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Copy in briefing folder attached to EUROPEAN POLICY, May 78, Bremen Policy. + copy of top letter in file.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

5th July, 1978

Dear Ken,

BREMEN: BRIEFING ON EUROPEAN CURRENCY REFORM

I attach:

i. a main brief for the Prime Minister on this subject;

ii. a commentary on the Schulman/Clappier draft of 28th June 1978;

iii. a commentary on a press interview given by Chancellor Schmidt on 28th June which the Germans have commended to us as reflecting his philosophy;

iv. a note about the approach to improving our position on resource transfers in the Community.

The Chancellor has seen and approved i. and ii.

I am copying this to the Private Secretaries to the Foreign and Commonwealth Secretary, the Chancellor of the Duchy and the Governor of the Bank of England, and to Sir John Hunt, Sir Michael Palliser, Sir Douglas Wass and Mr. McMahon.

Yours ever,

Tony Battishill

(A.M.W. BATTISHILL)

K. Stowe Esq., CB

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EUROPEAN COUNCIL, BREMEN, 6/7 JULY 1978

EEC CURRENCY ARRANGEMENTS. BRIEF FOR THE PRIME MINISTER

The objectives at Bremen are:

(a) to make clear that the UK is interested in currency stability, and is willing to discuss the principles for and to study the details of a new European currency arrangement;

(b) (i) at the same time to emphasise that stability is not an end in itself. Growth is also needed and greater currency stability should remove an impediment to growth;

(ii) To ensure they understand that credit arrangements are not a substitute — Transfer of resources is required

(c) to avoid commitment now to the setting up of any new currency arrangement;

(d) to ensure that the Communique refers to further study taking place under the auspices of Finance Ministers and on the basis of the Report of the Finance Council discussion on 19 June, which should be reproduced in full. A form of words is at Annex A to this brief;

(e) to avoid discussion of details among Heads of Government.

2. The arguments against early commitment even in principle are:

(a) decisions cannot sensibly be made without knowing the principles and characteristics of a scheme;

(b) the snake arrangement has failed to keep all member countries in

(c) a new arrangement must improve on this, and be durable. Otherwise the cause of stability will be seriously set back. Better to carry on as we are than fail in a new endeavour;

(d) to make a new scheme durable it must pay regard to the fundamentals;

(e) all concerned need to be satisfied before the plunge is taken.

3. Because they do not like the references to symmetry in the Finance Council Report, and because they may want to retain the initiative, the Germans may seek to base the Bremen discussion and Communique on a draft of their own. The arguments for using the Finance Council Report as a basis are:

(a) it refers to some fundamentals which could, if built on, differentiate the snake from a new arrangement, and offer promise of a durable scheme;

(b) it reflects discussion among all 9 Ministers;

(c) perhaps not all Finance Ministers are committed to all the propositions. But all the propositions have some support, and the Report as such is fully agreed;

(d) not all the desiderata are there. The UK did not insist on a reference to resource transfers at this stage. There was give and take in drawing up the Report. There will have to be a willing balancing of all partner countries' interests as the scheme is developed.
The Report is a very good first step.

4. The arguments against using a German or Franco/German draft, on the lines of the document we have seen, as a basis are:

(a) it does not reflect discussion on a Community-wide basis;

(b) it is far too committal, both as to the establishment of a scheme and the strictness of its form;

(c) the reference to a transitional period smacks of a two-tier system, which, if revealed now, would be likely to excite the foreign exchange markets, and is in substance undesirable;

(d) it goes into premature detail about units of account and the activities of a European Fund;

(e) it contains propositions about substituting European units for dollars which may upset the US authorities as well as the foreign exchange markets. It is quite unnecessary to risk this at this early stage.

5. Technical points. Although it is recommended that discussion of details should be avoided, the following are the points of importance to the UK:

(a) there must be provision to adjust exchange rates up or down if economic circumstances require it;

(b) the system must not impart a deflationary bias - ie the stronger and weaker must both make efforts to converge rather than the weaker being forced to accept the precepts of the stronger;

(d) so obligations to adjust must be placed on surplus as well as deficit countries;

(e) the idea of settlements being denominated in a new European Unit of Account, and passed through the present or a new European Monetary Co-operation Fund offer practical merit and are communautaire: further study should be strongly encouraged. This approach could be the best route to a truly symmetrical scheme - but we will not know finally whether it would serve our interests best until we are able to judge what precise characteristics will be negotiable. It may in the end suit us better to go for an effective rate scheme;

(f) therefore, while this EUA/EMCF approach suggests that a European unit should be the numeraire for the currency system, no such choice should be made yet. This is not just a UK point. The central banks have no experience of operating such a scheme. The technical details will need to be spelt out and there has been no discussion about them within the Community. One especially tricky point is the desire of some countries to preserve the existing snake within the new scheme;

(g) regard should be paid to the world system - specifically to relations with the dollar;

(h) account must be taken of the position of Italy. It hardly seems likely that they could soon join a scheme, given the underlying economic difficulties. This makes an apparent commitment by the whole Nine even more improbable.

ANNEX A

The objective should be a Communique which refers to European Currency arrangements as follows:

"Heads of Government wish to see developed for their consideration a plan for European monetary co-operation which would contribute both to a reduction in the general level of inflation and to a higher rate of economic growth within the Community.

To this end they have asked Finance Ministers to arrange for the preparation of, and to make a proposal for, new currency and credit arrangements, using as their starting point the conclusions of their discussion at the Finance Council of 19 June, which read as follows:

Text of Paper

[If necessary, include the cautiously worded references to some individual points as in the "Possible UK Counter draft"]

[If necessary, include a date for completion of the work]

SCHULMAN/CLAPPIER DRAFT OF 28.6.78
FOR A EUROPEAN MONETARY SYSTEM

Commentary

1. Opening sentence: "We propose to establish in the EEC a system of closer monetary co-operation (European Monetary System - EMS) leading to a zone of monetary stability in Europe."

We regard this as too committal at this stage, and also as unrealistic. We do not see how governments can commit themselves to establish a system of closer monetary co-operation without knowing in reasonable detail the particulars of the scheme by which this is to be achieved. In any event, given the possibility of an election before too long, the UK could hardly enter into what looks like a definite commitment - even if in fact it is really a rhetorical flourish. Our draft for the same sentence would be:

> "Heads of Government wish to see developed for their further consideration a plan for European Monetary co-operation with certain fixed characteristics."

2. Paragraph 1, first 2 sentences: "In terms of exchange rate management this system will be at least as strict as the so-called snake. In the initial stages of its operation and for a limited period of time member countries currently not participating in the snake may opt for somewhat wider margins around central rates."
This sounds like a proposal that we should all enter the snake and that has obvious political difficulties. But it also contemplates a two-tier system which, at an earlier stage, we had thought was opposed by the French. We had also thought that the French were anxious to portray the system as quite different from the snake, and that is what President Giscard said publicly at the end of last week. If that is so, these sentences are unhelpful.

3. Paragraph 1, third sentence: "In principle interventions will be in the currencies of participating countries."
No objection in principle to interventions in the currencies of participating countries. This would in fact help the dollar. But further work is needed to establish that it would be practicable.

4. Paragraph 1, fourth sentence: "Changes in central rates will be subject to mutual consent."
There would be political problems about a flat statement that changes in central rates would be subject to mutual consent. The right approach would be to talk about consultation. In the last analysis countries could not be prevented from changing their rates and even in the snake consultation has sometimes had to be perfunctory.

5. Paragraph 1, last sentence: "The European Currency Unit (ECU) will be at the centre of the system; in particular, it will be used as a means of settlement between EEC monetary authorities."
The statement that the European Currency Unit will be at the centre of the system is indefinite and it is notable that the earlier statement identifying this ECU with the existing European Unit of Account (EUA) has been deleted. This may be because M. Clappier has seen, as we have, that there could be technical difficulties about using the EUA as a reference point for currencies. It might be necessary to create a new unit for this purpose in which the weights of individual European currencies within the Unit were fixed. In the EUA they vary with changes in the market value of currencies.

6. A system centred on a new European Unit could have technical advantages, compared with the snake system. It could pin the responsibility for intervention more clearly on the currency which was deviating most from the average. And it could offer more flexibility in intervention tactics.

7. But final judgement must be suspended: it would depend on the precise characteristics of the new unit, which would need to be properly thought out.

8. Paragraph 2, first sentence: "An initial supply of ECU's (for use among Community central banks) will be created against deposit of US dollars and gold on the one hand (eg 20% of the stock currently held by member central banks) and member currencies on the other hand in an amount of a comparable order of magnitude."

The proposal is the ECU's would be created in return for both dollars or other existing reserve assets, and for member currencies. By saying, as an example, that 20% of central bank reserves might be used for this purpose, and that member currencies should be exchangeable "in an amount of comparable order of magnitude", M. Clappier has sought to keep his figure of about 25 billion ECU's for new credit in the picture. We applaud the idea of credit on this scale but there may be problems about allowing to become public a suggestion that 20% of European dollar reserves would soon be changed for ECUs. Unless there were careful preparation and the context were right, the markets might fasten on the idea that the Europeans were getting rid of 20% of their dollars and react against the dollar accordingly.

9. In any case, pooling existing reserve assets in the exchange for ECU's does not create more reserves. It changes their demonination, and thus the exchange risk. It is not made clear who would bear this: ideally it would be the stronger countries. It would in effect mobilise some gold. This could be more significant for most other EEC countries than for the UK, because we have relatively little gold.

10. <u>Paragraph 2, second sentence</u>: "The use of ECU's created against member currencies will be subject to conditions varying with the amount and the maturity; due account will be given to the need for substantial short-term facilities (up to 1 year)." This sentence is the key to the element of credit creation: countries would get reserve assets in exchange for their own currency. The idea is for a kind of a European IMF in which ECU's could be drawn on like successive credit tranches of an IMF borrowing, with similar progressive conditionality.

11. The procedures might be turned to good account as a means of financial burden sharing. But much further study is needed on all this and it remains to be seen what is negotiable.

12. Paragraph 3: "Participating countries will co-ordinate their exchange rate policies vis-a-vis third countries. To this end they will intensify the consultations in the appropriate bodies and between central banks participating in the scheme. Ways to co-ordinate dollar interventions should be sought which avoid simultaneous reverse interventions. Central banks buying dollars will deposit a fraction (say 20%) and receive ECU's in return; likewise, central banks selling dollars will receive a fraction (say 20%) against ECU's." This paragraph really refers to co-ordinating intervention in relation to the dollar. The last part of the paragraph would enable any country intervening, in either direction, to join the central monetary institution in the consequences of its intervention. For example, if under co-ordinated intervention Germany bought dollars, she could reduce her exchange risk on the resulting dollar holdings by depositing 20% of them with the central authority and receiving ECU's in return. There could also be some offset here to the impact on the German money supply of creating DMs in order to buy dollars. It is in the UK's interest that a sensible dollar policy should be made to work.

13. Paragraph 4: "No later than 2 years after the start of the scheme, the existing arrangements and institutions will be consolidated in a European Monetary Fund."
This sentence recognises the French desire, which we would be inclined to support, to include something like a European IMF in the new system. The proposal is that the present EEC short-term and medium credit arrangements would within 2 years be consolidated into a European Monetary Fund. It is not clear why a delay of up to 2 years would be necessary.

14. Paragraph 5: "A system of closer monetary co-operation will only be successful if participating countries pursue policies conducive to greater stability at home and abroad; this applies to deficit and surplus countries alike."
There is here the vestige of a recognition that both surplus and deficit countries would have to be ready to change their policies

in order to make such a system work. However, it is drafted in terms of "policies conducive to greater stability". That sounds much more like a discipline for deficit countries - the German model of stability without much growth. Our formulation would be that in order to avoid an inherent deflationary bias in the whole system there would have to be policies directed to greater growth in the surplus countries and greater stability in the deficit countries.

15. Paragraph 6: "The competent Community bodies are requested to elaborate the provisions necessary for the functioning of the scheme and to conclude their work not later than 31 October 1978." We think the date of 31 October 1978 is unrealistic but the Prime Minister may prefer to let that emerge or to let others make the point.

Conclusion

16. Some aspects of this Schulman/Clappier draft are acceptable: the flavour of developing a system different from the snake: the idea of building on the present embryonic European Monetary Co-operation Fund in the direction of a European IMF, with reserve assets issued in exchange for national currencies: the implications about the need for ample credit: the suggestion that there must be a dollar policy.

17. One thing is quite unacceptable: the appearance of instant commitment to a scheme.

18. And the point about shared responsibility for convergence between weaker and stronger economies is at best inadequately treated.

19. Some things may be acceptable - the idea of the new limit of account - the idea of strictness like that of the present snake. But some of these apparent technicalities have profound implications. Very much more study is needed, and judgement will have to be suspended in the meantime. The future work should be put in the hands of the Finance Ministers, and should be on the basis not of this Schulman/Clappier draft, but of the Report of Finance Ministers, which is a document agreed among all the 9.

CHANCELLOR SCHMIDT'S INTERVIEW WITH "BUSINESS WEEK" : 26 JUNE '78

1. In the Summit Preparatory Group the German representatives particularly drew the attention of all present to what Chancellor Schmidt said in this interview as a clear statement of his thinking and of his approach to the Bonn Summit. This note therefore attempts some comment on what Chancellor Schmidt said. The answers he gave in the course of the interview are numbered 1 - 25 on the attached copy and the numbered references in this note are to those paragraphs. It is probably a fair summary of Chancellor Schmidt's approach to say that he seeks to shift the emphasis off measures which he would call short term and which would in fact have a horizon of between 6 months and 2 years. He moves the emphasis on the one hand on to long term structural issues, as he sees them; and on the other hand on to monetary machinery of all kinds. He is preoccupied on the one hand with restructuring German (and no doubt European) industrial capacity to meet the challenge of the developing countries, including the "super-competitives"; and on the other with keeping down the mark, the public deficit, interest rates, and the influence of the Euro-markets.

2. The half dozen points, reflecting this philosophy, on which he lays stress in this interview can be summarised as follows:

i. whatever people say about the level of public deficit which Germany's savings ratio can accommodate, if public borrowing puts up interest rates that is a signal for him that it is too high;

ii. exchange rate instability is one of the structural problems of the world economy at present, which stands in the way of proper growth;

iii. the US deficit and the Euro-currency market between them mean that national central banks can no longer control adequately monetary expansion. This too is a structural problem;

iv. demand management won't achieve anything ("Some politicans have now adopted vulgar Keynesianeconomics");

v. industry is facing a structural problem rather than just a downward business cycle. This means it will have to reorient its capacity towards new products etc. He attributes this both to the evolution of the developing countries and to over capacity created during the Vietnam war;

vi. a new European currency scheme would impose more discipline on governments and make them more effective in fighting inflation. It would also combine EEC currencies "to function as a heavier counterweight in the international currency markets vis-a-vis the US dollar, in order to stabilise exchange rates between the dollar, European currencies and the Japanese yen".

3. Some comments on these propositions are contained in the following paragraphs.

The Public Deficit and Interest Rates.

4. Chancellor Schmidt is still inclined to make direct comparisons between the level of public deficit in Germany as a percentage of GNP (4.5%) and the corresponding figure in the US, which probably is a good deal lower (5). But these absolute comparisons really are meaningless and those who interviewed the Chancellor could not quite stomach them (6). The Japanese public deficit is higher than that of any other major country because their savings ratio is of the order of 25%. The German and British public deficits are now in the range of 4½% to 5¼% and we both have savings ratios in the range 12½% to 16%. The U.S. savings ratio is something like 6% or 7% and their public deficit is quoted by Chancellor Schmidt as 1% but by the Americans as 3%. Other factors besides the savings ratio must also enter into the assessment of whether a certain size of public deficit is inflationary. They include, for example, the flexibility of capital markets in different countries and the movement of capital in and out of the country. But the essential point is that the significance of a particular ratio of public deficit to GNP is relative to the circumstances and is not an absolute matter.

5. As to interest rates, we have not been able to find any evidence that the German Government is in difficulty about financing its deficit on the German capital markets or about the rates of interest it has to pay in order to do so. Annex A gives a few figures of what has happened to the yields of German Federal Government securities since the end of 1976. Current rates for all maturities seem to be well below the rates obtaining at the end of 1976 and if there has been a very small kick up in rates in the last month or two, that is not very surprising. Just as our interest rates were driven down by inflows in mid-1977, so German rates declined in the face of inflows and at the very short end were deliberately put very low to deter such inflows. The inflows have been much smaller recently and in some periods have reversed. So there has been some upward pressure on rates quite unconnected with the scale of public deficit.

6. In short we remain unconvinced by Chancellor Schmidt's suggestion that the present German public deficit (which I believe is now forecast as 55 billion DM in 1978 instead of the 60 billion DM originally budgeted for) is the limit of what can be supported if interest rates are not to be driven up unacceptably.

Exchange Rate Uncertainty

7. In (7) the Chancellor says that nobody knows what he will get for a DM or for a dollar 3 years from now. We have sympathy with his point about the damage which exchange rate uncertainty may do but, like the Americans, we believe that we can only get greater certainty if we tackle the fundamentals, especially the imbalances of growth and of balance of payments between the main industrial countries. Moreover it has been true at least since the end of the '60s that nobody could be sure where the DM and the dollar would be in 3 years time. Floating exchange rates may or may not have contributed to our troubles but we would regard them as more a symptom than as the main disease. Unless we can get a better balance of growth and of balances of payments we shall be forcing industry to go on living with currency instability, whatever mechanisms we attempt to devise.

The Euro-currency Market

8. We are inclined to think that Chancellor Schmidt may be placing too much of the blame for currency instability on the Euro-dollar market. We tend to see it as a channel for credit rather than as a major source of credit creation. But there are indications that the Germans wish to propose a new series of controls over the Euro-dollar market and the relationship of central banks to it. All that would have to be discussed at Basle amongst central bank governors. This is familiar ground to them.

Demand Management is Useless

9. We have never argued that demand management measures were a universal cure all. The present British Government has paid close attention to the monetary aggregates and of course to counter inflation policy. We fully take the point that in an economy where inflation is high and rising demand management measures may do more harm than good. But again this is a relative, not an absolute, question. We would say that where on the contrary rates of inflation are very low and falling, where there is a substantial current account surplus and where there is under-employed labour and industrial capacity, then judicious demand stimulus (that is,putting more purchasing power into the hands of those who spend money in the economy) can produce valuable non-inflationary growth. And all the major international organisations in the economic field completely agree with us - the IMF, OECD, European Commission. So does the U.S. So, for that matter, do the Japanese. They do not stand on the German argument. Chancellor Schmidt's position is simply an extreme one and may indeed have in it an element of deliberate tactical exaggeration.

Restructuring Industrial Capacity.

10. Chancellor Schmidt is obviously right to say that industry has to adapt itself to changing world circumstances. In most countries it did a very great deal of this during the '60s and in the period up to 1973. We would think that he exaggerates the extent to which this is a new point and perhaps sees it in too dramatic terms.

11. He says (8) that this is not just a downward business cycle, but something much more important. We agree that there are structural elements in the situation -- more of them than in previous business cycles. Nevertheless, there is a big cyclical element which can be helped by judicious demand management measures. The world has been in recession since the end of 1973 and has been very slow to pull out of it. But measures of demand management have contributed to pulling us out of the worst of the recession. The Germans ran a much bigger public deficit in 1975 than they are running now and they recovered from the worst of the recession in 1976. Similarly, the American economy has been pulled back nearer full employment by demand management policies. Chancellor Schmidt tries (9) to write off the fact that the Germans themselves have used demand management since 1973 but he does so only by playing with words ("We never called it a reflationary programme"). As to the super-competitives, they represent a serious problem for European and American industry but it is possible to exaggerate it. The growth of Japanese competition in the last 10 years has been a bigger problem. Moreover the answer is probably not (as Chancellor Schmidt sometimes seems to suggest) to move out of particular industrial areas and into others. It may consist just as much of moving up market in existing industries. Chancellor Schmidt believes in the market and one would expect him to think that the market would take the necessary decisions about the direction which restructuring should take.

<u>European Currency Reform</u>

12. Chancellor Schmidt's phrase about a combination of EEC currencies "to function as a heavier counterweight against the dollar" is suggestive of his objectives in pursuing European currency reform. A combination of currencies, of which the mark was one, would be "heavier" than the mark on its own ie a means of keeping the mark down. This is why he thinks it might help to "stabilise exchange rates between the dollar, European currencies and the yen."

13. On the other side he sees the impact of economic policy in terms of more discipline for other countries:

> "If somebody ties his national currency to such a complex, he comes under stricter rules as regards his overall economic behaviour. In a way, you have to gear your fiscal and monetary behaviour so that you can maintain your exchange rates without sacrificing your currency reserves or drawing too heavily on some joint pool or on monetary assistance from your partners."(16)

> "As long as you let your currency depreciate or appreciate in the markets every working day, you do not need decisions by cabinets or finance ministers. But the more you put yourself under the stringent discipline of your balance of payments, the more likely you will be effective in fighting inflation." (18)

14. But there is one place in which he recognises that a contribution would be needed from the German side:

> "It might mean for Germany, on the other hand, that we have to sacrifice some of our reserves. It might also mean that we have to expand our money supply somewhat more rapidly than we have done until now." (16)

In this sentence he is accepting the possibility that via the German money supply this scheme could mean more inflation for Germany. He must know too that he will get less help with inflation if the DM appreciates less. So by both routes he is prepared to pay in inflation to keep the DM down.

INTEREST RATES ON FEDERAL GERMAN GOVERNMENT SECURITIES

December 1976 - May 1978

A. Average yields on all Federal Government Securities (existing stock)

December 1976	7.2%
August 1977	5.7%
April 1978	5.2%
May 1978	5.3%

B. Average yields on new Federal Government Issues

December 1976	7.2%
December 1977	5.8%
April 1978	5.4%

C. Money Market Rates.

These rates are quoted in terms of a "spread" between highest and lowest rates in any month.

3 months money has remained throughout in the range between 3.3% for "lows" to 4.9% for "highs".

For overnight money "highs" fell from 4.7% in the early part of 1977 to 4.1% in the second half of the year. "Lows" began at about 3.8% and fell to 1% in December 1977 (currency inflows). Between January and May 1978 the spread has been between 3.6% for "highs" and 3.5% for "lows".