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Prime Minister.

Interesting papers about the Schmidt ideas for European monetary reform - with the FRG attempting to go too far too fast, perhaps deliberately to provoke UK resistance.

KRS.
28/vi

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K E Couzens CB
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19 June 1978

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Dear Ken

EUROPEAN MONETARY CO-OPERATION

I attach a note, with enclosures, recording developments in Paris last week on this subject.

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

Yours ever
Ken Couzens

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EUROPEAN CURRENCY ARRANGEMENTS

Discussions in Paris on : 14 and 15 June 1978

There were 3 sets of discussions relevant to new European currency arrangements in Paris on 14 and 15 June:

i. my meeting on 14 June at the Bank of France with M. Clappier and Herr Schulman;

ii. a meeting of Deputies of Finance Ministers of the Group of 5 countries in the French Ministry of Finance, also on 14 June;

iii. a talk between the Chancellor of the Exchequer and M. Monory on 15 June.

The Clappier/Schulman meeting

Flag A. 2. This meeting had before it a paper by M. Clappier (Annex A) outlining a scheme for a "European IMF", which would bring together all the balance of payments and exchange market credit facilities of the European Community. This paper mentioned for the first time a specific total of credit in support of a new currency arrangement (25 billion European Units of Account, equivalent to about $30 billion). This figure would however absorb existing Community credit arrangements, short and medium term, amounting to $10billion.

3. However, at this meeting Herr Schulman produced another document (Annex B) in the form of a draft announcement to follow the Bremen European Council meeting. In the course of this discussion I made 3 main points:

Flag B

a. although we regarded the form of any scheme and the scale of credit as very important, some of our most crucial requirements lay outside the machinery of the scheme itself. I had already explained our viewpoint about resource transfers in a currency union or near union. In addition, it was essential to us that a currency scheme should not have a built-in deflationary bias. The convergence of policy which we all agreed was essential under any scheme could not mean policy changes only from the side of the weaker countries. Countries in persistent balance of payments surplus as well as those who found themselves in continuing deficit would both have to adjust their policies. A persistent surplus was an indicator of inadequate level of demand. Herr Schulman accepted in principle the need for adjustment from both sides though he said - rightly - that it would be difficult to devise machinery to give effect to it in practice. He made some attempt after I had had to leave the meeting to reflect the point in his draft statement for Bremen but has accepted on the telephone that his drafting was not satisfactory;

b. there was no possibility that the UK could subscribe at Bremen to a statement that: "A system of closer monetary co-operation will be established in the Community ...... at least as strict as the so-called snake." The risk of a fairly early election, and the constitutional and political implications of that, were enough of themselves to rule out a far reaching commitment in the first half of July. The most that was conceivable was that Heads of Government might give directions, without commitment, for the preparation for their further consideration of a more detailed scheme having certain specified characteristics. The characteristics would be in very broad terms eg relationship to a basket of currencies rather than a single currency; greatly increased credit on a scale capable of impressing markets and matching the extent of intervention experienced in recent months; greater use of the EUA. I could not guarantee that even this would be acceptable but would consider whether I could outline such a remit in writing. Both Herr Schulman and M. Clappier seemed to accept that a firm decision was not to be expected;

c. like M. Clappier I thought there was a good deal to be said, if a scheme were possible, for casting the credit and reserve asset part of it in the form of a "European IMF" intended to look as little like the snake as possible. But care would be needed to marry in such a system medium term credit intended to support balance of payments adjustment (a natural IMF function) with short term intervention credit which resembled a central bank swap rather than an IMF drawing, and ought to run for a year and be quite unconditional. The distinction was fully accepted.

4. Herr Schulman and M. Clappier will be present at the Summit preparatory meeting in Bonn on 27 /28 June and there may be some further discussion of this subject there. Herr Schulman is clearly hoping for a UK paper on the lines described in paragraph 3(b) above.

This is now being drafted by Ken Couzens for reference to you.

G5 Deputies Meeting

5. Those present were Solomon (US), Matsukawa (Japan), Lahnstein (Germany), Haberer (France) and Couzens (UK).

6. The two main items of the discussion both had a bearing on a European currency scheme. Lahnstein said that the Bonn Finance Ministry, the Bundesbank and a strong section of SPD Ministers favoured a stimulus limited to 5 billion Deutschemarks ; which would be a part of the normal budget and effective only from 1 January 1979. The SPD wished to reserve as much stimulus as possible for the election year 1980. The latest forecast for the budget deficit of 55 billion Deutschemarks instead of 60 billion would release the 5 billion stimulus. The Economics Ministry and FPD circles on the other hand wanted a bigger earlier stimulus through across the board tax cuts.

i.e. there is no real additional growth.

7. Solomon, Haberer and I joined in expressing the view that if the outcome were as Lahnstein proposed - and if there were also no fresh action by Japan - the markets would judge the Summit a failure and there would be renewed appreciation of the yen and deutschemark. It was not clear how far there was an element of tactics in Lahnstein's account.

8. In reply to a question by Solomon, Lahnstein said that agreement had been reached between the Finance Ministry, the Bundesbank and Schulman of the Chancellor's Office on a proposal for a European currency scheme. He gave an account of this which accorded with the Schulman paper at Annex B. He assured Solomon that it was not intended, unless in the very long term, that the European Unit of Account should be available as a reserve asset outside the Community eg to Saudi Arabia. For the rest, Solomon's reaction was that while all this was a matter for Europeans, the US would be concerned if such a scheme had the effect of depressing growth in Europe.

Chancellor's meeting with M. Monory

9. A record of this meeting is at Annex C. The indications from this discussion, and from private exchanges with M. Haberer and M. Clappier, were that most of the senior people concerned with the matter in France would prefer at least to defer until the middle of next year French entry to a closer European currency arrangement. They are concerned about the inflationary phase through which they expect to pass with the raising of nationalised industry prices and removal of price controls. They would like to surmount this period of difficulty first when the franc might become vulnerable. And M. Monory is anxious to complete first what he sees as a structural change which will give French industry a more competitive tone. It remains to be seen whether the President will accept this line of advice.

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).

tighter than Schmidt first suggested: it was 2½% e.w.

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

Currency limits would be defined 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~~ buy dollars, or whether the central bank responsible for the weaker currency should sell them.

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

- a part (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.

ANNEX C

RECORD OF A MEETING BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND THE FRENCH MINISTER FOR THE ECONOMY

Those Present:

Chancellor of the Exchequer	Monsieur Monory
Mr Couzens	Monsieur Haberer
Mr Battishill	Monsieur Leroux
Mr Bayne	

French Contribution to Collective Action

1. Monsieur Monory said that he aimed to make the French economy more open to competition both external and internal. He took a positive attitude to international collaboration, but France was vulnerable to inflationary pressures because of their efforts to adjust the prices of nationalised industries and to free industrial prices. Nevertheless, France would be ready at the Finance Council meeting on 19 June to support collective action. Its contribution would be to accept a larger budget deficit than forecast. The 1978 Budget as voted had a deficit of Frs 8.9 billion. He was prepared to see this grow as large as Frs 20-22 billion - at least 0.6 per cent of GDP. He was also trying to encourage industrial investment. After this first phase of measures, he would consider as from 1 January 1979 whether further measures were necessary. But at present, French GDP growth for 1978 was forecast at 3.2 per cent. If the Germans would do more to stimulate their economy, France could also do more.

cf. UK = c.3.5%
FRG = c.4.0%

2. The Chancellor of the Exchequer pointed out that if the views of the German Finance Ministry and the Bundesbank prevailed, the only measures which the Germans could take would have effect only in 1979. They were unlikely to achieve 3 per cent growth of GDP in 1978. The SPD were already looking forward to the elections due in autumn 1980.

/European Monetary

European Monetary Cooperation

3. Monsieur Monory asked the Chancellor for his views. Mr Healey said that if any new European system was very strict, its effect would be to limit growth. In practice it would simply hold down the value of deutschmark, while obliging the other members to keep their currencies overvalued. Monsieur Monory agreed. He did not want to go too fast. If France entered a new system now, the difference of inflation rates between France and Germany could lead them into serious trouble before the end of the year. Nevertheless, he was favourable to the idea of a new European system. Monsieur Haberer interposed that the essential condition was that a new system should have a really great increase in credit facilities.

4. Mr Healey said that he was sympathetic, though not enthusiastic. There were two essential points:-

a) the stricter the limits of the new system, the larger must be the intervention funds available and the lower their conditionality.

b) Even if this condition was met, it was essential to have a system which was not hostile to growth. Otherwise, we should have trouble with the Americans.

The danger was that the Germans would launch an initiative between now and the Summit which would attract public attention from the real problem of growth. This would lead to very great disappointment only a few weeks after the Summit had been held.

5. Monsieur Haberer pointed out that it would be possible to tell the Germans that others would not support their monetary ideas unless they committed themselves to faster growth. Mr Healey pointed out that there was an imbalance between a new monetary scheme, which would contain concrete commitments and a simple statement of intention by the Germans to stimulate their economy, which might not be honoured.

6. The essential thing was that Finance Ministers, when they met on 19 June - their last meeting before the Bonn Summit - should set out very clearly the conditions they must attach to a new monetary arrangement. It would be easy to do this

You approved the Chancellor's pre-conditions last week-end.

because there was no German plan yet on the table, so that all the conditions could be defended on grounds of principle and would not look like attacks on German ideas. Mr Healey added that he was not certain that the Germans were unanimous in wanting new monetary arrangements; there was a difference between the Federal Chancellor on the one hand and the Finance Ministry and Bundesbank on the other.

7. Monsieur Monory agreed entirely. There was a danger that the Germans were using the monetary discussions to distract attention from commitments to growth. There was a danger that they might attempt to secure a premature commitment at the Summit. He did not intend to be hurried, and intended to put this point to President Giscard, whom he would be seeing later that afternoon. He made it clear that there were differences between the President and senior officials of the Treasury - the implication being that the President wanted to move ahead faster.

15 JUNE 1978

HERR SCHULMAN'S DRAFT FOR AN AGREEMENT AT BREMEN

1. A system of closer monetary cooperation will be established in the Community. In terms of exchange rate management it will be at least as strict as the so-called snake. In the initial stages of its operation, however, member countries currently not participating in the snake may opt for somewhat wider margins around central rates. Changes in central rates will be subject to mutual consent. The European Unit of Account will be the numéraire of the system. Non-member countries [with particularly strong economic and financial ties with the Community] can become associate members of the system.

2. Participating countries will coordinate their exchange rate policies vis-à-vis third countries. To this end they will intensify the consultations in the appropriate Community bodies and between Central Banks participating in the scheme.

3. The smooth functioning of the system will require the existence of adequate financial support mechanisms. Unlimited automatic (very short term) credit facilities will be available to all participating Central Banks. The adequacy of other Community credit facilities will be reviewed by the competent Community bodies.

4. The European Unit of Account will be given a greater role in the new system. First, it will serve as its pivot. Secondly, it is also envisaged that the EUA will become the [principal] instrument of settlement between participating monetary authorities.

...

5. The competent Community bodies will be asked to study the modalities of the creation of an initial supply of EUA's (for use among Central Banks) against deposition of member currencies, US dollars, /SDR's/, and gold. They will also examine whether changes in the existing arrangements and institutions are required in order to bring the new system to fruition.

6. A system of closer monetary cooperation will only be successful if participating countries pursue policies conducive to greater stability at home and abroad.