

NOTE OF A MEETING HELD AT 10 DOWNING STREET AT 0930 ON 3 JULY 1978

Present

- Prime Minister (Chairman)
- Chancellor of the Exchequer
- Secretary of State for Foreign and Commonwealth Affairs
- Chancellor of the Duchy of Lancaster
- Governor of the Bank of England
- Sir John Hunt
- Sir Douglas Wass
- Sir Michael Palliser
- Sir Kenneth Berrill
- Mr. Couzens
- Mr. McMahon
- Mr. Stowe
- Mr. Wicks
- Dr. Donoghue
- Mr. McCaffrey
- Mr. Franklin
- Mr. Mountfield

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EUROPEAN CURRENCY ARRANGEMENTS

The Meeting considered two separate papers enclosed with the Chancellor's minute of 22 June to the Prime Minister and with his Private Secretary's letter to No. 10 of 30 June, analysing various aspects of the proposed European monetary system.

The Prime Minister said that there had been a number of recent developments on this front, following the Finance Council meeting on 19 June, and leading up to the European Council in Bremen on 6 July. The French and German positions had moved closer together, and there was now a joint draft which the German Chancellor wished to have discussed at Bremen. Herr Schmidt had invited him to a meeting in Bremen before the Council, but it might not be sensible to take up this invitation. The subject would come up again both in the Council itself and at the informal dinner of Heads of State on

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Thursday night. There might also be time for a tripartite discussion with Herr Schmidt and President Giscard d'Estaing, but the timing of this needed care. The line now taken by the French was very different from that which M. Monory had taken at the Finance Council, although over the weekend there had been some signs of French retreat. This might be purely tactical, or might indicate that French orthodoxy was prevailing over the President's original wishes. (It was later suggested that the French needed assurance of German support for the franc while their internal stabilisation programme continued, but until its success could be judged they might be unwilling to accept the full rigours of a new monetary union, particularly at the present exchange rate.)

In discussion, it was argued that there was a good case for taking a generally welcoming line to the joint Franco-German initiative. It was in our interests to enter into the early and formative stages of discussion of a new monetary system, and to shape it in a direction which served our interests. We could use constructively the energy which the German Chancellor was putting into his scheme. Without our early involvement, the scheme might develop in ways which could be harmful. It was already disturbing that the French and Germans had entered into private talks, after undertaking to keep all these discussions on a tripartite basis. It might in any case be important to have the new systems agreed in principle by the summer, in case the Bonn Summit meeting proved to be a failure and the pound came under severe financial pressure later in the year. The new proposals were more interesting than the original "snake" which we had been forced to leave in 1972. A regime of floating rates now looked much less attractive to all European countries, and in practice markets were becoming used to a system of fixed rates and large scale intervention again. The French and Germans needed our support to make the new system a success, and we were in a strong position to insist on our own terms. While the motives of the German proposal were undoubtedly to reduce upward pressure on the deutschmark we could afford to ignore the motives and concentrate on the results. Discussion in the Finance Council had already gone in the direction we favoured. The decision contained all the points which we thought were

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important apart from resource transfers and on growth, and these were implicit in the decision. Our object now should be to shift the discussion at Bremen away from the Franco/German joint paper, and back to the lines of the Finance Council decision. We should avoid too sour a note, but put down markers about the points which we still considered important. We should concentrate on the risk of deflation, an argument which would appeal to all the EEC countries, and play down the emphasis on resource transfers at this stage. We should emphasise that too rigid a system of currency stability was just as much an obstacle to growth as wild currency fluctuations. We should seek a general orientation towards currency stability in the Bremen discussions, reserving our main push on growth until the Bonn Summit. This would avoid the UK being put into the position of demandeur in the Bremen discussions.

On the other hand, it was also argued that the smaller European countries did not want the big 3 to line up too solidly without their being brought into the discussion. There was nothing new in the joint paper, which presented the same ideas which Chancellor Schmidt had deployed at his last meeting with the Prime Minister. As in 1972, there was nothing in the idea of an enlarged "snake" which necessarily attracted the UK. We certainly needed many more details of the joint proposals before we could agree to consider them even in principle.

To be attractive to us, they needed to be matched by reductions in the burdens imposed by the EEC budget, the Common Agricultural Policy and BAOR. The present plan merely involved imposing strict external monetary disciplines on other countries, while helping to keep down the deutschmark. We needed symmetry of obligations between the weaker and stronger members of the union. Until this was accepted in principle, there was no point in becoming drawn too deeply into discussion of the detailed plan. It was however worth noting that the Franco-German draft was weakest on resource transfers, the width of the "snake", and the mechanism for adjusting exchange rates.

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Against this background, it was argued that our interests were best served by discussion of the Franco-German proposals among the Nine early in the meeting, and preferably before any smaller tripartite discussion with President Giscard and Chancellor Schmidt. This would help the UK to present its case for resource transfers and a commitment to growth, with the obvious support of other members, and avoid us becoming isolated in a tripartite discussion. We were not committed to put in a paper of our own, but merely to comment on any schemes put forward by the French and Germans. It would be better not to table the draft provided by the Treasury, but to use it as a speaking note for this purpose.

In further discussion of the joint Franco-German draft, the following points were made:

(a) Despite references to a system "at least as strict as the existing snake" there were suggestions of a two-tier currency system. Its attraction to us would depend on the currency link proposed: whether a European unit of account, a "basket" or the effective exchange rate. There was a danger, if we joined the second tier, that this would be seen as lack of confidence in our own currency, which would bring us under attack earlier in a currency crisis. It would be easier to repel such an attack from within a narrow parity band, and under the scheme as drafted, commitment to the narrow band would also provide earlier support.

(b) It was not clear how the new joint intervention arrangements would work. It would be in our interests for the deutschmark to become the currency of intervention, and the scheme would allow us to borrow deutschmarks, and other European currencies, for this purpose. Intervention policy on the dollar would need to be grafted on to these arrangements. There would have to be collective decision taken on the intervention policy to be adopted, and it might be that a European Intervention Agency would need funds under its own control for this purpose.

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(c) The Germans might see some attraction in this course, for the illogical reason that it seemed to them to neutralise inflows into Germany and thus the pressures on their own internal money supply. Our own experience suggested that this argument was specious, but it affected the German attitude.

(d) The Americans were worried at the suggestion that US dollars and gold held by member central banks should be deposited as counterpart for the creation of a new supply of ECUs. In fact, this worry was groundless because the dollars would be reinvested in New York, but it would be important to reassure the Americans on this score.

(e) The draft suggested that within two years "the existing arrangements and institutions would be consolidated in a European monetary system". This implied the creation of something like a European IMF. It would embrace three separate lines of credit, a very short (one month) operation in support of the "snake", the existing Community short term facility, of up to six months, and a medium term credit like that which the Italians had obtained. The proposal appeared to merge all these, and expand, under the auspices of a European monetary co-operation fund. It would be important to ensure that such a system imposed symmetry of obligations on creditors as well as on debtors, for example by charging interest on the balances of surplus countries.

(f) The requirement for "mutual consent" to changes in central rates could be politically difficult if it implied unanimity. But in practice, as in the existing "snake", it was likely that all countries would recognise the need for a change. The Treasury draft made this clear by requiring that "changes in the rates should be made where adjustment was required by underlying economic conditions". The point was largely presentational and should not present a practical problem.

Summing up the discussion, the Prime Minister said that he would be prepared to accept an invitation to a tripartite discussion but he did not intend to arrive early in Bremen for such a discussion. He would also welcome a discussion in the

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plenary session of the European Council, and at the informal dinner. He would however look for assurances which would protect British interests, especially on questions of growth and resource transfer. He would certainly not be prepared to reach any final conclusions at the Bremen meeting. The Treasury should prepare a detailed commentary on the Franco-German draft. The Foreign and Commonwealth Office should revise the telegram to European posts in the light of the discussion, and issue it as part of the preparation for the Bremen meeting.

3 July 1978

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