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My dear Prime Minister

When we last met on the subject of EMS I suggested to you that, if it seemed useful, I would try to send you a piece which would argue a different line from that of many at the meeting.

The enclosed paper attempts to set out a possible way through this difficult subject, and I send it now in the hope that it may be a possible help in your discussions on Thursday or at least suggest delay in any definitive decision at this time. ?

Yours sincerely

Gordon Richardson

The Rt.Hon.James Callaghan, MP

cc Policy

European Monetary System and the choice for the UK

The European Monetary System poses a particularly difficult choice for the United Kingdom.

First the timing is unfortunate. Inflation differentials and the diversity of economic performance, though narrower than a few years ago, are still too wide to give confidence that a tightly-locked exchange rate system involving all nine EEC countries would not come under strain fairly soon. This concern is reinforced by the current situation in the exchange markets.

The weakness of the dollar - itself an important factor in the conception of the EMS - has now reached a violent stage. Major currencies can now move as much as two per cent in a single day against the dollar; and this has the side-effect that they can move sharply and to some extent arbitrarily against each other. The bouts of dollar weakness in early August and early October both put great strains on the snake as inflows tended to concentrate on the deutschemark. Large scale interventions were necessary and ultimately, in mid-October, a realignment. In these turbulent circumstances it will be difficult to ensure that the cross-rates between the EEC countries are in the most appropriate pattern when the new European exchange rate system starts in January.

Moreover, in due course, the dollar will probably turn. It is impossible to predict when, or under what circumstances, this will occur; but when it does, the movements could be almost equally violent- certainly as unpredictable - in the other direction. Again they could differ substantially and to some extent abritrarily between the major European currencies, causing renewed tensions.

Sterling has recently risen rather less than most of the continental currencies, including the French franc, which may help to give us some measure of protection against a violent dollar recovery, if one should occur. On the other hand, the markets may in these circumstances come to regard the sterling exchange rate as unduly high in the light of our inflation and balance of payments prospects; and we are probably more exposed than most of the continental countries apart from Germany and Switzerland to capital outflows by non-residents. (Part of the 1977 inflow must be considered as potentially volatile in unfavourable circumstances.)

All this suggests that the present may not be a very propitious moment for linking sterling tightly to the strong European countries. Equally, however, we may be in for a difficult time if, for example, all the other eight countries join a new intervention system and we remain outside. The problems should not be insuperable if our own domestic stance is appropriate - both as to policy and as to presentation. But if Ireland and Italy were to join, as well as France, it is clear that we should have much to do to dispel the presumption that we were intrinsically weaker, or more inclined to countenance exchange rate depreciation, than these countries.

So much for the immediate anxieties. But there is, of course, much more to the idea of a European Monetary System than the immediate intervention arrangements. Over the longer perspective it looks increasingly clear that the continuing relative shift in economic power between the United States on the one hand, and the EEC countries taken as a whole on the other, is being insufficiently reflected in political, institutional and monetary arrangements. Both at present and prospectively, neither the US economy nor the attitudes of US policy-makers look capable of sustaining the dollar as effectively the world's only reserve currency and taking the preponderant responsibility - as in early postwar years they did - for the international monetary system and its stable functioning. The present may be a period of abnormal weakness of the US - in terms both of policy-making and inflationary performance; but over the years it looks unlikely that US performance will be stronger than that in the rest of the world by a sufficient margin to maintain the dollar's hegemony. The perception of these facts, and the accompanying wish to diversify to some degree out of dollars, by public and private institutions around the world, is indeed an important cause of the dollar's present weakness.

Ultimately it may prove possible to move to a solution of the world's reserve currency problems on a genuinely world-wide basis, by means of the SDR. But this is necessarily some way off; and in any case, even in such a world there would be a need for a resolution of the contradictions noted already between economic power and political and monetary institutions on opposite sides of the Atlantic. These underlying considerations, taken together with the evident determination of Schmidt and Giscard, probably mean that some form of European Monetary System will not only be started this winter but will grow and evolve. Its ultimate shape is at this point naturally difficult to discern; and will indeed depend on the input of all the countries involved from now on.

It would seem of the greatest political importance that the United Kingdom be fully involved in these endeavours from the start. It is only from the inside that we can influence developments; and if a fully-fledged EMS is likely in the end to emerge we shall be much better off as an early rather than a late joiner. We should be able to contribute much to the negotiations from the UK's greater experience in managing an