

# Conservative Research Department

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SECRET

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MRS. THATCHER

c.c. See below

EMS

I have prepared the attached note in something of a hurry in order to put forward some important issues which should determine what we prepare to say on the subject in the next few days.

Since preparing it, there has been a strong hint in today's Guardian that the Government have already decided to abandon the EMS.

*p.p. Anne Jorgensen & Lawrence*

Adam Ridley

c.c. Sir Geoffrey Howe,  
 Francis Pym  
 Lord Thorneycroft  
 Lord Soames  
 John Nott  
 Douglas Hurd  
 Nigel Lawson

## EMS

The last few days have at last allowed us to begin to discern the true scale and significance of the EMS proposal. While for the most part the question is still seen as a predominantly technical one, people are beginning to articulate more clearly the political issues at stake. However, they have not gone anything like far enough in analysing or describing these political factors. Since it can be argued that the EMS is 95% about politics - and high politics at that, and since time is fast running out, it is imperative that we should now consider what those political issues are and how we should react to them. Since the signs are that the debate in this country has been woefully narrow and ill-formed, it is perhaps reasonable to suggest that the mere fact that the emphasis in the arguments that follow is a little unfamiliar is not, in itself grounds for dismissing them.

## GERMANY AND FRANCE

The Bremen and Aachen proposals are, to a degree a reflection of the powerful determination of Giscard and Schmidt to make serious progress soon in the unification of Europe. While the economic benefits they can foresee are not trivial, the whole manoeuvre is also seen and felt by them as a political act of a kind which is vital if the Community is not to wither away. There are other motives which inspire them, some self-interested, some not, many of which we can only guess at. On the German side there is the deepseated desire for solidarity vis a vis the Eastern threat. With that in mind there is the more than theoretical possibility of their wanting access to, and sharing of, France's growing nuclear expertise; and an anxiety about the way their relations with the rest of Europe would develop if they were to become the sole dominant force in the Community. On the French side the desire to avoid German dominance is, naturally shared. So this is a matter on which Schmidt and Giscard agree. It is, also, not difficult to see that they may well feel, after years of increasingly close bilateral contacts on many fronts and levels, no

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overwhelming desire to enlarge that cosy bilateral relationship.

France's goals have been classified in two important ways recently. First, chronologically at least, come the major economic reforms instituted by Barre. He and Giscard believe that to carry France's economic progress further they must open up their economy in a variety of radical ways - with more reliance on monetary policy, the abolition of price control and a number of other important changes. Barre has always been - like most French men - a firm believer in as fixed an exchange rate as possible, and has wanted France to re-enter the snake for some time. He also needs money and time to establish his reforms, and show some successes in what is inevitably not a short-term exercise. So the extreme enthusiasm of Giscard and Barre for Bremen reflects not merely a medium-level judgement about exchange rates etc., but some very fundamental, long-term economic and national goals - ones which ought to be sympathetic to the vast bulk of the British Centre-Right, if not to many members of the Labour Party, and which certainly cannot be ignored. The TV broadcast Giscard made on November 17th is, if reports are anything to go by, a very important indication of the way Giscard's thoughts are evolving.

#### ENLARGEMENT

Those few who recollect the Tindemans Report will remember its suggestion of a two-tier Europe, and echoes of that debate are to be discerned in the quiet thinking now being devoted to the consequences of enlargement. The key point is simple. It scarcely seems sensible and it barely seems feasible to continue to run a Community of 12 (let alone more) on the same basis as one of 6 or 9. The economic strength and political sophistication of the new adherents is inadequate. And such practical considerations as the rotation of the political presidency of the Community between twelve states are of growing importance - in some peoples' eyes almost decisive in themselves.

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Regardless of the correctness of this analysis, it would appear that France and Germany (and others?) see enlargement as requiring the creation of a two-tier Community, perhaps a several-tier Community. This might evolve in several, not necessarily mutually exclusive ways. The first and most obvious is a division between E.M.S. countries and the rest. While this need not amount to a great deal initially, it would become of very substantial and growing importance if, and as soon as, the E.M.S. evolved a "Monetary Fund", an associated range of economic policy co-ordination decisions and so on. The second way is the emergence of a "Directoire" of France and Germany, building on the bilateral relationship already referred to. Given the present political weakness and lack of durability of most other European Governments, particularly here and Italy, this development must be a serious possibility, at least as long as Schmidt and Giscard are both in power.

#### THE U.K.'s POSITION

Our own position is depressing. Indeed it may not be too much to suggest that we are in the neighbourhood of a rather important turning-point - of becoming and being seen to have become a second-class European country, perhaps even an irremediable burnt-out case.

Economically we know we are weak, and are perhaps about to move from relative to absolute decline, even if we have staggered back from the brink of utter disaster. While our recovery since 1976 may impress and encourage our neighbours, neither we nor they can believe that it may be relied on to continue for long - particularly with the re-emergence of union troubles.

Politically we are seen by outsiders to be sinking back into a parochial and provincial mode of thought and behaviour. Our loss of national will and commitment to anything of great importance, the triumph of undirected pragmatism over idealism, are having serious consequences. In the context of the Community our partners are, no doubt, under no illusions about the attitudes of the bulk of the

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Labour Party at every level. And their anxiety about Conservative attitudes is changing fairly quickly into a real fear that we are already, or will shortly become, little better than a carbon copy of Labour, unable to take or even support any political initiative in the Community, and fearful of speaking up in its defence here, even to correct the most absurd accusations levelled at it.

Our post-war history is littered with examples of our increasingly feeble attempts to pursue great issues, make the grand gesture, <sup>and</sup> generally reassert the world role we once exercised. It is understandable and in some respects right that we should now have swung to the opposite extreme. But to do so extremely, totally, or for long periods, is also dangerous. Our motto, not least in Europe, seems to have become a perverse version of "look before you leap". This is all very well on some occasions. But in a frightened and uncertain world it is sometimes vital to reverse the formula and to leap before you look - or at least before you have explored every technical issue and established beyond all doubt that you will land on firm ground and that no possible harm will come to you. That kind of absence of confidence, faith and willingness to take risks is self-evidently a recipe for reinforcing most of our current problems and one could well imagine it leading to disaster in some circumstances.

It is not fanciful to suggest that some of our failures to get the Community to move our way in such matters as CAP reform is a consequence of our feeling and behaving in this way. Who can be surprised if our petty-minded grubbing-about should increasingly be ignored if it is felt that we are capable of nothing else?

#### E.M.S. AND CONCURRENT STUDIES

This general analysis is directly relevant to the negotiations over E.M.S. The French and Germans appear to have made no sustained serious effort to involve us, as a central participant, in launching the proposals. (It would have been odd if they had done so, and

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if we had played along!) One must imagine that they were doubtful whether our presence mattered that much any more, sure we would want to delay rather than promote the venture, and unwilling to pay any significant price to "buy" our participation.

"Buying us in" is something the Government have tried to promote in the so-called concurrent studies into CAP reform and the problem of the U.K.'s unfairly large net contribution to the Community Budget. It is now clear that this manoeuvre has failed. Indeed it seems increasingly likely that the chances of significant amelioration on either front in the near future will remain slender unless we join the EMS (unless or until the EMS itself collapses). Why should other Community countries wish to make concessions to the Government of a partner whose heart is increasingly not in the whole venture and who will probably feel compelled to continue to grumble and create trouble even after these big abuses are remedied?

One suspects that the Government, particularly perhaps the Prime Minister and some of the key advisers, are to be ~~xxxxxxxxxxxx~~ blamed for not having fully appreciated what was going on, or at least for not being up to expressing (however cynically) the kind of generalised commitment in principle which is probably essential if a Government and its interests are to be taken sympathetically and seriously in the Community.

PARLIAMENTARY CONSIDERATIONS.

Turning to the future, our attitudes and behaviour in the near future could well be extremely important. The Government are going to have to debate at least the principle of EMS - apparently in early December, shortly before the European Council makes its first decision. The scale of Labour opposition to the EMS is obviously so great that Callaghan will only be able to get Parliamentary approval if he can make up the numbers he needs from our ranks. This pretty obvious fact will, presumably, have important consequences for his behaviour in the much nearer future.

To be specific, if he feels that we are so luke warm about the scheme that he won't get enough of our votes - let alone that we might vote against the whole thing - then he will presumably prepare to pull back in sufficient time to avoid the humiliation of defeat. Up to now we have not, one imagines, given him sufficient evidence of a balance of hostility to make concern about our votes a major or immediate anxiety. But one can well see the issue getting more serious for him before very long if we continue to adopt an official line of sitting largely on the fence, or appear to be badly split on the issue.

(Such considerations will, in due course be still more acute should we (1) enter EMS in January, and (2) have to legislate to fully implement some aspect of it before the election. The Government are desperately seeking to prevent this happening, but the possibility probably can't be ruled out completely).

The matter goes further. Our friends in Europe will certainly be increasingly concerned with the line we take, and it would be amazing if they did not judge us by higher standards than those they apply to the Labour Party. One would imagine that "par for the course" for them would be -

- (a) a firm commitment in principle to EMS, and soon,
  - (b) constructive pressure on Callaghan; and censure of him if he rats on the whole scheme;
- and possibly

(c) a certain amount of concern expressed about the matter in an EDU context and/or with certain key parties or individuals.

If we fail significantly enough we shall be in no position to hope to shape the Community more to our tastes as a Government.

TECHNICAL CONSIDERATIONS.

We are left, then with the questions as to what EMS involves. (which can be but is not here supported by a fuller argument,) would be as follows:

(a) the much reported controversy over "baskets" and "parity grids" is a secondary issue. So in the question of whether and by how much the UK should devalue if we join the system.

Far, far more important are:

(b) the scope for adjustment of parities, and the methods by which this might be achieved. There is, probably, a "crawling peg" procedure which could be devised which would meet most of the conditions which we might demand of it. But not much has been made of this issue yet, and it needs much more attention and emphasis. Without some devise of this kind the risks of the scheme being self-detonating, and of our being near the explosion are high.

(c) the pursuit of economic strategies designed to narrow differentials in inflation rates - and of which the most important would be co-ordinated, converging monetary targets, rather as suggested by the London Business School earlier this year.

(d) progress in eroding our exchange controls visa vis our partners though this is an issue which is far from being as simple as it looks -



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You may also be interested in this note which was prepared earlier in the Summer.

*WITH COMPLIMENTS* Adam Ridley

MORE OBSERVATIONS ON THE PROPOSALS FOR AN EUROPEAN  
MONETARY SYSTEM

The first and overwhelming point about the Bremen initiative is its political significance. For whatever reasons, most of the major members of the Community, in particular the French and the Germans, have made a decisive commitment of will. As far as can be judged, they are quite determined to go ahead with some kind of scheme on the lines that they have suggested, while fully recognising that there will be many complications which will have to be resolved before it can become effective. The very sketchy proposals published in the communique of the Bremen council meeting were no more than an expression of determination, a sketch of the direction in which it was intended that events and policy changes should evolve, a framework for negotiation. In other words, the Bremen initiative is something which will not go away. We can make of it what we will, and everything hangs on the attitudes with which one enters the serious discussions which are now in train.

One also gathers that the principal countries involved would be unhappy, but not totally desolated, if the United Kingdom were not to take much further active part in the scheme. They could carry on at a pinch without us. This would leave us two options, unless the whole scheme is so badly designed as to collapse swiftly - a possibility which naturally cannot be totally ruled out. Should things work reasonable well next year, we can either join later - with a much diminished stature and a smaller role in the new scheme of things. Or we can choose to remain permanently outside the new arrangement and suffer from indefinite second-class membership of the Community, occupying the position much as was described by Peter Jenkins as "shop steward of the weaker economies such as the Spaniards, Italians and others." To put the point slightly differently, what is at issue today is not a particular scheme, but the future evolution of the Community and our determination and willingness to play a constructive and positive part in it as contrasted with our possible desire to remain in increasing obscurity on the fringes.

The Prime Minister's Position

It has been made fairly clear in the days since the Prime Minister returned from Bremen that he is much more positively inclined towards the initiative than earlier reports suggested. They were coloured first by his bad mood during the summit - this meant that people tended to confuse his state of mind in general with his attitudes to the proposals in particular. Second, the Treasury's briefing on Monday - by the now near-infamous Ken Couzens - was extremely unfortunate in tone. For various reasons the individual in

question is violently anti-German, and made no effort to conceal that fact from most of the people present at the Press Conference. So unfortunate were the words he used that the Prime Minister was extremely angry and has been studying very carefully the precise transcript of what happened on that unfortunate occasion. His underlying position has been made far clearer by his remarks in the House on July 10th, most of all by a few sentences in the latter part of the exchanges after his statement, to which the Foreign Office and other officials are now drawing attention constantly in any guidance which they give to outsiders - not least to the Americans. The particular words in question are those that occur in Col. 1034 of Hansard July 10th. Mr. Spearing had asked the Prime Minister

"Whether .. it would not .. promote stability .. at the expense of the authority of HMG to order our own internal finances .."

To this the Prime Minister's reply ended as follows:

/Mr. Spearing/ "asked whether it would remove some powers from us. The answer is "yes". .. If /the scheme/ meant lessening powers in order to increase prosperity, the House would have to take a decision whether it wished to remain poor and independent or whether it was willing to sacrifice some powers and be more prosperous."

It is not difficult to see that the Prime Minister might well be in a position where he wishes to mask his true feelings and intentions in order to keep the more excitable Members on the left wing of his Party in a quiescent state until after the election. The Foreign Office have drawn my attention to another important fact. In the meeting of the Finance Ministers Council after the Copenhagen Summit in the Spring, the Chancellor was in the chair. A scheme of this kind was very much on the agenda and, not only did he speak very positively in favour of it during the debates themselves, but he took a fairly enthusiastic line about the whole venture in the discussions with the Press afterwards.

#### Importance of Conservative Attitudes

It is not, I imagine, for me to underline the diplomatic implications of the posture which the Party is seen to take to the Bremer proposals. But there may be something to be said for making one point. To our friends in the Community, the initiative is, as already suggested, primarily a political one. Most of them understand our reservations very well, and are not unsympathetic to them. In their eyes what each member has been called to do at the moment is to affirm its willingness to undertake closer economic co-operation. They do not see the position as one where what we have been asked to do primarily is to pass judgement on any particular scheme, although that factor is not of course totally trivial. Everything which we say on the matter in public will, naturally, be scrutinised particularly carefully by representatives of those parties in the Community who are most sympathetic to us. In particular our new comrades in the EDU and other like-minded

parties of the centre-right who hold what we say in the next weeks and months to be a fundamental guide to our likely behaviour in the future. So our posture now could well have an important impact in due course on the evolution of our position within the Parliament particularly after the elections next year.

### More Technical Issues

One question which has, most importantly, not been resolved so far in the discussions is the nature of the political machinery required if the new scheme is to be operated effectively. There are two obvious questions at stake here. Does one need new political machinery to guide the operations of the EMS? Or can one imagine general rules being laid down much as at present by the Finance Ministers meeting in the Council of Ministers? Second, at the more executive level, does one have to envisage the creation in the very near future of a substantial central bureaucracy with great power, rather on the lines of the IMF? Or can the scheme be operated largely or, indeed, totally on a de-centralised basis, which has been the pattern with the management of the snake and similar arrangements up to now? At the moment the position appears to be that there are no decisive views in either direction on either issue. It is all to play for. Certainly it does not seem to an outside observer that there is any overriding necessity to envisage a major transformation of the political or executive institutions of the Community to make the scheme work.

A second important issue is how far this initiative fits into the age-old debate between the "economists" and the "monetarists". On the face of it the EMS proposal would seem to be somewhat dangerously at the "monetarist" end of the scale, in as much as little or nothing has been said at the Summit about the need for more decisive commitment on the behalf of the member countries to bring about the requisite degree of convergence of inflation and monetary policy which the effective operation of the EMS will require. One should not, however, assume that because the issues were not much discussed in public or referred to at the Press briefing, they were not considered very seriously in private. One is given to understand that the principal governments involved were clearly seized of the importance of pursuing policies which would bring about the necessary degree of convergence. In a sense what has now happened is that instead of saying which should come first - the chicken or the egg - people are now saying that what we can do is make a modest degree of progress simultaneously on both the economic policy co-ordination front and on bringing about more harmony and stability in the monetary area. From a rational point of view this does make quite good sense. Provided the terms of the EMS are not in themselves too rigid or demanding, provided, too, that the participating governments pursue on their own policies, which will bring about convergence, then everybody will be considerably better off and we have less reason to believe that the scheme will be anything like as prone to self-detonation as some of the community's earlier initiatives.

It is important to note that there are possibly quite important concessions of a semi-technical kind which have already been agreed and which would have the effect of making the operation of the new snake-like arrangements less de-stabilising than they have been in the past. In particular one gathers that the Germans may have agreed that it is vital in such a scheme in future that corrections of imbalances in exchange rates and inflation rates should be made by the stronger currencies revaluing rather than by the weaker currencies having to leave the snake and return after a bout of extremely damaging speculation in circumstances which are likely to cause great political humiliation. If something on these lines can be worked out then one of the major weaknesses of the snake system may well be resolved. Indeed it is, of course, just this problem which caused so much strain in the old Bretton Woods system, and if at last the Germans are willing to behave in a more responsible way it would be a pity if we missed the opportunity.

Another important question is what budgetary consequences of the EMS would be for the UK.

The answer at this stage must be that no one could possibly tell. There are so many parts of the scheme that still remain to be worked out. In particular there must be great obscurity about what is intended for the agricultural sector.

Some of the early press guidance seemed to suggest that the EMS would permit a dramatic simplification of the CAP. It is, however, not easy to see how this could come about without some pretty major changes. There is no way in which MCAs and the very substantial net flow of resources out of the UK to finance the community's budget could be dealt with unless the Germans in particular are willing to make some rather remarkable adjustments in a manner which it is not yet easy to predict. If all artificial monetary devices were abolished, then German price levels would have to fall very substantially, perhaps by as much as a quarter. It is almost impossible to see how such a change could be made without the Germans moving to a quite different system of agricultural support, at the very least introducing something like a system of domestic deficiency payments in order to permit the EEC agricultural price structure to sink to the new low levels dictated by monetary harmonisation. One gathers that there was considerable discussion of the agricultural issue at Bremen, both in the context of EMS and in relation to the well-known problems of enlargement. It was decided that much more work would be needed both on reforming the CAP and on the consequences of enlargement. Since we have such interest in diminishing the burden and improving the rationality of the CAP, this aspect of the future work being undertaken by Finance Ministers and by the Commission must be of particular importance to us, and it is rather a pity that so little seems to have been done to date.