

June 1979



Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

20th June, 1979

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~~Prime Minister~~
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Dear Bryan,

ECU SWAP

At the Prime Minister's briefing meeting yesterday on the European Council in Strasbourg, I understand there was some discussion of the possibility that the Prime Minister would announce in Strasbourg the UK's decision to participate in the ECU Swap. If the Prime Minister decides to announce this decision in Strasbourg, the Chancellor suggests that the Prime Minister should use the following form of words, which has been agreed with the Bank and telephoned to the Cabinet Office:

|| "I can tell my colleagues that the UK Government have it in mind to participate in the deposit of reserves on a swap basis with the European Monetary Co-operation Fund in exchange for ECUs. This will make it clear that, whatever our decision in due course on participation in the exchange rate arrangements, we desire to be closely involved in the evolution of the European Currenty Unit and of European monetary institutions."

As you will see, this form of words will make it clear that the decision to participate in the ECU Swap should not be taken to mean that the Government have already decided to join the EMS exchange rate arrangements.

..... I also enclose a technical note on the ECU Swap. You may like to draw the Prime Minister's attention in particular to paragraph 6 which explains that, in the last Parliament, there was considerable Parliamentary interest in the Government's decision on this point. On past form some Labour members are

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likely to react adversely to the Government's decision and their hostility could be increased if the announcement were made outside Parliament. For this reason the form of words in paragraph 2 above stops short of announcing a firm decision, which could more wisely be left for the House of Commons, when the Prime Minister reports upon the Council meeting. In any case the Prime Minister will no doubt wish to have the Parliamentary background in mind, which could lead to pressure for a debate.

I am copying this letter to the Private Secretaries to the Foreign and Commonwealth Secretary, the Lord Privy Seal, the Lord President of the Council, the Minister of Agriculture, the Attorney General, the Governor of the Bank of England and Sir John Hunt.

Yours sincerely,

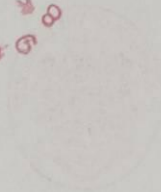
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TECHNICAL NOTE ON THE ECU SWAP

The most obvious feature of the European Monetary System is its exchange rate arrangements. There are agreed cross rates between each pair of participating currencies, each of which has to keep within $2\frac{1}{4}\%$ of every other currency, except for the Lira which has a special margin of 6%. When a gap of $2\frac{1}{4}\%$ (6%) appears between any two currencies there is an obligation on both Central Banks concerned to intervene in the markets to prevent the gap exceeding $2\frac{1}{4}\%$ (6%). The Central Bank of the weaker currency can borrow the currency of a stronger country for this purpose but has to settle such debts out of its reserves within three months. The European Monetary Cooperation Fund (EMCF) acts as the agent and the accounting body for such settlements.

2. The EMS has other elements beyond these exchange rate arrangements. They are enhanced medium term credit; an arrangement for depositing 20% of gold and dollar reserves with the EMCF and receiving ECUs in exchange; and a plan for the creation within two years of a European Monetary Fund which would, if it came about, be a step towards a European Central Bank.

3. If a full European Monetary Fund were ultimately established (after legislation in member countries) reserves would presumably be transferred to the Fund in a more permanent way. For the present, however, the "deposit" is a three-month revolving swap of 20% of gold and dollar reserves for ECUs (European Currency Units) issued by the EMCF. The gold and dollars remain physically with the "depositing" central bank which is free to invest the dollars as before and retain the income from them. The ECUs are used to settle intervention debts between EEC central banks arising out of exchange rate intervention but the underlying swaps are to be unwound after

the preliminary two-year period, before the EMF is set up.

4. If the UK participates in the ECU Swap, we would not reduce the liquidity of the reserves because we would have the right to withdraw the underlying gold and dollar assets from the EMCF in case of need. There would also be no loss of income to the reserves because we would continue to manage the assets we have deposited and the income on these would accrue to us direct. We would, however, have little or no use for our ECU holdings whilst we are a non-participant in the exchange rate arrangements. On present levels we would deposit around \$3 $\frac{1}{2}$ bn of our reserves and receive ECUs in exchange. There would also be an increase of around \$200 million in the published value of our reserves because the EMCF values gold deposited with it at a higher rate than the rate we use for valuing gold in our own reserves.

Legislative Implications

5. The Attorney-General in the previous Government advised that, although there were strong arguments that full participation in the EMS exchange rate arrangements would be lawful under existing legislation, equally there were strong arguments that it would be constitutionally improper to undertake a major new continuing commitment on this basis. Legislation might not be needed immediately but should be taken within a reasonable time after the UK entered fully into the EMS. The previous Attorney-General did not, however, think that legislation would be called for, either on legal or constitutional grounds, if participation were limited to the deposit of reserves with the EMCF on a swap basis.

Parliamentary Considerations

6. There has been some Parliamentary interest in the deposit of reserves with the EMCF. Mr Douglas Jay MP and other Labour backbenchers suggested that there should be legislation to

cover the deposit of reserves. In a Written Answer on 29 January 1979 to a Parliamentary Question, the then Chancellor informed Mr Jay that "on the basis of the present proposed arrangements for the deposit of reserves and the issue of ECUs legislation would not be required". Mr Healey had previously given an undertaking that legislation would be enacted if the UK were to participate when the full European Monetary Fund was set up in 2 years time. There is likely to be considerable Parliamentary interest in the decision to deposit reserves against ECUs, particularly amongst Labour backbenchers. Even if legislation is not required there could be pressure for a debate.

General Considerations

7. There are in the near future no significant financial advantages or disadvantages from depositing reserves with the EMCF. The main argument for depositing reserves is that it might help the Government in other dealings with the EEC, though it has to be regarded as a small and weak bargaining card. It could also do something to help the UK's position in any discussions on the working of the EMS, the future role of the ECU and the development of the European Monetary Fund. However if we do not join the exchange rate system and our partners proceed in due course with the European Monetary Fund, we could hardly legislate to join them in depositing reserves unless the ECU became a real transferable asset usable outside EMS intervention.