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My dear Prime Minister

When we last met on the subject of EMS I suggested to you that, if it seemed useful, I would try to send you a piece which would argue a different line from that of many at the meeting.

The enclosed paper attempts to set out a possible way through this difficult subject, and I send it now in the hope that it may be a possible help in your discussions on Thursday or at least suggest delay in any definitive decision at this time. ?

Yours sincerely

Gordon Richardson

The Rt.Hon.James Callaghan, MP

cc Policy

European Monetary System and the choice for the UK

The European Monetary System poses a particularly difficult choice for the United Kingdom.

First the timing is unfortunate. Inflation differentials and the diversity of economic performance, though narrower than a few years ago, are still too wide to give confidence that a tightly-locked exchange rate system involving all nine EEC countries would not come under strain fairly soon. This concern is reinforced by the current situation in the exchange markets.

The weakness of the dollar - itself an important factor in the conception of the EMS - has now reached a violent stage. Major currencies can now move as much as two per cent in a single day against the dollar; and this has the side-effect that they can move sharply and to some extent arbitrarily against each other. The bouts of dollar weakness in early August and early October both put great strains on the snake as inflows tended to concentrate on the deutschemark. Large scale interventions were necessary and ultimately, in mid-October, a realignment. In these turbulent circumstances it will be difficult to ensure that the cross-rates between the EEC countries are in the most appropriate pattern when the new European exchange rate system starts in January.

Moreover, in due course, the dollar will probably turn. It is impossible to predict when, or under what circumstances, this will occur; but when it does, the movements could be almost equally violent - certainly as unpredictable - in the other direction. Again they could differ substantially and to some extent abritrarily between the major European currencies, causing renewed tensions.

Sterling has recently risen rather less than most of the continental currencies, including the French franc, which may help to give us some measure of protection against a violent dollar recovery, if one should occur. On the other hand, the markets may in these circumstances come to regard the sterling exchange rate as unduly high in the light of our inflation and balance of payments prospects; and we are probably more exposed than most of the continental countries apart from Germany and Switzerland to capital outflows by non-residents. (Part of the 1977 inflow must be considered as potentially volatile in unfavourable circumstances.)

All this suggests that the present may not be a very propitious moment for linking sterling tightly to the strong European countries. Equally, however, we may be in for a difficult time if, for example, all the other eight countries join a new intervention system and we remain outside. The problems should not be insuperable if our own domestic stance is appropriate - both as to policy and as to presentation. But if Ireland and Italy were to join, as well as France, it is clear that we should have much to do to dispel the presumption that we were intrinsically weaker, or more inclined to countenance exchange rate depreciation, than these countries.

So much for the immediate anxieties. But there is, of course, much more to the idea of a European Monetary System than the immediate intervention arrangements. Over the longer perspective it looks increasingly clear that the continuing relative shift in economic power between the United States on the one hand, and the EEC countries taken as a whole on the other, is being insufficiently reflected in political, institutional and monetary arrangements. Both at present and prospectively, neither the US economy nor the attitudes of US policy-makers look capable of sustaining the dollar as effectively the world's only reserve currency and taking the preponderant responsibility - as in early postwar years they did - for the international monetary system and its stable functioning. The present may be a period of abnormal weakness of the US - in terms both of policy-making and inflationary performance; but over the years it looks unlikely that US performance will be stronger than that in the rest of the world by a sufficient margin to maintain the dollar's hegemony. The perception of these facts, and the accompanying wish to diversify to some degree out of dollars, by public and private institutions around the world, is indeed an important cause of the dollar's present weakness.

Ultimately it may prove possible to move to a solution of the world's reserve currency problems on a genuinely world-wide basis, by means of the SDR. But this is necessarily some way off; and in any case, even in such a world there would be a need for a resolution of the contradictions noted already between economic power and political and monetary institutions on opposite sides of the Atlantic. These underlying considerations, taken together with the evident determination of Schmidt and Giscard, probably mean that some form of European Monetary System will not only be started this winter but will grow and evolve. Its ultimate shape is at this point naturally difficult to discern; and will indeed depend on the input of all the countries involved from now on.

It would seem of the greatest political importance that the United Kingdom be fully involved in these endeavours from the start. It is only from the inside that we can influence developments; and if a fully-fledged EMS is likely in the end to emerge we shall be much better off as an early rather than a late joiner. We should be able to contribute much to the negotiations from the UK's greater experience in managing an international currency; and we should be able to play an important part in ensuring that the developing EMS is outward- rather than inward-looking; that it is complementary rather than hostile to the US and the dollar; and that it supports rather than competes with the IMF and the SDR. For ourselves, it would seem a much easier task to negotiate the improvements that we need in fundamental Community matters such as the net transfer of resources, from an evidently "European" rather than an "anti-European" standpoint.

The question for policy is how these conflicting considerations can be reconciled. It is conceivable, however, that with goodwill and careful negotiation it might be possible to find a way through. The EMS is a much wider concept than simply a supersnake. It involves the ideas (at this stage still fairly inchoate) of pooling reserves, instituting a European Monetary Fund and developing a multilateralisation of unconditional and conditional credit arrangements that go well beyond a simple expansion of the present arrangements. Short of complete monetary integration - which is a very long way off and may indeed never be achieved - these aspects of an EMS would be compatible with a variety of exchange rate and intervention systems. Even if the intervention arrangements to be set up on 1st January were to break up under excessive strain in the reasonably near future, the development of the EMS would probably still continue.

It might therefore be open to us to join the System in December, while delaying <u>sine die</u> our adherence, or our full adherence, to the intervention arrangements. (The possibility that some countries might not wish to join the intervention arrangements straight away has explicitly been raised by a number of leading Europeans - most recently by Emminger.) We could appropriately cite our need, in the present circumstances of currency turmoil and with further battles to be won this winter over inflation, to concentrate on solving our own problems with appropriate fiscal, monetary and incomes policies. We could indicate our willingness to enter the intervention arrangements when we judged the combination of external and internal cirucmstances was more propitious. We should make clear our determination to maintain a stable exchange rate and cite the policies adopted over the past two years to this end. In the meantime we would play a full part in the further development of the EMS; the moves towards pooling of reserves, the development of the ECU as a good reserve asset and the development of the credit mechanisms.

On this last, there is a practical point of considerable importance. All the proposals being currently considered for the expansion of credit in the interim period before the European Fund is set up, involve either an expansion of existing forms of Community-wide credit or arrangements for multilateralising them immediately again on a Community-wide basis. Not surprisingly there has been no discussion so far of the possible rights of access to these credit mechanisms of countries not participating in the intervention system. There could be problems and opposition to full access under these circumstances. But a commitment to the EMS in principle, plus a willingness to play our part in helping to provide credit to others, should go a long way towards giving us access to credit lines which would be helpful in maintaining market confidence.

Others in Europe share our apprehensions about the viability of a tight intervention system in present circumstances and fear that a premature and over-ambitious widening of the snake could simply lead to early disaster. Equally, others see the political importance of the initiative on a European scale. If it were seen that we were genuinely concerned to be involved in the development of an EMS there might therefore be some understanding for an approach by the UK on the lines outlined above; and it might be possible to secure general support form the rest of the Community for our stance.

31st October 1978.