

GEN 136(78) 5th Meeting

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MINISTERIAL GROUP ON EUROPEAN MONETARY CO-OPERATION

MINUTES of a Meeting held at
10 Downing Street on
TUESDAY 10 OCTOBER 1978 at 10.00 am

PRESENT

The Rt Hon James Callaghan MP
Prime Minister

The Rt Hon Denis Healey MP
Chancellor of the Exchequer

The Rt Hon David Owen MP
Secretary of State for Foreign and
Commonwealth Affairs

The Rt Hon Eric Varley MP
Secretary of State for Industry

The Rt Hon Edmund Dell MP
Secretary of State for Trade

The Rt Hon John Silkin MP
Minister of Agriculture,
Fisheries and Food

The Rt Hon Harold Lever MP
Chancellor of the Duchy of
Lancaster

Mr K E Couzens
Treasury

The Rt Hon Gordon Richardson
Governor of the Bank of England

Sir Kenneth Berrill
Head of Central Policy
Review Staff

SECRETARIAT

Sir John Hunt
Mr M D M Franklin
Mr P Mountfield

SUBJECT

EUROPEAN MONETARY CO-OPERATION

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EUROPEAN MONETARY CO-OPERATION

The Group considered papers by the Chancellor of the Exchequer (GEN 136(78) 14, 15 and 16) and a paper by the Secretary of State for Industry (GEN 136(78) 17). Their discussion and conclusions reached are recorded separately.

EUROPEAN MONETARY CO-OPERATION

The Group had before them a series of papers on different aspects of the negotiations about a European Monetary Union, circulated by the Chancellor of the Exchequer and the Secretary of State for Industry (GEN 136(78) 14, 15 and 17) together with two earlier papers, (GEN 136(78) 9 and 10) and a minute dated 2 October from the Private Secretary to the Chancellor of the Exchequer to the Private Secretary to the Prime Minister.

The Chancellor of the Exchequer said that it was necessary to stand back from the detailed papers before the Group, and to consider the overall picture. Events had moved faster than anyone had expected. It might now be necessary to reach an early decision, particularly because of the risk of market speculation starting in the period before the European Council. Our initial position had been that the scheme should be durable, should impose symmetrical obligations so as to prevent an over-reliance on financing, and should be supported by adequate resources for intervention. In all these it would be different from the "snake". Chancellor Schmidt had initially agreed to support these requirements, but had now changed his position. The scheme as it stood was likely to emerge was not very different from the snake. Nevertheless, it was almost certain that France would remain, and that Italy and Ireland would probably enter as well. The French might prefer to opt, but would not want to be left out at any price. It was a question of how quickly we could get the rate of a sterling rate significantly higher than it would otherwise be? We would have to pay a substantial price for flexibility in exchange rates. It had to be maintained our effective rate would fall in the last few years of floating. It might have been more difficult to do so within the snake because of the pressure to which this

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MINISTERIAL GROUP ON EUROPEAN MONETARY CO-OPERATION

LIMITED CIRCULATION
GEN 136(78) 5TH MEETING MINUTES
TUESDAY 10 OCTOBER 1978 AT 10.00 AM

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EUROPEAN MONETARY CO-OPERATION

The Group had before them a series of papers on different aspects of the negotiations about a European Monetary Scheme, circulated by the Chancellor of the Exchequer and the Secretary of State for Industry (GEN 136(78) 14, 15, 16 and 17) together with two earlier papers, (GEN 136(78) 9 and 11) and a minute dated 2 October from the Private Secretary to the Chancellor of the Exchequer to the Private Secretary to the Prime Minister.

THE CHANCELLOR OF THE EXCHEQUER said that it was necessary to stand back from the detailed papers before the Group, and to consider the overall picture. Events had moved faster than anyone had expected. It might now be necessary to reach an early decision, particularly because of the risk of market speculation against sterling in the period before the European Council. Our initial position had been that the scheme should be durable, should impose symmetrical obligations so as to present no obstacle to growth, and should be supported by adequate resources for intervention. In all these it would be different from the "snake". Chancellor Schmidt had initially appeared to support these requirements, but had now changed his position. The scheme as it seemed likely to emerge was not very different from the snake. Nevertheless, it was almost certain that France would rejoin, and that Italy and Ireland would probably enter as well. The French might prefer us out, but Schmidt wanted us in though not at any price. In this situation, four questions arose. First, should we accept the risk of a sterling rate significantly higher than it would otherwise be? He would himself pay a substantial price for stability in exchange rates. In fact we had maintained our effective rate reasonably well in the last few years of floating. It might have been much more difficult to do so within the snake because of the pressures to which this

would then have exposed us. Second, even if we were prepared to accept these risks, would membership of the European Monetary Scheme give us even 12 months stability? The divergencies in performance between the different member countries were still too wide to make this likely. The Bretton Woods system had collapsed because of the 2:1 gap in the inflation performance of the main members. The gap between the different European countries was now 4:1, and there was no confidence that it could rapidly be reduced. We had not been able to stay in the original snake in 1972, and the Italians and French had been forced to leave over the next few years. It took time, within the mechanism of the snake, to reach agreement on parity changes, and members could lose very large reserves as a result of this delay. The technical adjustments proposed in the papers before the Group would help, but the central point remained the freedom to adjust one's parity rapidly. However, if it were publicly clear that the scheme allowed considerable flexibility, then it was not much different from the crawling peg and would present speculators with a one way option against sterling. The United Kingdom faced in any case a difficult period in the exchange markets in the next few months, because of the uncertainties over the political situation, pay policy, and the possibility of a revived dollar. In these circumstances we would be unwise to join unless the scheme were changed. Third, any decision to join would need very careful presentation to minimise speculation against the weaker currencies. Speculative pressure would make it important to assert our firm priority for counter inflationary policy. The most helpful development would be a substantial appreciation of the deutschmark rather than a collective depreciation of the other currencies, between which exchange rates had been reasonably stable. Fourth, domestic political considerations would make entry extremely difficult. It was not clear that the Government could secure a majority in favour of entry, or for any legislation which might be needed, either from the House of Commons or within the Parliamentary Labour Party, particularly since the arguments were so finely balanced. For all these reasons, he now felt it would be wrong to join the scheme in the form in which it seemed likely to emerge.

In discussion, there was wide support for this view. The purpose of the scheme was to secure greater monetary stability. This would tend to keep the international value of the deutschmark low, and would on balance have an inbuilt deflationary bias. Within the United Kingdom, our continuing weakness stemmed from our high rate of inflation and our poor industrial performance. While the industrial strategy promised some improvement, it would take time to work through. Meanwhile we could not hope to match the

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low inflation rates of other European countries. Some further adjustment of parities was essential, particularly to protect some of our most exposed industries. The position now was worse than it had been when we first left the snake in 1972. The inflationary gap was bigger and the strain of maintaining a particular parity greater. Moreover resource transfers from the United Kingdom to the rest of the Community were growing more perverse. We would not be alone in finding it difficult to stay within an inflexible EMS. Unless a substantial German revaluation were part of the package, the whole scheme might fall apart after a few months. There would be no political advantage in association with such a failure. The scheme as it was now emerging was still essentially the original snake. The "European" element, including the proposed European currency unit and the European Monetary Fund, were mainly political window dressing. President Giscard was probably anxious to secure German support during the awkward transitional period in his counter-inflation policy. Chancellor Schmidt had initiated the scheme partly as a reaction to United States policies at the time of the Copenhagen Summit, and had come under strong pressure from the German banks to stick closely to the snake arrangements.

On the other hand, it was argued that, since we could not prevent others going ahead with the scheme, the real question was whether, once it had been established, we would be worse off outside it and unduly exposed to speculation. Inside the scheme, we should have important financial support for sterling, and at least the possibility of eventual concessions on resource transfers. There was still scope for influencing the details of the scheme before it began and during the two year transitional period. Although the sterling parity might be a little higher than it would otherwise be, this would be offset by the benefits of stability, and by our ability to control events and not be blown about by speculation. Membership of the scheme would not in itself lead to deflation. It was lack of international support, rather than an overvalued currency, which had forced us to adopt deflationary measures in the past. Devaluation was no long term solution. Even if controlled depreciation might be made necessary by our falling competitiveness, there was more chance of securing this on favourable conditions within the framework of the EMS support arrangements. While true symmetry of obligations was perhaps unobtainable, there was still useful concessions which could be obtained in negotiation which might make the scheme more attractive. Moreover, the Germans were likely to revalue the deutschmark at an early stage, either before or soon after entry, to protect their own money supply. While membership of the scheme might require tight monetary

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discipline, it seemed unlikely that it would call for sterner measures than our present situation demanded in any case. It might indeed be a useful reinforcement.

In further discussion of the tactics, it was argued that even if we decided in principle now against membership of the scheme, it would be unwise to make this known prematurely. It would be better to continue to work for a system which we might join later. To do otherwise might prejudice the chance of a successful outcome to the "concurrent studies" on resource transfers. We should not seek to polarise positions towards the Community. It would however be necessary to warn Chancellor Schmidt at an early stage of our likely decision. It was also necessary to decide quickly on tactics in the markets. If it were believed after the Prime Minister's visit to Bonn that a decision had been taken, sterling could become a target for speculators. The best line would be to emphasise the continuing high priority being given to counter-inflationary measures, whether we joined the scheme or not. The Government had indeed no intention of weakening these policies, and there were some signs that the unions would now realise the seriousness of the position they had adopted on pay. This might make it less necessary to adopt stringent fiscal and monetary measures, although the possibility of having to do so could not be ignored. Above all, it was important to avoid any impression that we would be staying outside the EMS because of the weakness of sterling and our inability to sustain the present exchange rate.

THE PRIME MINISTER, summing up the discussion, said that the Group by a large majority felt that it was clearly not in our interests to join the proposed European Monetary Scheme in the form in which it seemed likely to emerge. For tactical reasons we should however continue to take part constructively in the negotiations in the period before the European Council in December. The Chancellor of the Exchequer should be guided accordingly at the Finance Council on 16 October. In his conversations with Chancellor Schmidt on 18/19 October he would explain that the scheme was evolving in a way which was unlikely to meet our original objectives. This could be done by reference to the requirements which he had enunciated in Bremen and the extent to which the outcome seemed likely to fall short of them on all counts. We would do nothing to stop the other countries from going ahead, and should not seek to present this as a pro or anti EEC issue. The precise tactics would be worked out at a briefing meeting the following week. The Chancellor of the Exchequer should arrange for further consideration to be given to the consequences of a decision not to

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join and in particular the tactics in the exchange markets and the difficulties of a possible break in the link between sterling and the Irish pound. Meanwhile, it was important that there should be no advance disclosure of the Government's position.

The Group -

Took note, with approval, of the summing up of their discussion by the Prime Minister and invited the Chancellor of the Exchequer to be guided accordingly.

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