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To: Mrs. Thatcher

cc: Sir Geoffrey Howe
Mr. Francis Pym
Lord Thorneycroft
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Mr. John Nott
Mr. Douglas Hurd
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The European Monetary System

1. Adam Ridley's note of 23rd October on the EMS was designed "to put forward some important issues which should determine what we prepare to say on the subject in the next few days." This note has been somewhat hurriedly prepared for the same purpose, as a complement to Adam's note. I should make it clear at the outset, however, that my own view is that we should avoid committing ourselves to any firm position on the EMS for as long as possible. For a happy few Eurofanatics and Europhobes this is a clear-cut issue on which we can and must stand up and be counted. For most of those who are neither Eurofanatic nor Europhobe, however, and who have taken the trouble to study the matter, it is a hideously complex and awkward issue, both economically and (more important) politically - and the interaction of the economic and political considerations serves only to make it worse. Moreover, the situation is a rapidly moving one, and we are not privy to the negotiations going on: this makes it all the more important to avoid taking a position which would risk our being seriously wrong-footed by subsequent events.
2. It is, in this context, worth noting at the outset that, as a nation, we are now paying a high price for the present Government's wholly negative and passive attitude to Europe. Had we adopted a more positive and constructive approach, we could have been promoting a new European initiative of our own, possibly outside the monetary field altogether, and one that harmonised with our own national interest. As it is, however, the only European initiative on the table is one designed by Germany and France, which undoubtedly presents the UK with a number of

difficulties, and to which we are obliged to react - in the knowledge that a hostile reaction would inevitably be construed as hostility not to the proposed means, but to the professed end, simply because we have not put forward any alternative means towards the further progress of European unity. This in turn creates problems with our partners in the Community (and also, to some extent, within the Conservative Party.) It is fair to suggest that a Conservative Government would have been thinking in terms of a UK-designed European initiative, rather than simply reacting, belatedly, to Franco-German initiatives as and when they arise.

3. As implied above, both Schmidt and Giscard see the EMS as the next stage in the progress of European unity. They also undoubtedly see it as an important step in the consolidation of the Franco-German entente which they both see as the cornerstone of their foreign policy. However, it is essential to look behind this and understand why this particular economic proposal has been chosen by them as the means to these wholly political ends. The fact of the matter is that both Schmidt and Giscard see the scheme as being in their own specific national interest, albeit for somewhat different reasons. For both men there is an immediate and a longer-term argument. At the present time, Schmidt is faced with a serious problem arising from the acute weakness of the dollar and the accompanying flood of money into Germany. If this is allowed to be resolved by market forces - i.e. if the Deutschmark is allowed to float cleanly, and appreciate steadily not merely in terms of the dollar but also in terms of other European currencies - then German exports will be faced with a growing problem of competitiveness and German industry with a growing loss of profitability and of markets. If, however, to prevent this, the appreciation of the Deutschmark is reduced (as it has been so far) by an active intervention policy, i.e. the purchase by the German monetary authorities of large quantities of dollars, then the result is an excessive growth of Germany's money supply and the undermining of her hitherto successful anti-inflation policy. Hence the attraction of the EMS: if other European currencies can be helped to float upwards against the dollar, an in line with the Deutschmark, then (a) the problems for German exports and German industry will be very much less acute and (b) the monetary consequences of any continuing influx of dollars - which in any case should be diminished in scale, since the case for intervention in support of the dollar will have been largely removed - will tend to be spread rather than concentrated on Germany.

4. The immediate French national interest in the EMS is wholly different. Essentially the proposal is seen as a useful adjunct to the internal 'Barre reforms' - the theory being that the health and strength of the French economy and French industry demand greater exposure to the bracing atmosphere of competition and monetary and fiscal discipline; and that the Barre policy of tighter fiscal and monetary policies within France, and the dismantling of subsidies and controls, can be helpfully augmented by the external discipline of a higher value for the franc than would otherwise occur (or, at the very least, not be undermined by progressive and unrestrained franc depreciation.)
5. The longer-term interest of the two countries in the EMS is, by contrast, much the same. Both wish to see the European Monetary Fund grow in importance, to the point where the Ecu gradually becomes a significant international reserve currency; although even here there is a difference of perspective. Both countries are interested in the political power, hitherto enjoyed by the United States, of running an international reserve currency. But whereas France would rather see the franc as the new reserve currency, but is obliged to settle for the Ecu as a second best because the franc isn't strong enough, Germany (which after all would be the dominant force in the European Monetary Fund) recognises that the emergence of the Deutschmark as an international reserve currency would arouse historic hostilities to which the Ecu would be immune.
6. In France, the longer-term objective described in para 5 above is felt to be a more important national interest than the arguable immediate advantage seen to accrue from membership of the EMS. In the case of Germany, it is probably that the reverse is the case.
7. To what extent should the arguments that have led both France and Germany to favour the EMS commend themselves to Britain? We have, in this country, had sufficient recent experience of the mixed blessings of running a reserve currency not to be over-impressed by this aspect of the argument. So far as the short-term considerations are concerned, the interest that Germany sees in the EMS is perfectly understandable, but is clearly not one that we can share. However, the very different motives that have swayed the French have obvious applicability to Britain, too. In other words, a case can be made for the proposition that no British Government will - in practice - feel able to maintain a sufficiently tight monetary and fiscal policy unless buttressed by the external constraint of a 'fixed' exchange rate.

8. However, there is an important difference between France and the UK here. The essence of the argument is that, in practice, the desire to maintain a fixed parity, and to avoid devaluation, reinforces the case for avoiding inflationary policies, and makes the initially unpleasant measures required to squeeze inflation out of the system more acceptable to the electorate. But the difference is this. In France membership of the European Community is wholly non-controversial, and taken for granted; thus a new Euro-discipline is readily acceptable. In the UK, however, sentiment towards EEC membership is so different that the introduction of a harsh Euro-discipline - however beneficent - might well serve merely to reinforce hostility to EEC membership and make the pursuit of disinflationary monetary policy if anything less rather than more acceptable to the electorate. Certainly, those who support UK membership of the EMS as a part of their devotion to the EEC cause should pause to reflect whether adherence to the discipline which is its sole merit might not in practice prove so unpopular as to make support of continuing EEC membership political suicide. It is one thing to proclaim the economic necessity for a period of deflation: it is quite another for this to be required by some newfangled Euro-arrangement. The implications of this for the Conservative Party, in particular, need no underlining.
9. So, should the UK join? One thing we clearly cannot do is lay down prior conditions - for example the renegotiation of the CAP, or a reduction in our excessive Budgetary contribution to the EEC. However desirable these may be, our bargaining strength (in the EMS context) is zero, since both France and Germany are wholly indifferent as to whether we join or not - indeed, on balance, they would probably prefer us not to join. We can, of course, take measures of our own, prior to joining, that would ease the problems of membership. The EMS proposal is in many ways analogous to the reconstruction of the Gold Standard after the first world war, and the decision we face comparable to the decision we took in 1925 to go back to the Gold Standard - the United States and Germany having already done so. Two questions were argued out in that controversy; whether we should tie the £ to gold, and if so at what parity. It is generally felt now that we were wrong to have gone back to gold at the old and artificially high pre-world war I parity. Certainly, we would be wrong to join the EMS at the present artificially high sterling parity - artificially high inasmuch as it is propped up by exchange control, which we are theoretically obliged under the Rome Treaty to do away with, anyway. Not only would a lower parity be easier to live with and make a success of, but the removal of

exchange control would be highly beneficial in itself, particularly at the present time. However, if we join at the present, artificial parity, the need to defend that parity will make it very much harder to abolish or even liberalise exchange control subsequently.

10. It is also necessary to consider whether the scheme can possibly work irrespective of whether the UK joins or not. It is agreed in both France and Germany that the EMS can work only if there is a general trend towards a convergence of inflation rates among the member countries. The leading - and highly respected - West German economic research institutes have already gone on record with the joint view that there is no chance of the present highly divergent inflation rates within the Community being made to converge sufficiently, in the foreseeable future, to enable the EMS to work. It seems likely that the Banque de France privately takes a similar view: it does hope, however, that, while neither the UK nor Italy will be able to remain within the super-snake, the French and German inflation rates will begin to converge sufficiently, from now on, for a Franco-German monetary system (to which existing snake members would adhere) to work.
11. Even the French, however, recognise that this process of convergence will take time, and that, in the meantime, there will need to be a progressive devaluation of the franc in terms of the Deutschemerk (although a smaller one than would occur without the EMS.) One great lacuna in the whole EMS grand design is the lack of attention paid to the nature of the adjustment mechanism. The 'adjustable peg' Bretton Woods system led to vast speculative flows of funds which were highly destabilising and eventually destroyed the system; and its recreation on a European scale would be likely to result in the same sort of debacle - only much sooner. The idea seems to be that parity adjustments under the EMS would be much more frequent, and smaller, than under Bretton Woods; they would thus be less dramatic, less spectacular, and less disruptive. However, it is not altogether clear that the architects of the EMS will be able to ensure changes in parities that are sufficiently frequent to avoid the forces that destroyed Bretton Woods, while not being too frequent as to undermine the stability and discipline that is the whole purpose of the EMS.
12. There are two further points worth recalling in the context of Bretton Woods. The first is that this, too was a system in which it was originally intended, by its architects, that there should be frequent parity adjustments. The rigidity that in practice emerged occurred because, having defended a parity for a time, Governments were reluctant to incur the loss both of money and of face involved in yielding to the market so

long as they were not forced to do so. The second point is that the history of the Bretton Woods regime gives the lie to the popular belief that all our troubles derive from the instability and permissiveness of floating exchange rates. It may be convenient to the Labour Party propaganda machine to maintain that all was well with the British economy, and with British fiscal and monetary policy, until Bretton Woods collapsed in 1971 and the £ was floated in 1972, but it does not correspond with the truth.

13. There is, nevertheless, much that is attractive, if not about the EMS as such, about the philosophy of the EMS. A greater degree of convergence of European inflation rates, - particularly if that convergence is towards the German inflation rate - is clearly desirable. An additional external discipline, if effective, that reinforces the sound money policies necessary to achieve such a convergence is also desirable. (There is a real risk, however, that the availability of huge credits under the EMS, which is being sought by the present Government, would blunt the edge of any discipline and prove the worst of all worlds.) There are also obvious dangers in the UK, alone, staying out. It would risk abdicating for good the leadership of Europe, and more precisely the direction of the EEC and its policies, to an exclusive Franco-German axis. It would appear to be a public declaration, not merely of the irremediable weakness of the UK economy, but - worse still - of our unwillingness to undertake the disciplines necessary to restore it to strength. (Statements that we intend to carry out the right policies, but independently, would be viewed with understandable scepticism by the market.) And if staying out led at any time to a crisis of confidence in sterling, it would be difficult indeed then to turn to our European partners for help - nor, of course, can we any longer turn to the US and its ailing dollar for succour. Of course, if the EMS were to disintegrate shortly after its formation, our remaining outside would not matter; but although there is a chance that this is what would happen, there is no guarantee.
14. Reluctantly, therefore, I reach the conclusion that, faced with the unpalatable choice, we should join. The best hope is that the system would shortly collapse thereafter, not due to the weakness of the £, but because of pressures on the lira and perhaps even the franc; and that we could then propose some alternative and more sensible framework for European economic convergence.
15. However, the issue is further complicated by the fact that we are in Opposition and not in Government. For a number of reasons - but perhaps most of all in the light of the European dimension sketched out in paragraph 8 above, it would be far better if Labour were to take us into the EMS. Although it appears increasingly unlikely that Callaghan - while personally keen on the idea - will dare to risk the Party row that a

decision to join will create, we should still do everything we can do nudge him to do this. This means, broadly, expressing bipartisan support for his ostensible policy of cautious approval of the EMS. Not only are there no votes in being more enthusiastically pro-EMS, but a decision to join by a Labour government would be an inestimable prize, and would effectively prevent Labour playing the anti-European card with any conviction in the future. Moreover, bipartisanship on this issue would be redolent of statesmanship.

16. If, however, as must be conceded to be more likely than not, Callaghan decided in the end not to join, despite the bipartisan support we had given him over this controversial issue, we could and should then turn on him (a) for being afraid of the big bad Benn and (b) for having brought the British economy to such a parlous state that it is too weak to join even with the French and Italians (so much for the great Labour recovery.) But we should not give any undertaking that, as soon as we are re-elected, we will bring Britain into the EMS. To give such an undertaking would gratuitously split the Party, just as Callaghan has united his; and - while we should certainly express general goodwill - it would be foolish to make a commitment of this kind now when we do not know what state the economy (nor indeed the EMS) will be in by the time we assume office.