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NOTE OF A MEETING HELD IN THE CABINET ROOM AT 1845 ON TUESDAY 4 APRIL 1978

Present: Prime Minister
Secretary of State for Foreign and Commonwealth Affairs
Governor of the Bank of England
Sir John Hunt
Mr. Ken Couzens
Mr. Kit McMahon
Mr. Bryan Cartledge
Mr. Nigel Wicks

(The meeting took place after the briefing meeting for the European Council. The Chancellor had had to leave that meeting early because of an unavoidable engagement.)

Telephone call with President Giscard

The Prime Minister said that President Giscard had telephoned him that morning to say that Chancellor Schmidt had raised with him during his recent visit the question of new monetary arrangements for Europe. The President had suggested that he, Chancellor Schmidt and the Prime Minister should have a discussion at a private breakfast in Copenhagen on Saturday morning. He had told the President that the Chancellor had raised the question of new monetary arrangements with him when he was in Bonn last month. He had also said to the President that if the Chancellor's idea of pegging currencies resulted in sterling being maintained at a higher level than otherwise, it would not be attractive. The President had said that this was not the purpose. The Prime Minister said that he had replied that it might nevertheless be the consequence.

The Prime Minister then asked for views on what the Chancellor might have in mind, and what its consequences might be.

Mr. Couzens said that his guess, no more, was that the Chancellor was contemplating some pooling of reserves, and a possible extension of the snake. This would fit in with other

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strands of thinking which were emerging, and Mr. Jenkins's approach. His guess was that the effect of such an arrangement would be to lower the average value of the German mark with the average value of the other currencies increasing. This would be attractive to the Germans. The Germans might, in exchange, be willing to make their reserves available on rather better terms than was normal. But clearly the amount of reserves which would be made available could not be open-ended. The idea might help us if our currency was falling, and we wanted to maintain its level. But the disadvantage would be that we would be less competitive. The proposal would also not fit in well with what the Prime Minister had told President Carter in Washington. It would look too much like ganging up with the Germans against the United States. The Prime Minister, agreeing, said that the Chancellor believed that it was impossible to get anything from the United States. Mr. Couzens commented that the Chancellor's ideas might be another piece of his fatalism.

The Governor said that the Chancellor's ideas could be a device for tying up the mark, sterling and the franc. It was not clear what would happen to the currency of the other members of the Nine, and especially to Italy; he might have it in mind to leave Italy out of any arrangement. He might also be looking for a link with the dollar.

Continuing, the Governor said that it might look as if we were being asked to join a low inflation and low growth group. His personal view, however, was that the United Kingdom would be unlikely to gain much from a policy of depreciation. Events in the markets in the last ten days had strengthened his view in that regard. There had been a note of menace there. The situation was certainly different from 1976, but a fall in the exchange rate could hit us nastily.

Mr. McMahon said that a crucial point was what was meant by pooling reserves. If it meant pooling our dollars, it would be a support mechanism against the dollar. But it would be feasible for a country to put its own currency into a pool.

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In that circumstance, the arrangement could chime in with the Prime Minister's 5-point plan, and with Mr. Solomon's ideas, since this sort of pooling would not hurt the dollar. He personally could see some advantage from the stability which might be engendered by our joining the snake. It might also be easier to manage a sterling depreciation if we were in the snake. The Governor commented that if a lot of sterling was bought by the pool, then the policy consequences would inevitably follow.

The Prime Minister then asked about the Germans' objective. Mr. Couzens said that it was probably stability in a world which was not prepared to go for growth. But the French would certainly want some growth, and so would we.

The Prime Minister then said that he would be grateful if a note could be prepared for him to take to Copenhagen showing how the snake operated, evaluating the Chancellor's proposal, and giving a line for him to take in discussion with the President and the Chancellor.

Sterling

The Prime Minister then referred to the situation in the foreign exchange markets. He said that if we were running a current account surplus, there would surely be a shortage of sterling in the near future. The Governor said that the authorities thought that they could beat the professional sellers, but there had been some considerable commercial selling in the last few days. The Prime Minister asked whether the Governor would be worried if the reserves fell to $10 billion. The Governor said that he hoped that the exchange rate could stay at present levels until after the Budget. But clearly it would not be welcome for sterling to fall immediately afterwards. This could mean that sterling was on another ledge which it might be difficult to get off.

The Prime Minister, referring to Mr. Burns's recent speech, asked why we should not spend our reserves since we had a small

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surplus, and our money supply wasbroadly under control. The Governor said that if we were to spend reserves on a significant scale, he hoped that this would not be the only policy which we would adopt. He hoped that the Chancellor's Budget would be cautious both as to composition and the size of the stimulus. It needed to be remembered that our interest rates were still lower than those in the USA, and we might need a 1% rise in short-term rates if US rates increased. Mr. McMahon said that much of our reserves were potentially volatile. It was therefore not sensible to try to hold on to them if they wanted to move. We should be prepared to let the rate move with the market, stickily if necessary. Mr. Couzens said that the market should not be allowed to gain the momentum.

N.L.W.

c.c. Master Set
Econ. Policy, Pt. 20 (Sterling Dollar)

5 April 1978