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An interesting read,  
and some development of ideas  
which is helpful - but a long way  
to go.  
K.S.

Dear Ken

## CHANCELLOR SCHMIDT'S PROPOSALS FOR EUROPEAN CURRENCIES

I attach a record of a discussion which I had with M. Clappier and Herr Schulman in Paris on Friday, 12 May.

We still await a paper in which Chancellor Schmidt's proposals are described, though this is now promised within the next week or so. However on this occasion Herr Schulman did begin to give rather more precision to the German proposals:

- i. the approach to the exchange rate aspects was more precise, flexible and realistic - always within the scope, of course, of a move back towards fixed exchange rates;
- ii. some precision was given to the idea of creating and using European Units of Account. The German suggestion appeared to go beyond using the EUA as a numéraire; and to include an issue of units in exchange for national currencies which would give each member country a certain interest-free access in need to the currencies of other members. For example, the UK, having purchased £Xm units with sterling, would be able to sell them either to the central pool or to another member central bank for a basket of European currencies in which German marks would be the largest single component. But Herr Schulman's remarks on this were the merest outline and included little or nothing about the scale of this EUA operation or the conditions attaching to it;
- iii. it was clearly recognised that the scheme ought not to damage the dollar. The aspects of the plan envisaging more intervention in European currencies and greater dependence on non-dollar reserves could be consistent with that.

However these clarifications still do no more than touch the edge of a large subject, and there was no real movement from the German side on credit outside the EUA issue, or on resource transfer.

SECRET AND PERSONAL

I thought it right at this stage to stake out a UK position on resource transfers within the Community, as well as on such matters as the flexibility of the proposed exchange rate links, the scale of reserves and the terms and length of credit. I also mentioned the link with efforts to achieve higher growth in the Community. It seemed right to deploy the arguments now both on the merits and as a matter of tactics.

In the light of last Friday's discussion with M. Clappier and Herr Schulman, I think it would be better to wait until Herr Schulman's paper is available and we have had an opportunity to discuss it à trois in Washington before preparing the paper described at sub-paragraph ii of your letter of 26 April about the costs and opportunities of Chancellor Schmidt's ideas for the UK. The paper at sub-paragraph i of your letter about the implications for the UK of separate French re-entry to the Snake is however already in draft and I expect to let you have the final version of that within about a week. It may need to be updated as the detail of the German proposals and the French reaction to them become clearer but it seems worthwhile to make a first analysis now.

I am copying this letter and enclosure to the Private Secretaries to the Chancellor of the Exchequer, the Governor of the Bank of England, Sir John Hunt and Sir Douglas Wass.

*Yours ever*

*Ken Couzens*

K E Couzens

CHANCELLOR SCHMIDT'S PROPOSALS FOR EUROPEAN CURRENCIES

NOTE OF A MEETING AT THE BANK OF FRANCE 12 MAY 1978

M. Clappier, Herr Schulman and I discussed the possible lines of a scheme based on Chancellor Schmidt's proposals from 11.30 am to 4 pm at the Bank of France on Friday, 12 May.

2. There was no new piece of paper available to us beyond the record of what Chancellor Schmidt had said at Copenhagen which he left with the Prime Minister at Chequers on 23 April.

3. At my suggestion we organised the discussion under four headings:

1. Exchange rates.
2. Reserves and Credit Arrangements.
3. Currencies of intervention and the relationship with the dollar.
4. Questions outside the scheme itself which might have an important bearing on its acceptability or practicability, including "resource transfers" and European growth.

Exchange Rates

4. Points emerging from this part of the discussion were as follows:

a. Herr Schulman saw a range of possibilities about the margins within which currencies would be permitted to fluctuate. These ran at one extreme from the 1% which applied under Bretton Woods and which Chancellor Schmidt had appeared to favour at Chequers, through the 2 $\frac{1}{4}$ % of the present European Snake to perhaps 5%. If the total margin were as much as 5% that would mean a 2-tier arrangement with the present Snake currencies adhering to their narrower 2 $\frac{1}{4}$ % margin. M. Clappier repeated a view he had already mentioned to me that the extent of the margin made little practical difference to the position one found oneself in when defending a rate. I said that although I sympathised with that argument as a

technical matter, a wider margin could make depreciation somewhat less difficult politically. The extent of depreciation from the bottom of a band might need to be less. The effect would be a kind of crawling peg arrangement.

b. I asked whether it was possible to envisage a still looser arrangement under which, at least for an initial period, there would be no fixed rate at all. There would be agreement to seek greater stability, to coordinate intervention and to pool the use of reserves but Governments would not be committed to particular rates. There would be the kind of coordination of intervention which had happened between the Americans and the Germans under their recent swap agreements.

M.Clappier thought that such an arrangement would not be practicable because the markets would find out the limits to which central banks were operating and the position would then be little different from what would happen under fixed but freely adjustable rates. M.Clappier's approach, on this occasion as on the previous occasion when he saw me, seemed to be that the essence of the matter was whether to accept a fixed exchange rate or not. Whether from conviction or for tactical reasons, he was inclined to polarize the issue.

c. I suggested that if the proposals were to succeed, it would be necessary for the exchange rates which applied at entry to the scheme to be such as could be held for at least 6 months and perhaps longer. Otherwise the markets would not be convinced that greater stability had been achieved. M.Clappier said he thought the present franc exchange rate was about right but he conceded that that view might change if the inception of the scheme were delayed for 6 or 9 months. I said that the question whether at a particular point in time an exchange rate struck a reasonable balance between the needs of competitiveness and the avoidance of inflation was a different one from the question whether that rate could be successfully held for 6 or 9 months.

d. In reply to this part of the discussion Herr Schulman envisaged an initial period of up to 2 years during which there could be relatively frequent adjustment of exchange rates. This would be a period of "tatonnement" or "groping" for more stable rates, which might produce something like a crawling peg situation. Every effort would be made to de-dramatise exchange rate changes.

SECRET

e. It seemed clear from what M. Clappier said that he did not envisage an initial devaluation of the franc on entry to the scheme. I did however ask H. Schulman whether German thinking excluded a sterling devaluation on entry. He said that it did not.

f. H. Schulman said that the exchange rate and associated margins for each member currency ought to be related to the European Unit of Account rather than to any other single European currency. Stability in terms of a particular relationship with the "basket" of currencies represented by the European Unit of Account would be a less exacting than stability say in terms of the deutschemark.

### Reserves

5. H. Schulman envisaged that a Central Pool or Authority (which would be built on the existing FECOM and not in any circumstances on the European Commission) would issue a quota of European Units of Account to each member country in exchange for national currencies. These European Units of Account, which would be available unconditionally, could be presented by any member country to the central bank of another member country to obtain the relevant national currency for intervention purposes. For example, if the UK needed to intervene in Deutschemarks it could obtain them by presenting EUA's from its allocation to the Bundesbank. I pointed out that the scale of intervention nowadays required very large reserves to help deter pressure on an exchange rate. It was possible to expend \$ $\frac{1}{2}$  billion a week on intervention without difficulty and the Japanese had on occasion expended much more. M. Clappier said he thought reserves of \$30-40 billion would be needed.

6. On credit H. Schulman simply referred to the improved scale of resources available under existing Community arrangements. Both the short term credit and the medium term credit had been increased. I pointed out that in recent times it had been perfectly possible for a single country (Italy) to exhaust the Community credit resources though of course these had now been enlarged. Indeed, the UK had at one stage used up a large part of the borrowing powers of the IMF.

SECRET

7. M. Clappier said that the short term credit would need to be extended to 1 year. I stressed the difficulty for the UK of incurring medium term debt which would add to the already very large medium term debt obligations which we were facing for the period 1979-84. We needed longer credit terms than the 8 years or so at present envisaged.

Intervention and the Dollar

8. H. Schulman said that from the German side there was no intention that this arrangement should be damaging to the dollar. It would not be in the interests of Germany or of Europe if the arrangement had that effect. He was therefore thinking in terms of intervention to support member currencies being in European currencies not dollars, with settlements between central banks in European Units of Account.

9. H. Schulman also envisaged a coordinated policy of intervention in relation to the dollar between central banks. M. Clappier spoke of an objective of keeping the dollar within a range of say 2 to 2.20 to the deutschemark but H. Schulman thought that it would be too ambitious to aim at a particular dollar rate. In subsequent discussion I asked about a situation in which it was assumed that most intervention would be in European currencies while the bulk of our national reserves was still in dollars. H. Schulman accepted the possibility of a substitution arrangement by which the Central Pool would accept dollars in exchange for EUA's and would then invest the dollars. It was also accepted that as a technical matter it might sometimes be necessary to intervene in dollars. It would then be desirable to take that intervention in dollars into account in operating the coordinated intervention policy in relation to the dollar for the Community as a whole. If the dollar were weak and a particular member country were obliged to intervene in dollars to support its own currency, that intervention might have to be offset by purchases of dollars either by the Central Fund or by other Community Central Banks.

10. H. Schulman described an arrangement under which the risks involved in purchases of dollars to support a weak dollar by any member of the Community might be spread. Purchases in accordance with a

*but not too ambitious to aim*

coordinated intervention policy would give the central bank the right to place an agreed proportion of its dollar purchases with other member central banks.

11. We also discussed the possibility that the Central Pool might take over the present US/German SWAP agreement. Failing that, the agreement would have to continue to be a bilateral matter between Germany and the United States.

#### The Community and Resource Transfers

12. H. Schulman clearly expected that I would raise again the question of resource transfers, to which I had referred at our previous meeting. Chancellor Schmidt had passed on to H. Schulman the table showing net costs and benefits from the Community which the Prime Minister had handed to the Chancellor in Copenhagen. He appeared to accept the figuring in it. I said that it was a standard feature of currency unions that there were resource transfers from the stronger to the weaker components or members of such a union. This was true within the United Kingdom and in many federal systems. The same might be expected of the Community if it moved closer to monetary union but at present some of the transfers within the Community were perverse, as the Prime Minister's table showed. I added that the combined effect of the Common Agricultural Policy and the cost of the British Army of the Rhine had been a charge on our balance of payments which had increased by several hundred million dollars each year for the last three years, and was forecast to go on increasing. This was both a constraint on UK growth and a constraint on our ability to achieve a more stable exchange rate. The point was left there.

13. The only area of resource transfer of which H. Schulman spoke during the discussions was the European Investment Bank. He suggested that its capital could be trebled or quadrupled and that there could be an interest rate subsidy, contrary to earlier German policy. Both M. Clappier and I said that this was at best an indirect source of help of a limited kind. I pointed out that with the accession of the Mediterranean countries we were unlikely to get any net benefit from the Regional Fund of the Community and no doubt there would be other heavy demands on the EIB.

## Timing

14. Herr Schulman asked M.Clappier and myself what prospect we saw of reaching broad agreement on these proposals by the time of the Bremen European Council. We both thought this was a very fast timetable.

15. Herr Schulman then asked me whether I thought it would be politically possible for the UK Government to enter into such a scheme before the UK election. I said this was a political matter on which I was not qualified to speak. For what it was worth, my personal opinion was that anything which appeared as a simple decision to enter the European Snake could be politically divisive and therefore possibly difficult before an election. It might be different if the agreement were one which they could present as unambiguously in the interest of the UK: which also included action on European growth eg under the plan now being worked out by M. Ortoli and the European Commission.

16. It was agreed that Herr Schulman would now prepare a paper to be sent to us within a week or 10 days and which we could then discuss further at a private dinner to be arranged by M.Clappier in Washington on 26 or 28 May. We would all three be there for the next meeting of the preparatory group for the Bonn Summit.