have political difficulties in France and possibly in the UK.

<u>The heart of the matter</u>

17. It seems right at this point to leave questions of tactics and come back to some general implications of entry to a European currency scheme not fully discussed in the companion "assessment" paper.

18. Over a period it seems reasonable to expect that membership would lead us to put rather more weight in our policies on looking after the exchange rate, and therefore on resisting inflation. The scheme would not and should not stop depreciation (or appreciation) when the underlying circumstances required it but the presumption would be that the need for devaluation had better be quite clear. Depreciation would be more of a conscious act and less of a gradual

business. How much of a shift of policy this would really involve would depend on what attempts we would have made to regulate the exchange rate - and especially to check its fall - if we had not entered the scheme. The right comparison is probably with a "dirty" float in which we were leaning against depreciation, especially when it showed signs of becoming rapid.

19. Supporters of a scheme of this kind would say that over a period adherence to it would not only introduce a bias against inflation but also a bias in favour of efficiency. Depreciation even if it is often unavoidable is an easy option for industry and for business generally. While improving competitiveness, it may even hinder the pursuit of efficiency. On this view it is right to lean against depreciation just as one leans against inflation. The question is whether industry will respond to the spur - or collapse under it.

20. It is also possible to argue that the effects of a currency arrangement like the snake on national economic development can be exaggerated. Within the snake the Benelux countries have since 1973 had a relatively favourable experience on inflation but the Scandinavian members have had a much worse inflationary record and balance of payments experience. This seems to reflect not common snake membership but different economic structures and demand management policies. There may be risks in drawing conclusions for Britain from either group since none of these countries has a currency playing a major role in international trade or finance.

21. Perhaps the heart of the matter is this. Is the disposition of our people, the nature of our institutions and the skill of our leaders such that with the help of a scheme on these lines we could secure a gain on inflation without paying a serious price for it in loss of employment and damage to our balance of payments? Checking inflation or improving non-price competitiveness of UK industry are as much - perhaps more - social and political issues as economic ones. The present Government has amply demonstrated this in the field of incomes policy. And clearly President Giscard has in mind thoughts about a

psychological climate for counter-inflationary discipline and promotion of industrial efficiency in considering entry to a Snake or near-Snake. That fits with what his Government see as the needs of the French economy where they are trying both to combat inflation and to make industry more competitive by removing price controls.

22. However, if membership of such a scheme were to serve rather than damage the national interest, there would have to be a readiness to devalue within the scheme without long delays when the underlying circumstances required it, as well as to make that necessary less often by fighting inflation. Otherwise the right balance between countering inflation and maintaining industrial competitiveness would be lost. The political difficulties of a step devaluation would have to be accepted. Since the nature of this scheme is to increase the share of political decisions and reduce the role of purely market decisions, it is natural that it should demand more political determination both in fighting inflation and in carrying out necessary devaluations. But every effort to de-dramatise devaluations would have to be made.

Conclusions

23. i. the UK has given its view of the pre-requisites for a successful scheme. It may not be easy to devise machinery to secure all these requirements;

ii. the German objective is mainly to keep down the mark, but also perhaps to divert attention from their own reluctance to adopt growth policies. Much opinion in France probably favours deferring entry to a new European currency scheme at least until next year. The U.S. is now adopting a more neutral position on such a scheme;

iii. it now seems that it may not be difficult to avoid pressure at Bremen for a decision in principle for or against UK entry to such a scheme, but we may be asked by both the French and the present snake countries to agree to the preparation of a scheme with a view to a decision a few months hence;

iv. making a success of UK membership of such a scheme probably requires both a determination to do better on inflation and the efficiency of British industry, and a readiness to devalue within the scheme when the underlying economic realities require it.

EUROPEAN CURRENCY ARRANGEMENTS: AN ASSESSMENT OF THE UNITED KINGDOM'S INTERESTS

An assessment of the United Kingdom's attitude to new European currency arrangements requires:-

- some description of the arrangement itself, particularly with regard to the degree of stringency in the obligation to maintain any given exchange rate;
- and some description of the credit arrangements which might be available to assist in support of the exchange rate at the required level.

2. But the precise details of the machinery are not the first consideration. Any scheme involving greater fixity for exchange rates requires an assessment of two fundamental, related issues:-

- the implications of greater fixity for the sterling exchange rate for the United Kingdom's domestic policy objectives - growth, employment and price stability; and for its freedom of action in the use of the instruments for achieving these objectives: incomes policy, monetary policy and fiscal policy.
- the implications of the currency arrangements for the policy objectives and instruments of the members taken together, and in particular the stronger members. If the strong were to dominate, leaving only the weak to adjust this would not be an enterprise in the common interest, because it would impart a deflationary bias. There must be a more symmetrical approach to adjustment.

3. It has also to be considered whether a European scheme, by definition excluding the US dollar and the yen, would contribute to the currency stability element in the Prime Minister's five points approach, and would help to create conditions for an increase in world trade and the rate of growth of the industrialised countries as a whole.

Possible Arrangements: where discussion has been taking place

4. Discussion about possible arrangements has been going on at two levels. One, secretly, among the nominated representatives of the UK, France and Germany. But at the same time the EEC's Monetary Committee was asked by the April (post-Copenhagen) Finance Council to consider some models, and representatives of all member countries have helped to prepare a report sketching out some possibilities. The Finance Council has just considered this (on 19 June) and it is to be forwarded to the Bremen Summit meeting.

The Restricted Group

5. In the restricted Group, the Germans have not been very precise, but M. Clappier has set out the bones of a currency and credit scheme (Annex 1). This would involve quite stringent obligations to maintain the chosen pattern of exchange rates, though the margins would be round an index not a nominal rate (see further below). There would be supporting credit mechanisms, derived however from quite ambitious ways of building on the present embryonic European Monetary Co-operation Fund (EMCF).

6. One of M. Clappier's intentions, and one which might prove presentationally very sensible, is to suggest a scheme which looked different from the present snake, though in its fundamentals his scheme would be quite similar.

7. M. Clappier mentions, but does not lay heavy stress on, the need for better convergence of economies, in providing the crucial environment for a durable system: and thus on the obligations of the stronger as well as the weaker countries to adjust, if necessary.

The Monetary Committee

8. The technical approach to new arrangements has - like M. Clappier's scheme - to embrace the currency system itself, and ideas for credit mechanisms to facilitate the intervention which may be necessary to maintain the prescribed margins.

9. These credit mechanisms can involve straightforward mutual borrowing and lending like the present snake's very short-term credit, and the Community's present short and medium-term support arrangements, which could be enlarged and their terms modified.

10. Or they can be based on a development of the European Monetary Co-operation Fund. This would imply moves towards the concept of a central bank for the Community, with reserve pooling, and credit creation.

11. On the currency arrangement itself, the Monetary Committee Report (Annex 2) usefully describes three "families" of arrangements, each of which could have variations.

12. First, those, like the present snake, which involve a prescribed margin between nominal exchange rates, and a provision for changing the reference rate after consultation but a presumption against changing it often. The margins can be of any chosen width, the narrower the more stringent (2¼% for the present snake). The margin might be widened temporarily for newcomers, and there could be other ameliorations for a transitional period, including permission to drop out of the scheme for a while, or rather easier arrangements for making small changes in the initial reference rate.

13. These schemes imply obligatory defence of the chosen rate within the margins, by intervention if necessary.

14. Second, schemes also involving margins but based on a "basket" index rather than a nominal rate. The basket could be the European Unit of Account (EUA), the country's effective rate, or the SDR (though the latter is not specifically mentioned by the Monetary Committee).

15. M. Clappier's proposal is in this family. He would have rather narrow margins, 1%, round an EUA index.

16. The defence of a composite index, as UK experience with the effective rate measure has shown, can imply more flexibility than the defence of a nominal rate: but defence with a narrow margin could still be stringent.

17. The basket or index arrangement might be technically complex, because a large or sudden change in one currency has a chain reaction on the indices of the partner currencies. The effective rate scheme, in particular, would not bind the European currencies so closely together as nominal rates, because it brings in relationships with third countries (eg the dollar and yen) according to each country's trade weights with third countries.

18. By the same token, the effective rate and SDR would bring dollar and yen changes to bear on intra-Community relationships, though without of themselves implying a fully concerted dollar policy. With nominal rates or the EUA, a common policy towards the dollar (there is no such policy in the present snake) has to start from scratch.

19. The "basket" schemes, like the nominal rate scheme, imply obligatory defence of the chosen index within the margins, by intervention if necessary.

20. Third, schemes with agreed zones. There is no positive obligation to defend, though there could be a "best endeavours" to do so, and there would be a negative commitment - to refrain from policies which would jeopardise the chosen zone. Moving out of the zone would trigger consultation.

Support arrangements

21. The present snake has a very short-term support arrangement specifically associated with it. Currencies of participating countries are made available without limit, but have to be repaid by the end of the following month. The Community as a whole has short and medium-term credit mechanisms, briefly described in Annex 3. The Monetary Committee's report assumes that appropriate facilities would be available to support

any new community currency plan: these could include all the existing facilities, which could be extended and their terms modified. The generosity of the support arrangements would be in some relationship with the stringency of the obligation to defend the chosen rate or index. There has been no suggestion by the Germans, in any of the discussions, of schemes which would place the German reserves on easy terms at the disposal of countries participating in the new currency arrangement.

22. If however there were to be further development of the role of the EMCF, such ideas might come to be discussed, since such a development would involve some complex and profound issues. The Monetary Committee so far has touched on the EMCF only very lightly.

23. There could be reserve pooling, under which a proportion of reserves could be held in common, and used, under agreed rules, for intervention, with arrangements for repayment or reconstitution which could embody an approach to the sharing of rights and obligations.

24. The reserve pooling could take the form of the issue of EUAs against deposits of other reserve assets - dollars or gold. The EUAs would be automatically available to the country which had deposited the original dollars or gold. This would effectively liquify gold holdings for use in intervention, but it would not really be true to say that new liquidity had been created.

25. If however the EMCF were to issue EUAs against the deposit of national currencies, this would create new liquidity and in practice would mean that German reserves became available for use by weaker countries in the arrangement, if these EUAs were drawn and turned into currencies for intervention or other use. M. Clappier envisages an issue of 25 billion EUA (say $30 billion) against national currencies. Each country would have a quota of this, and then could draw EUA, turning them into

currencies for use, on its quota, but subject to increasing conditionality as it progressed to 100% (something like the IMF). All these ideas need further joint study.

Credit not enough

26. It has been an important part of the UK's approach that there have to be appropriate credit mechanisms but that these, though necessary, are insufficient. The maintenance of the agreed margins in a new scheme could not be durably sustained on borrowing and lending: it would need convergence of the real economies, and an acceptance of reciprocal obligations by both strong and weak.

27. In other words, the techniques of currency and credit arrangements are not the heart of the matter. The following paragraphs describe the approach to the crucial question of symmetry.

Symmetry

28. A successful Community exchange rate system embracing all member countries would be a big step on the road towards economic and monetary union. It could contribute to achieving the fundamental objectives of the Community which include price stability and economic growth. But it would only succeed if the costs and benefits were fairly distributed.

29. Until the most recent round of discussion the approach, consciously or unconsciously, had been more biased. One German objective was, and almost certainly still is, to keep down the value of the deutschemark, and insulate it against pressure from a falling dollar by linking it with other currencies. But this helps to keep Germany more competitive and to perpetuate the maladjustment. There is clear advantage to Germany in transferring the obligation to intervene from the Bundesbank to the central banks of the weaker Community countries because she would thus avoid the expansionary effect of inflows on her domestic monetary supply.

30. More serious has been a presumption that the onus of adjustment in the case of imbalance should lie mainly or even solely with the borrowing country. This means in effect that the borrowing country has to follow the short-term domestic precepts of the strong country. The risk is that, in such a scheme, the weaker countries would be under pressure to retrench while the stronger countries did nothing to expand demand so that the Community as a whole would suffer a cumulative loss of growth and welfare.

31. The countries still in the snake with Germany have not been as sensitive to this point as we are for a variety of reasons. The relative size of their economies and the degree of their dependence on Germany is such that, unlike France, the UK and Italy, they do not in practice have the option of running an economic policy which is to a high degree independent of that of Germany. The Dutch with the benefits of North Sea gas have a basically strong economy and have not had much difficulty in staying in the snake. The Danes have a relatively weak economy but they receive significant resource transfers from the rest of the Community through the operation of the CAP - unlike the UK which makes substantial transfers of resources to the rest of the Community. The other Scandinavian countries have had rather more difficulty in staying in the snake but they have made use of the option to devalue their representative rate and re-enter the snake at a lower level.* Even though the present snake is confined to Germany and its economic satellites, it does from time to time show signs of strain - at the moment, for example, the Belgians are clearly worried about their position.

32. If Britain and France (and still more if Italy) were to join a Community exchange rate system the arrangements would have to have a higher degree of symmetry than the Community systems have had so far or it would stand little chance of being permanent. A balanced system, which shared the burdens of adjustment equitably between the strong and the weak countries,

* The Swedes withdrew entirely in August 1977.

would not only be more "communautaire", it would also stand far greater chances of durability than a system that loaded the dice in favour of the potential creditors. Before we committed ourselves to negotiations about technicalities, it would be important to ensure that sufficient agreement existed within the Community on the fundamentals of the new scheme. This ought to have the following characteristics:-

(i) Balance of payments adjustment: domestic policies and capital flows. The failure of one or more Community currencies to stay within the prescribed margins of the scheme without sustained intervention could be an indication, not of short-term speculative attack, but of a balance of payments disequilibrium requiring adjustment. One appropriate form of adjustment would be a change of domestic, monetary and fiscal policies so as to achieve a greater convergence in economic performance. In a viable Community system which included Britain and France, the convergence must come from both the surplus and the deficit countries and, in addition, the agreed policies must take account of political realities in all the member states. Thus, in a typical case with low inflation and low growth in Germany and higher inflation and growth elsewhere, the Germans ought to accept an obligation to expand domestic demand as their contribution to the elimination of the imbalance. Community exchange rate schemes as so far implemented or envisaged have placed too much of the burden of adjustment on the deficit countries thus giving a deflationary bias to the system as a whole (unless the potential deficit countries decide to leave as Britain and France left the snake). If, for political or other reasons, the strong countries wished to avoid expanding domestic demand, other approaches retaining the merit of equity would be for the adjustment to consist either of a stable long-term capital flow from the strong to the weak countries on normal commercial terms with no conditions attached, or, more radically, for a permanent transfer of resources in the required direction.

(ii) Balance of payments adjustment: exchange rate changes

Given the present extent of the divergence between the inflation rates of the Community countries, any currency scheme will have to permit occasional changes in the exchange rates of member countries to take account of fundamental divergencies in the various economies. In this respect the snake has worked reasonably symmetrically: the Germans, in particular, have shown a willingness to revalue their exchange rate when it appeared to be the one strongly out of line. The need in a new Community system that included sterling would be to ensure that changes in exchange rates either upwards or downwards could be made when needed, quickly, quietly and without political drama. One of the technical suggestions that has been made to facilitate an effective realignment of exchange rates is that the currency most out of line should be given temporary leave of absence from the Community system so that the authorities could judge, by observing subsequent market behaviour, at what rate it would be safe to re-enter the system. Whatever precise method is adopted, the system should be one which would help to reduce the disparities in the economic performance of partner countries, without preventing the markets from reflecting these.

(iii) The extension and receipt of credit. Even if the underlying adjustment process worked well, a Community exchange rate system would require some form of credit arrangement. The credit would be needed to give the authorities of both a strong and a weak country time: first, to judge whether the pressure on their currencies was ephemeral or persistent; second, to permit decisions to be taken; and, third, to allow the resulting measures to work. Here again the weakness of previous arrangements has tended to be that too much of the political and economic costs have been borne by the debtor and not enough by the creditor. Some way must be found of distributing the burden equitably between the two groups. Both the exchange risk and the interest cost of the borrowing and lending needs in some way to be shared so as to give the creditor just as strong a financial and political incentive to ensure that the debtor is eventually able to repay the loan as the debtor has to ensure that he does in fact repay it. One possibility would be by development of the EMCF (see paragraph 22 above). If credit and debit positions took the form of positive and negative balances at the EMCF, it would be possible to charge interest both on the positive and on the negative balances so as to give both the creditor and the debtor an incentive to adjust. If the balances were denominated in EUA, the exchange risk would automatically be shared.

European arrangements and the five-point plan

33. Any scheme limited to European currencies is unlikely to make a decisive contribution to the success of the five-point plan. For this purpose measures to improve the long-term stability of the dollar would be necessary. Even so, improved stability of European currencies could help if it resulted in better business confidence, higher investment and a higher growth rate in Europe. The risk, as explained above, is that the gain to confidence through greater stability of Community currencies would be offset by a deflationary bias in the conditions of the scheme.

Where the UK interest lies

34. A Community exchange rate system would be likely to be helpful to the UK if it had the following characteristics, and unhelpful if it lacked them:-

(i) It permitted us to choose an exchange rate for sterling at which to enter the scheme which seemed to us appropriate in relation to initial rates chosen by our Community partners. If we went in at too high a rate, relative to that of the DM in particular, our rate might come under strong market pressure within a matter of months.

(ii) If we judged that an attack on our rate was irresistible, we must be free to change it in preference to accepting credit. There would be no point in having a scheme which forced a country to increase its indebtedness in order to maintain an uncompetitive rate. This would both increase the debtor country's liability to repay debt and also reduce its ability to repay it - eventually, it would require an even greater exchange rate adjustment. This point is particularly important for the UK because of our large existing external debts. Our Community partners may be less sensitive to it at present even though it would apply to any potential debtor.

(iii) The conditions of the scheme must allocate any obligations to adjust domestic policies equitably between the surplus and the deficit countries. Only in this way is it likely to avoid a deflationary bias. Membership of a Community exchange rate system would carry with it an obligation to share with Community partners (in a genuine, not just a formal, sense) decisions which member countries might otherwise have (in effect) taken on their own. To be helpful to the UK, the Community system would need to place as much pressure on surplus as on the deficit countries to adjust their policies. If this were thought too constraining an obligation by the potential creditors, another acceptable approach would be for the persistent creditors to facilitate the adjustment process by the transfer of long-term capital or of real resources.

35. No purely legislative forms could possibly ensure that all the conditions in paragraph 34 above would be fulfilled. The normal rule of unanimity would ensure that our Community partners could not force us to adopt an exchange rate or domestic policies that we thought inappropriate. But, equally, it would do nothing to ensure that, if we went into deficit in pursuit of what we judged to be a reasonable rate of expansion, the persistent surplus countries of the Community would expand their economies so as to help us restore balance of payments equilibrium. If our Community partners both refused to maintain an adequate rate of growth and

and also placed difficulties in the way of a devaluation of sterling that we judged necessary to adjust our balance of payments, we should be forced to leave the scheme. For this reason Ministers would need to judge whether a reasonably durable scheme had been devised before committing the UK to joining it.

The advantages and disadvantages from joining an arrangement

36. We could expect considerable benefit to confidence and our counter-inflation policies if we managed to sustain for a reasonable period - i.e. about a year - the exchange rate at which we joined a Community scheme. If we changed it soon after joining we would lose face and probably also weaken the credibility of the scheme as a stabilising mechanism. The implication is that, in joining, we would place ourselves under a greater obligation than we would incur outside the scheme to pursue domestic policies designed to preserve the initial exchange rate. Policy at present is judged partly with reference to the exchange rate, but, once inside a Community scheme, the change in the balance of influences on our policy-making in the short-term could result in a lower rate of domestic expansion than might otherwise have been possible. Recognizing this would be a crucial feature if Ministers decided to join.

Conclusion

37. There could be European currency arrangements which would, on balance, bring more benefit than cost to the UK. It does not emerge that the loosest kind of arrangement is necessarily best for us - the argument of this paper is that our interest lies in seeking obligations which will ensure real economic convergence, with adjustment by both stronger and weaker currencies, rather than a lax scheme. In the forthcoming discussions, as we did at the June Finance Council, the UK can display an open mind; but in the early stages we must ensure that discussion is focussed on the fundamentals and not confined to technicalities.

# OUTLINE OF A SCHEME BY M. CLAPPIER

1. Exchange parities would be defined by reference to the European Monetary Unit (identical with the European Unit of Account).

Margins of fluctuation for currencies would be 1% in each direction. Some currencies could however have wider margins of fluctuations on a temporary basis.

Currency limits would be defended by way of intervention in Community currencies, and credit positions between central banks would be settled in European Monetary Units within suitable periods.

2. European Monetary Units would be issued by the European Monetary Fund (EMF) to central banks of member countries in return for:

- American dollars or gold (eg 20% of reserves). The counterpart of these amounts would then be available for drawing by the relevant central banks without restriction;

- national currencies in an amount equal to 25 billion European Monetary Units. The share of each central bank would be proportional to the weight of its currency in the European Monetary Unit. Within each quota, there would be a limit (eg 25%) on the right to draw European Monetary Units against national currency. The rest of each national quota would be subject to conditionality, which would increase with the scale and length of the credits. In exceptional cases a central bank could obtain credits in European Monetary Units exceeding its national currency quota, but there would then be very strict conditionality.

3. Interventions in dollars would continue to be made by central banks but:

- it would be desirable to arrange an active system of co-operation between European central banks, and between them and the American monetary authorities, in order to reduce by all appropriate means fluctuations between the European Monetary Unit and the dollar.

- interventions must be co-ordinated so as to avoid simultaneous intervention in opposite directions in relation to the dollar. A simple mechanism would be needed to determine whether the central bank of a strong currency country/ should buy dollars, or whether the central bank responsible for the weaker currency should sell them.

- apart (20%) of dollars purchased would be automatically taken over against European Monetary Units by the European Monetary Fund.

- apart (20%) of the dollars sold would be supplied by the European Monetary Fund against European Monetary Units.

- the proportion of dollar interventions which were "Europeanised" in this way could be progressively increased so as progressively to substitute European Monetary Units for dollars in the reserves of European Central banks.

4. It goes without saying that to ensure the harmonious functioning of a system intended to produce greater stability between European currencies, it would be more than ever necessary to achieve convergence of monetary policies.

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