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Prime Minister

For Copenhagen.

BW 6/4

SECRET AND PERSONAL

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MR. WICKS

Chancellor Schmidt, the Snake and Pooling Reserves

I have only two comments on the paper prepared by Mr. Couzens for Copenhagen:-

(i) It assumes that Chancellor Schmidt's motivation is not primarily to help the dollar. This is probably right: but we may be misjudging him (in which case see paragraph 9c. of Mr. Couzens' paper). The Prime Minister will clearly want to probe the purpose of the scheme.

(ii) Some of the disadvantages to us are fairly clear. This could however be a move towards a two-tier Community. The Prime Minister will obviously bear in mind the political and other implications if this happened and we were not in the top tier. Thus there is a case for ensuring either that this is a scheme that we can live with or that it founders.

John

(John Hunt)

6th April, 1978

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K E Couzens CB
Second Permanent Secretary
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6 April 1978

N Wicks Esq
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Dear Nigel

CHANCELLOR SCHMIDT, THE SNAKE AND POOLING RESERVES

I attach a copy of a paper and enclosures by way of briefing for the Prime Minister. In the time available it has been possible to agree it only in general terms with the Bank.

I am copying this letter and enclosures to the Governor, to Sir John Hunt and to Kit McMahon.

Yours ever

Ken.

K E Couzens

CHANCELLOR SCHMIDT'S PROPOSAL : RESERVE POOLING AND THE SNAKE

1. As the Prime Minister knows this note and its enclosures have been prepared in some haste in the Treasury and the Bank with the most limited consultation. We hope however that it will be sufficient for the Prime Minister's discussion with Chancellor Schmidt and President Giscard. The Prime Minister may think that the main objective of the discussion should be to get Chancellor Schmidt to explain in more detail what he has in mind; and to say why he is making the proposal and what he sees as the implications of it. If the matter is to be pursued we assume that it would have to be referred to some small group for examination and that Finance Ministers would have to be brought into it. But any such examination would have to be strictly confidential if it were not to affect currency markets.

The Proposal

2. We know that Chancellor Schmidt has suggested a pooling of part of each country's reserves. As far as we can see, that could only make sense if linked with an agreement to use the pooled reserves for market intervention to influence currency relationships. It may be that Chancellor Schmidt despairs of the dollar and wishes to try for greater stability within Europe, regardless of what happens outside. This might have certain attractions for the French if the terms seemed right to them. We would think however that there was not much future in any arrangement which treated the dollar as a lost cause.

3. Chancellor Schmidt's proposal therefore suggests to us that what he wants is some development of the European "snake" or of a "near snake" alongside it. The snake is after all an existing arrangement for a more stable relationship between European currencies than free floating might produce and in particular it relates certain currencies to the Deutschemark. The Bonn correspondent of the "Times" reported on 4 April:

"It has been suggested in Bonn that Herr Schmidt may have suggested a strengthening of the European joint currency float as one method of protecting Europe from the effects of the dollar's decline on foreign exchange markets."

4. Sir Oliver Wright's telegram 238 of 4 April also suggested that the Germans were preoccupied with the possibility of re-vitalising the snake. But he also reported that the Chancellor's Office "discouraged any idea that a reinforced snake was more than brain storming at this stage" and said "they do not change their view that economic and monetary cooperation should proceed hand in hand". A copy of that telegram is attached.

5. The essence of the idea would then seem to be that the Mark, the Franc and sterling should be kept in some predetermined relationship with one another, no doubt within a band or "tunnel". They might fluctuate as a group in relation to the dollar or the yen but their fluctuation in relation to one another would be limited. The pooled reserves would be an instrument to this end.

Nature and History of the Snake

6. A note by the Bank about the history and operation of the snake with a brief comment on the implications of UK linkage with it is attached.

A Variant

7. Also attached is a short note by the Bank about a different scheme which would not involve pooling of foreign currency reserves but would consist of an understanding to use domestic currencies (Marks, Francs, Sterling) up to certain limits for intervention policies. The objective of keeping three currencies in a certain relationship to one another would be the same but this variant would not involve sales of dollars. It would however add to the money supply of the countries concerned when their currency was used for intervention.

v. At least a considerable part of British industry would regard joining a snake as a threat to UK competitiveness. In spite of the relative success of Stage 3 of the pay policy, they see our increases in wage costs moving further out of line with wage costs increases in Germany and they think that the sterling exchange rate will have to decline over a period to reflect that. They would probably be right in assumingthat the effect of UK membership of the snake would be to keep our average exchange rate higher relative to our competitors than if we stayed outside it. Equally, it is likely that the average Deutschemark effective rate would be rather lower than otherwise. So it would be German industry which would benefit unless we secured a consistently higher rate of German growth to offset this.

vi. There are of course domestic political aspects to what would be seen as greater integration into the EEC.

vii. There is an acute problem about Italy. It is hard to see how they could be brought into a near snake arrangement. The reality of the matter would then be that we were on the road to a two tier Community. Countries like Greece, Spain or Portugal would of course find themselves in the same boat as the Italians.

viii. As it stands, the Schmidt proposal does not fit with the Prime Minister's initiative with President Carter. The German emotional reaction to the state of the dollar is to turn away from it and withdraw into Europe; the British reaction is to go and see our American friends. Very possibly a decision to enter the snake on a German initiative would be seen by the markets as somewhat damaging to the dollar. At least to some extent it could imply more sales of dollars to keep sterling and the Franc nearer the Deutschemark.

The Pros and Cons

8. The following is a strictly provisional list, not intended to be in order of importance.

Cons : i. We have consistently argued that anything like membership of the snake required greater convergence of economic policies and much more generous credit than has hitherto been on offer. It may be that Chancellor Schmidt proposes to move on credit (ie the use of German reserves to keep the Franc and Sterling at higher levels). But if there is a lack of convergence on growth as well as on inflation any predetermined relationships between currencies could come under repeated attack;

ii. We and the French have both spent periods in the snake and have both been obliged to leave it. It is not obvious that the prospects for a durable relationship of the three currencies is better now than in the recent past. The contrary is arguably the case.

iii. Currency relationships can of course be changed within the snake and there have been plenty of changes recently. It is also true that few countries are in practice ready to let their rates float entirely freely so that some of the problems of moving rates exist in a floating system. However, it can still be argued that the political difficulty of adjusting rates, up or down, is greater in the snake. The change is always a political act. For at least some of the time that need not be the case in a floating system.

iv. Even with the help of the French and the smaller EEC countries the chances of influencing German economic policy strongly and consistently do not seem all that good. And certainly the present snake is basically a German economic zone.

Pros

9. a. The proposal could offer us greater exchange rate stability and more help by that route with inflation. If we wanted to give that degree of priority to holding up the rate, joining the snake on suitable terms could enable us to mobilise German reserves in support of sterling.

b. It would be a move towards Europe where our economic interests increasingly lie. It might be good for relations with President Giscard. And 6 or 7 EEC countries within a snake arrangement would have a better chance of influencing German policy if they could agree among themselves.

c. Some of the objections could be removed if a link with the snake and a move to more European currency stability could take place at the same time as the other elements in the 5 point plan - including parallel action to stabilise the dollar.

Tactics

10. There is clearly a problem here on dealing with a German proposal which with, or without, intent may have the effect of cutting across the 5 point plan. We would want to lead Chancellor Schmidt back to the need for more growth in Europe and the need to take a series of actions to stabilise the dollar. The Prime Minister may feel that, given his relationship with Chancellor Schmidt, it may be possible to do something like this without appearing totally negative on his "snake" proposal.

THE SNAKE

1. The European system of narrower margins (the snake) is an arrangement intended to reduce the relative fluctuations of the currencies adhering to it. It was originally recommended by the Werner Report of 1969 as the first step towards monetary union of the member states of the EEC and was endorsed in principle by the Council of the European Communities in March 1971.

2. When it first came into operation on 24th April 1972, the fixed rate system was in its last stages. The return to fixed parities at the Smithsonian Agreement of December 1971 (after the dollar had gone off gold in August 1971) involved greater fluctuations than in the classical Bretton Woods system. Whereas previously countries had maintained their exchange rates within a margin of 1¼% on either side of their dollar parities, the undertaking now involved a margin of 2¼% on either side. This meant that in an extreme case the value of one EEC currency in terms of another could change by 9%: (if currency A rose from its bottom to its top limit, it would have appreciated by 4½% against the dollar; if currency B did the reverse, A would have appreciated by 9% against B).

3. Under the narrower margins agreement, the participating countries undertook to keep their individual dollar central rates within a maximum of 2¼% of each other as well as maintaining the post-Smithsonian arrangements with respect to the dollar. This meant that, plotted on a graph in terms of the dollar, the participating countries' currencies would all lie within a 2¼% band (the snake) which could itself move up and down within a 4½% band (the tunnel). When the dollar finally floated permanently in March 1973 the "tunnel" disappeared but the snake remained as a group of currencies floating jointly.

Rules for Intervention and Settlement

4. Throughout the history of the snake there has been much theological discussion about the nature of the intervention and

settlement and credit rules. The theory has been that to keep the currencies in the required fixed relation to each other, intervention should be primarily in snake country currencies (i.e. when A and B are at the top and the bottom of the snake respectively, A would buy B's currency with its own and B would sell A's currency for its own). In practice, however, there has always been a lot of intervention in dollars: i.e. when country B has been weak in the snake, it has often sold dollars to support itself.

5. Where the intervention is in snake currencies, the rules are that unlimited finance is made available by creditors to debtors within any month; at the end of the month a debt up to the value of the debtor's quota in the EMCF credit arrangements can be rolled over automatically for three months; but no central bank may remain in debt for more than six consecutive months and any deferment of debts exceeding the debtor's quota requires the prior agreement of the creditor(s).

6. In practice, if there is a big run on a weak currency, these credit arrangements have proved very tight. Under pressure from the smaller countries, there has been some enlargement in the facilities recently, but the Germans have remained strongly opposed to expansion on the scale that most other countries would think appropriate.

History

7. The founder members of the snake were the original six EEC countries. On the 1st May 1972, in anticipation of their joining the EEC, the UK and Denmark joined the snake and on the 23rd May Norway joined as an associate. Sweden joined as an associate in 1973.

8. Over its history there have been a number of departures and returns, and an even greater number of revaluations and devaluations, within the snake. Only Belgium has over the whole period not only remained within the snake but kept its original exchange rate.

9. The UK was forced out by a speculative run after less than two months membership and after losing \$2.6 billion of our reserves. The Danes left at the same time, but rejoined a few months later again. The Italians dropped out in February 1973

during a dollar crisis and have never returned. The French were forced out in January 1974 during the oil crisis. Giscard brought them back in July 1975 at their old exchange rate - universally thought at the time to be ill advised and soon proved to be so, since they had to leave again in March 1976. The Swedes were forced to leave in August 1977. The surviving members are, therefore, Germany, Belgium, the Netherlands, Denmark and Norway.

10. There have been a number of discrete exchange rate adjustments by countries staying within the snake. (These are closely analogous to revaluations and devaluations under the Bretton Woods system.) The deutschemark, for example, was revalued by 3% in March 1973 and a further 5½% in June 1973. The guilder was revalued by 5% in September 1973 and the Norwegian krone by 5% in November of that year. In October 1976 there was a general realignment, with the deutschemark revalued by 2%, while the Danes devalued by 4% and the Swedes and Norwegians by 1% each. In April and August 1977 there were further devaluations of the Scandinavian currencies, the Swedes being actually forced out of the snake on the second occasion, as already indicated.

Comment

11. The original idea that the snake should be an instrument helping towards the convergence of exchange rate policies of EEC members, leading ultimately to economic and monetary union, has proved unworkable. In practice, the snake has been an association of countries with a bias both towards external surplus (the net position of snake countries has been in strong cumulative surplus since its inception); and towards lower than average inflation rates. It is difficult to assess how far those countries that have managed to stay in the snake have done so because inherently their economic performance was better than their neighbours'; and how far membership of the snake itself helped to improve that economic performance. There is probably something of both.

12. For some years the snake has effectively been a manifestation of a "deutschemark area": i.e. the membership has comprised Germany and a number of small neighbouring countries who trade very heavily with each other and with Germany. These smaller countries have found the discipline of membership very onerous and

and the net appreciation of the snake as a whole under the influence of Germany very difficult. They have nevertheless thought the price worth paying because, linked so closely as they are in trading terms, they have benefited in their struggle against inflation from Germany's superior performance.

13. As with any arrangement for more or less fixed rates, there are disciplines and constraints on national policies which can have both advantages and disadvantages. In the turbulence of recent years, with the OPEC surplus and widely divergent inflation rates, the disciplines of the snake proved too severe for the three large EEC countries, other than Germany. Their trade, (especially that of the UK) is much less closely centred on Germany, or indeed the EEC, than that of snake members. Their inflation rates have, at least in recent years, been significantly higher.

14. A currency agreement which once again included the other large EEC members would have a different character from the present snake - or indeed the snake they once belonged to and have since left. The snake has already proved to be able to accommodate more revaluations and devaluations within it than was once thought possible. It would also be necessary, however, for credit arrangements to be considerably greater than they are at present; and if effects on activity and employment were not to be adverse there would need to be greater growth prospects in Germany. If these conditions were fulfilled, it is at least arguable that there could be benefits in a wider currency arrangement.

Bank of England
6th April 1978

POOLING RESERVES

1. The most obvious meaning to attach to the phrase "pooling reserves" is that the UK, France and Germany would each put into a central pool $X million worth of their own external reserves - either just dollars or possibly dollars, gold and SDRs in some proportion. The point of such an act would be that the pool (managed perhaps by the Central Bank Governors jointly) would be used to support any of the three currencies. Thus if sterling or the franc were weak dollars would be sold from the pool for pounds or francs instead of (or as well as) from the remaining reserves of the country concerned.

2. The advantage of the arrangement would presumably be that with more support visibly mobilised, it would be easier to keep up the exchange rates of the countries concerned. The arrangement, however, would not appear particularly relevant to the present <u>world</u> problem of a weak dollar. It would do nothing to support the dollar or to hold down the exchange rates of any of the countries concerned against the dollar. Rather the reverse: if heavy support operations were necessary, the intervention carried out would tend to weaken the dollar.

3. An alternative idea would be that each country would put into a pool not part of its external reserves, but a quota of its <u>own</u> currency. This is broadly the way the IMF is funded. Now if intervention were needed to keep the three exchange rates close to each other it could be done without ill-effects on the dollar. If sterling were weak the pool could buy pounds with deutschemarks. This would have the effect of strengthening the pound and weakening the deutschemark.

4. It would also mean, of course, that the composition of the pool would change: more pounds in it and less deutschemarks. There would have to be settlement arrangements whereby, in this case, the UK bought back the excess pounds replacing them with deutschemarks purchased with our reserves. (Again this is analogous to repurchase arrangements in the IMF.) It would be for consideration what time was allowed for such settlement to be made - in other words how much credit giving there was in the arrangement.

5. Such an arrangement could fit quite well into a world initiative and while it might not actively help the dollar it would tend to insulate the currencies concerned from the effects of a weakening dollar without adding to the dollar's problems.

6. It would, of course, be inherent in any such arrangement if it were actively used, that the deutschemark would be kept lower and sterling higher than (if current market trends are assumed to continue) they would otherwise be. But this is, of course, the essence of any currency stabilisation arrangement.

Bank of England,
6th April 1978.