NOTE FOR THE RECORD

1. Herr Horst Schulman, of Chancellor Schmidt's office, called on me soon after 11 am on Thursday 20 April at his request. I gave him lunch and accompanied him to Heathrow where he caught at 3.15 pm 'plane back to Bonn. No-one else was present during our discussion.

2. Philosophy, not Specifics. Schulman began by saying that he thought the Prime Minister's dinner for Chancellor Schmidt on Sunday evening, 23 April could be a historic occasion for Europe. However, in answer to my enquiry he said that there was as yet no piece of paper describing the scheme which the Chancellor had outlined in Copenhagen. Chancellor Schmidt was still working on such a paper.

3. I showed Schulman the outline I had prepared of what we understood Chancellor Schmidt to be proposing at Copenhagen. His reaction was that all this was too technical and rigid. These details were all for discussion. Moreover too much emphasis should not be placed on the idea of an EUA parallel currency. He wished to approach the matter at a broader and more philosophical level at this stage. He later spoke of a month as being sufficient for officials to work out "details" at a later stage. What seemed to be in his mind (and perhaps therefore in the mind of Herr Schmidt) was to seek a philosophical (if not emotional) commitment to a broad concept of linked European currencies and a Europe more self-reliant in monetary matters.

4. Motives for the Proposal. One starting point for the proposition was that currency instability within Europe was one cause of the low European growth since 1973 compared with, say, the United States. Compared with the US or Japan Europe suffered from not being a single currency area. Fluctuations in exchange rates had gone beyond what was justified. Reducing these fluctuations would not necessarily be a sufficient condition for better growth, but it was a necessary condition. Schulman accepted that fluctuation against the dollar and yen were very important, but thought greater intra-European stability could make a contribution. On the other hand nobody was talking about fixed exchange rates. There would have to be adjustment from time to time.

5. I said that our Ministers had made the point that the market could be said to have exaggerated matters with sterling, taking it to \$1.55 in October 1976 and \$1.95 only 15 months later. Every company engaged in international trade was now exchange-rate conscious and enormous volumes of funds now moved with changes in currency expectations. We were conscious of the impact of dollar instability on confidence, investment and so on. We were less clear that, say, the Change in the sterling-mark exchange rate had of itself done serious damage to European growth recently; or that the instability could be significantly reduced by action confined to Europe and directed at currencies alone.

6. Herr Schulman said that the prospect for the dollar in the long term was poor. Its depreciation went back to the late 60's and the recovery of the last week or two was temporary. He had no confidence in the ability of the US Administration to secure adequate energy legislation.

7. He also mentioned that the 3 main European countries had in the last year or two moved closer together economically. This was true on inflation - where he said he was much impressed by the achievement of our second pay round (1976/77) in actually reducing living standards. It was also true on the balance of payments and even on levels of growth of output.

8. Exchange rates and competitiveness. This led us into a discussion of the problem of export price competitiveness for a country entering a linked currency agreement; and of the circumstances in which a country which was weaker economically could live in a currency union with a stronger one. I pointed out that if we entered "a snake" with the DM we must expect to have to devalue at intervals, as Denmark and Norway had had to do in the present snake. But that kind of devaluation was a much more political act than depreciation in a floating exchange rate situation, even if the float was "dirty" at times. Moreover unless one devalued rather strongly on entering

the "snake" - and possibly even if one did - the odds were that one would end up with a rate on average higher than it would otherwise have been. There were counter inflationary benefits in that, but there were also competitive disadvantages.

9. Herr Schulman argued that devaluation was "almost entirely a monetary phenomenon" and suggested that our concern with competitiveness through the exchange rate was a reflection of our addiction to Keynesian economics, which found very little support in Germany. In this connection he implied that Chancellor Schmidt was still living down his statement of some years ago that "he would rather have 5% inflation than 5% unemployment".

10. I said that Germany seemed in the last 6 months to have been as much concerned as anybody about the impact of what they regarded as too high an exchange rate on their exports. We had much more at stake on this since the balance of payments was for us a very real constraint on growth. We were not as strong industrially as Germany, had a high import propensity and so tended to export employment. As far as I could see, there was nothing specially Keynesian about recognising at some point that your exchange rate was now out of line with your competitiveness and acting - or allowing the market to act - accordingly. Moreover this was not just a question of relative inflation rates. Non-price competitiveness inevitably came into it. I accepted that depreciation ought not to be an easy option and that one ought to make every effort to be and become competitive without it. We had done that eg with pay policy. But relative economic strength could not be ignored, especially when coupled with low growth in Germany.

11. <u>Resource transfers in currency unions.</u> I pointed out that a common feature of currency unions with weaker partners was a structural flow of resources from the stronger to the weaker. That was true of Scotland, Wales and Northern Ireland in the United Kingdom. There was parity of services, even active subsidy; but below average tax contributions. Within the snake, Denmark and Holland were

strong net beneficiaries from the EEC because of the CAP, which was a structural element of the Community. There was no such structural gain for us, quite the contrary. We were the second biggest net contributors and the Community was not now for us a fast growing industrial unit. Although Herr Schulman envisaged a reduction of the disproportion of the CAP in the Community Budget, he accepted that no major resource transfer system of this kind was in sight for us in the Community. The alternative in a snake would have to be devaluation.

12. Other points. Other points made were:-

i. there could be political difficulties for the UK Government about a commitment to closer European integration through snake or near-snake membership in what could be an election year. But that was for discussion between Ministers;

ii. Herr Schulman accepted that Germany was still in current account surplus at much the same level as last year and that the February figures for production and orders had been poor. But there was a J-curve effect on the current account, there were capital exports and they now thought the first quarter's growth figures might be misleading and affected by special factors;

iii. the Commission was pursuing its own proposals on EMU. It was better to let all that take its course;

iv. Herr Schulman rehearsed again thoughts about developing the use of the European Unit of Account. They were on familiar lines;

v. Chancellor Schmidt was not linking agreement on reflationary action by Germany to this proposal;

vi. he envisaged that at some stage a joint meeting with M. Clappier would be necessary.

13. It was left that we could expect further discussion at Chequers on Sunday evening.

K E COUZENS
21 April 1978

CHANCELLOR SCHMIDT'S SNAKE: SOME POSSIBLE QUESTIONS

1. Is this a very promising time for new exchange rate linkages? The imbalances in the world and the volume of money moving with exchange rate prospects are both greater than ever. Europe is exposed to them. Why should a wider snake succeed now when it failed twice with France and once with the UK before?

2. Is Chancellor Schmidt putting too much weight on North Sea oil as enabling us to keep a stable currency or to look the DM in the eye? What about our import propensity and industrial problems?

3. Does he appreciate the Unity of the UK !! the possible impact of too high an exchange rate on Scotland, Wales, Northern Ireland? And on opinion there?

4. Does he accept that we have to be as much or more concerned about the impact of our exchange rate on British industry as Germany has been about the "over-valuation" of the DM?

5. Does he think that sterling, or the franc or the lira could long be held in a "snake" against a strong adverse move of confidence? Would he really be prepared to commit German reserves in a snake to resist it?

6. What reserves does he see Germany putting in? And on what terms? Does he think we would be wise to increase our present heavy indebtedness by using large amounts of reserves which we had to repay?

7. Can he yet show us a written description of the scheme he has in mind which we could consider in detail?

8. Does he accept that this ought not to be a diversion from the plan which all are now supporting for concerted policy action to improve growth and stability? Are we not at risk of a further deterioration in 1979 if we don't make a success of that?

9. Isn't the right tactic not to give the Americans up - we can't afford to - but to keep up the pressure on them and help them in a concerted package?

SECRET

CURRENCY ARRANGEMENTS WITHIN THE EEC

Introduction

The UK has to steer carefully in discussion about EEC currency matters. On the one hand, to secure greater stability is desirable. And it is not necessary to be fanatical about EMU to see value for the UK in various kinds of greater co-ordination within the Community. Moreover, at this particular juncture it would be a mistake to jeopardise success with the five point plan by showing hostility to initiatives in this area.

2. On the other hand, the ideas could be mis-used in relation to the five point plan. They do virtually nothing in themselves to promote greater stability on the world scene.

3. Even more seriously, currency arrangements are not just a matter of aspiration and presentation. They have potent influence on the way an economy behaves, and matter critically to policies and politics. So they cannot be treated lightly.

4. The paragraphs which follow are designed to indicate, rather starkly, what the dangers could be. But - as there are no specific propositions before us - they are not specially tailored. They are not intended to be fully comprehensive, in this large and complex field. And they are not intended to suggest what an actual negotiating brief would contain.

5. The UK is fully ready to join constructively in studies. And the UK could accede to an arrangement which, on balance, brought sufficient advantage.

Snakes

6. The present "snake" arrangement requires the currencies concerned to be kept within 2¼% of each other. New varieties are now talked about: for example, that new currencies should join in an arrangement with wider margins, or providing for a specially calculated relationship with

the dollar and the present snake currencies. But these details do not greatly signify: the critical feature is that the arrangements involve embarking on a fixed relationship, usually one capable of being altered, but only to another fixed relationship. Even the variety of proposal which says that the target zone need not be obligatorily defended by intervention requires that domestic actions should be avoided which might threaten the target.

7. A fixed currency relationship between partners of about equal strength with similar dynamism should present no problems. But if the relationship is between countries or regions differently endowed, or on divergent paths as regards growth and inflation, there is, first, an underlying implication that there will have to be resource transfers, on a continuing basis, to equalise standards of services, etc. This happens, via the UK Budget, between, say the South East and the North East, the former paying more tax per head and taking out less per head in social benefits. It happens, via the CAP, between the snake countries of say Denmark and Germany, the former being a major CAP beneficiary. But in addition, the features of the relationship will be that:

- its maintenance will dominate other aspects of domestic policy, with probably painful choices about growth, employment and price stability and between different policy instruments, incomes policy, monetary policy and fiscal policy;

- <u>or</u> the currency of the weaker economy will require support which would need to be permanent if the underlying disparity in conditions could not be put right in other ways;

- <u>or</u> the currency of the weaker economy will have to undergo public and publicised devaluations, or changes of "target zone".

8. It follows that the undoubted benefits to be secured from the greater exchange rate stability associated with the fixed relationship are only secured at a price. The smaller members of the present snake acknowledge the price, but are glad to pay it. Their economies are so dependent on Germany's that, unlike the UK, they have no real choice. The question for the UK will be whether any new ideas will involve only a price worth paying.

9. The problems for the UK might well not be solved simply by choosing a low rate at which to enter a fixed arrangement. To aim deliberately at an initial depreciation would in any case have troublesome implications; both presentationally and in its effects on the cost of living. And the requirement either to maintain the chosen rate by supporting it if necessary, or to change it again, could prove difficult if the economy continued to behave divergently from that of the stronger countries in the arrangement.

Credit

10. Supporting the chosen rate can be facilitated by credit mechanisms provided that the lack of market confidence in the chosen rate is both temporary and reversible. Credit mechanisms already exist within the Community, and could no doubt be modified and liberalised. This is where attention will have to be focussed if there are going to be serious talks about any of these propositions. But, for us at least, more borrowing is not really an attractive proposition. Additional short-term debt would conflict with the UK's present debt management policy. Even 7-year credit would not help with our debt problem and the Community is unlikely to provide credit on a much longer basis than that. In any case, the Government has announced its intention to achieve a net repayment of our existing debt year by year, combining this with new borrowing to spread the maturities. Accepting new loans in order to preserve some parity within a snake-type

arrangement would increase the quantum of debt outstanding instead of gradually reducing it as planned.

11. There is always a danger, too, that EEC credit arrangements will be associated with conditionality. The Germans, but not only the Germans, are customarily severe about this point, as one of principle.

Reserve pooling

12. Ideas for reserve pooling might entirely solve the problem of support for the weaker currencies if the pool was at the disposal of a given country, without limit of amount and without obligation to repay. It was briefly thought in 1973 that the German Government had offered the UK just such an arrangement: but they may have been misinterpreted and in any case back-tracked at once. (The Bundesbank, who actually control German reserves, certainly never accepted the idea.)

13. Ideas for reserve pooling on any other basis have attractions - see below - but probably no significant benefit in relation to currency support. The proposition would, presumably, as in the past, take the form of deriving a pool from X% of each country's reserves. The choice of gross or net reserves would be highly significant. German reserves are very large, and virtually the same, gross or net. The UK's net reserves are very small. It would also have to be decided whether to pool currencies - in practice, dollars, or other assets.

14. There could be psychological advantage to weaker currencies from the existence of the pool. But, whatever the precise details (and this is a complex area) the evening out of rights and obligations, and the need to maintain the pool, would almost certainly require replenishment by the country on whose behalf the funds had been used. So reserve pooling does not of itself escape the disadvantages of

other forms of borrowing for currency support - unless it means literally pooling assets and liabilities.

Advantages of reserve pooling

15. Nevertheless, reserve pooling ideas could well be studied. An embryo body exists, the European Monetary Co-operation Fund (EMCF, or perhaps more conveniently FECOM from the French initials). As indicated above, pooling could have some psychological impact on the markets. The currency assets pooled would have to be dollars, since this is the main currency held in reserves. The EMCF could denominate the amounts pooled in European Units of Account (EUA), and could remunerate holders from the proceeds of investing the pooled dollars in United States paper. On this simple model, the main achievement of the pool would be to have made manifest a small step towards closer integration and to the use of the EUA. If the pool were used in intervention, denomination in EUA would change the balance of exchange risks, but might make more onerous the replenishment obligation by the country whose currency was being defended.

European Unit of Account: a parallel currency

16. The idea of gradually turning the EUA into a currency in use, among Governments, institutions, and finally among individuals is very attractive to those who believe in very close integration, and who believe that the development of a parallel currency would foster this. Mr Jenkins's note for Copenhagen reflected this. But he went into no great detail, and the possibilities need very close study. To use the EUA as a currency basket for, say, bond issues, might be useful. But the development of the EUA as an actual currency would soon bring up as a critical issue the role

of the Community institutions, and in particular the Commission, in determining the fiscal and monetary policies of the member states.

17. As with reserve pooling, there is no objection at all to UK participation in further study.

Intervention in Community currencies

18. A less far reaching step in Europe, and one which does have relevance to the five point plan and the position of the dollar, would be for the existing snake currencies to make less use of the dollar in their intervention. Using dollars can never wholly be avoided. But it could be lessened if snake countries would agree to provide each other with their currencies for intervention. Since the Mark is the strongest currency this is likely to mean that the Mark would be the main currency to be provided, and Germany might have to take dollars in exchange. So Germany might be unenthusiastic. But all other ideas in this broad area tend to favour Germany. The snake operation tends to keep the Mark weaker than it would otherwise be. And it places the need for adjustment on the weaker or more deficit prone country, rather than on the stronger or surplus country.

MH-M
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