

TO: ALL MEMBERS OF THE LEADER'S CONSULTATIVE COMMITTEE

EMS

Introductory note by Sir Geoffrey Howe.

The attached paper by the Research Department sets out some of the background to EMS. By the time we meet, I shall be able to say something about the party's thinking, on the basis of Tuesday's joint discussion in the Finance and Foreign Affairs Committees.

Colleagues will be well aware that this subject has generated a great deal of comment, much of it obscure and technical, quite a lot of it ill-informed. Should anyone wish to pursue particular questions further, Adam Ridley or I may well be able to provide suitable papers selected from the vast range now available.

In order to get to grips with the issues, a number of us have met ad hoc to consider what line we should take. There was not, of course, unanimity between us on every point but a tolerably clear consensus emerged, on the following lines:

1. This is not, and should not be presented as, a straight pro- or anti-European issue.
2. Nor is it a question of making a straight choice between the philosophies of fixed or floating exchange rates.
3. We should pronounce in favour of the EMS - not as the ideal way ahead but as a means of providing valuable disciplines and greater currency stability and of encouraging convergence of economic policies in Europe.
4. The political case for this conclusion is a strong one: the alternative could involve surrendering the direction of the EEC and its policies to the Franco-German high table, and a real diminution in our international status.
5. Radical reform of the CAP and a reduction in our net budget contribution to the EEC (this is what "transfer of resources" is really about) cannot be linked with, or made conditions precedent of, our accession to the EMS. Indeed, so weak are we that the logic could point the other way. We are unlikely ever to be able to make progress on those fronts unless the UK participates in EMS. A positive attitude expressed clearly now could help an incoming Conservative Government in securing the changes needed in these policies.
6. We should admit, and possibly stress, that there are dangers in entering EMS as we are, and argue that we should be best placed to enter it once we are committed (as a Conservative Government would be) to tighter monetary and expenditure disciplines, and have liberalised exchange controls. As the CRD paper makes clear, there is a good case for our seeking a transitional period, and perhaps for joining an "outer snake" if one is on offer.
7. We should be highly critical of Callaghan's mis-handling of the issue up to now - particularly the initial negotiations - which has left us on our own. But we should give general support for such attempts as he is continuing to make to take us into the System.

*Li Marley
Co-operates*



8. Callaghan/Labour are largely responsible for the unpalatable nature of the choice now facing us, because:

a. economically we are now so weak that the choice is scarcely open to us and even now they are unwilling to undertake the disciplines necessary to restore it to strength;

b. Labour's lukewarm attitude to Europe has compounded the difficulties on every front.

It is my own view that a Conservative Government elected this October could and would have been able to join, because of the credibility and confidence with which we could have committed ourselves to the right economic and monetary disciplines and to the liberalisation of exchange control. Such an opportunity is probably not now open to the present Government. At our earliest meeting we felt we should continue trying to push them in the direction of joining. That posture still seems right, it would be hugely advantageous for that decision to be taken by Labour (I fear it will not be). We need to maintain our Party's stock of European goodwill, if only to make palatable in Europe the qualification and transitional provisions that will eventually be necessary if a Conservative Government is ever to be able to get us back to the European high table, probably within something like the present EMS.

Fundamentally, we do believe in German principles of economic management and should be able to get ourselves alongside them. Until that time comes, we need (as Malcolm Rutherford has rightly pointed out) an exercise in damage limitation and not in recrimination.

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ECONOMIC MONETARY SYSTEM

(Paper by the Research Department)

1. EMS began with the five-point initiative for the restoration of the international economy launched by Mr. Callaghan early in 1977. His fifth point - a call for currency stabilisation - was taken up by our Community partners and the Commission, and led thus to the present proposals. Final decisions about the scheme are expected in the December EEC Summit. It is still due to come into operation on January 1st, but of course this is a tight timetable and some slippage is possible. All "snake" and EEC members other than the UK are likely to join.

The Scheme in Outline

2. The central economic goal attributed to it is the resumption of sustained and healthy growth through greater stability and predictability for the business community. Several things must be done to bring it about: lower inflation; calmer international currency flows and exchange rates both within the Community and with other countries, particularly the US; smaller differences in inflation between close trading partners within or outside the Community; and convergence of their general economic performance.
3. The key features of the proposals are as follows:
- (i) a commitment to hold members' exchange rate relationships to a narrow range of parities, and a set of rules to determine how that commitment is to be met. (There are substantial differences between the two types of rules suggested - the so-called "basket" and "parity grid" approaches. But they are not central to the big issues addressed in this paper).
- (ii) A central European Monetary Fund (or EMF), which will: provide short-term credits and longer term finance to EMS members; recycle speculative currency flows; create the breathing space and room for manoeuvre needed if parities are to be held in times of stress; create an European Currency Unit (ECU); and hold a substantial proportion of its member Governments' reserves. It is now proposed the EMF should have about \$25 billion of resources. (The IMF has somewhat more).
- (iii) At least in the transitional period (several years) procedures for changing parities, or for periods of "leave or absence" from the scheme.
- (iv) A commitment from each member to pursue policies which will lead to convergent patterns of economic development.

While the original "snake" was the first stage of an explicit programme for achieving full Economic and Monetary Union (the Werner plan) the EMS proposal is not part of any such long-term blue print.

Attitudes

4. Our Community partners support EMS for a variety of reasons, which are quite well summarised in the article from the Guardian of November 13th by John Palmer, of which a copy is attached. An important point not discussed by Palmer is the imminent prospect of enlargement. This threatens to make the management of the Community's affairs difficult without a "directoire" or inner

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circle of strong and dominant countries. This fits conveniently with the attitudes of the French and Germans, and was touched on some time ago in the Tindemans report. At a political level EMS has been widely welcomed an important step towards greater European unity and co-operation. Indeed some go so far as to believe that the Community cannot long survive without such an initiative. However, there are widespread reports that expert opinion is sceptical as to whether the scheme is desirable or even feasible.

5. The UK's attitude interests partners as much as a test of our general commitment to the Community as anything else. At first keen to see us as members, they are now much more neutral (even Schmidt). They are certainly not now willing to buy us in with special concessions. If we do not enter they will presumably pay less attention to us, whether by denying us a role in the Community's deliberations commensurate with our importance, or ignoring our national problems.

A Quid Pro Quo for UK Membership of EMS?

6. The Government has tried to use the EMS negotiation as a lever with which to bring about reform of the CAP, a reduction in the financial burden of our Community membership and a commitment to "growth policies". These three issues were handled in the so-called "concurrent studies" which were undertaken alongside the discussion of the EMS itself. This approach has got us nowhere, since the logic of the bargaining process now runs totally counter to that assumed by the Government. We can only hope for concessions on the CAP and our financial burden if we first adopt a positive attitude to EMS and, probably join it in good will fairly early on, if not at the outset. In the case of the CAP there is also the important technical argument that reform is difficult without much greater exchange rate stability - the kind of stability EMS might bring if it worked.

Domestic Political Considerations

7. Labour's attitude has been obscure, but is beginning to become clearer. Callaghan and Healey have been basically in favour, despite their anger at being upstaged and outflanked in the preparatory work by senior officials which led to the Bremen Summit, and the further embarrassment of exclusion from the Schmidt-Giscard agreement at Aachen. The election having been postponed, it appears now that they are preparing for the UK either to delay making up its mind about entry or to stand aside from the whole venture. Perhaps they fear severe party splits on both EMS and pay throughout a pre-election year. However there is no evidence that the Government have yet made a firm decision.
8. One must also consider how the Labour Party's attitude is likely to evolve next year or the year after, particularly if they lose the election and Callaghan steps down. The signs are that the left will launch a major campaign for our withdrawal from the Community. With a change of leader, official party policy could well switch to backing withdrawal before very long. So should we desire to enter EMS with bipartisan support, we may not have much time in which to secure it.
9. Expert opinion here is for the most part sceptical of the practical aspects, and in some cases hostile in principle. There are said to be few if any active supporters in the Treasury or the Bank of England. The City is not on the whole very enthusiastic about it, apart from three out of four major clearing banks (Lord Armstrong of the Midland is the exception). The Expenditure Committee is currently investigating the scheme and has not yet pronounced.
10. The attitude of public opinion at large is unknown, perhaps unknowable and in an important sense irrelevant. The scheme is so obscure that very few people know anything about it. There has been no opinion survey and it is uncertain whether such a survey,
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would tell us much of interest even if it was held*. Attitudes to it will probably be determined on the very simple basis of the general balance of pro- and anti-EEC feeling of the moment. Given the present balance of hostility, EMS will probably not be popular. Of course, were we to be able to secure e.g. improvements in the CAP after joining, public attitudes to both the Community and the EMS might become more favourable in due course. In the more immediate future it must be likely that, were we to become members of EMS and have to pursue painful economic policies as a result of our membership, the scheme could well stir up yet more anti-Community feeling.

Implications for Conservative Economic Priorities

11. With the EMS proposal neither fully worked out nor understood and its prospects uncertain, it is difficult to assess what effect our joining might have on the party's economic priorities. So the following judgements are rather tentative. In any case one must distinguish clearly between its possible effects if it works more or less as intended (with us as a member from the start), and if it fails. Since the technical implications are formidably complex, the following remarks are necessarily brief.
 12. The general economic philosophy of EMS and of its major protagonists is one we must broadly favour, with its commitment to monetary discipline, lower inflation and stability. So should be its implications of preserving an open economy, greater competition and favouring the general consolidation of the priorities of the centre-right. It is barely compatible with any other than the milder forms of socialist economic policies, and will undoubtedly enforce a variety of economic disciplines. However, some might question whether we might want to be able to float sterling more indefinitely. And few would claim that EMS is the ideal way to begin a move towards fixed exchange rates within the Community, even assuming we wanted to.
 13. The effect on us of the exchange rate limits set by EMS will depend on whether the band within which currencies may fluctuate is the same narrow percentage range for all, or narrow for some and initially wider for others such as Italy and the UK. To match the general inflation rate of other EMS countries we should almost certainly have to get our own rate down to the 3-5 per cent range. This is likely to take 2-3 years at least. During that period our costs and prices could rise by not far short of 10 per cent above the EMS average. Such a big gap could not be reconciled even with a wider margin of permitted exchange rate fluctuations of e.g. 4½ per cent, as has recently been proposed for the Italians, let alone with the 2½ per cent margin allowed in the narrow band of the snake. So if we entered the narrow band, we should have to be allowed several parity changes in the early years, until we were able to reduce our inflation rate sufficiently. Even with a wider band at least one or more parity changes would be essential for us. The same must go for Italy, France and Ireland.
 14. Little is known about the terms or procedures for parity changes beyond the fact that they are definitely to be allowed, as with the snake. Advance consultations amongst EMS partners are certainly envisaged. But such arrangements are difficult to enforce in practice. On the other hand, when recourse to the EMF is to be made at the same time as a country changes its parity, pressure can be exerted on the country changing its parity. It is probably intended that freedom to adjust parities will be reduced considerably after an initial period of transition.
 15. The adoption of a wide exchange rate band and freedom to change parities may well be fundamental in making it possible for France, Italy and the UK to join the scheme at or near the start. But while they reduce the need for early convergence, they do not eliminate it. Policies to induce convergence could take many forms. But undoubtedly their centre-piece would be monetary policy. As recent work by the London Business School suggests (in the "Economic Outlook" for October 1978), we should probably have to cut our monetary expansion initially to around half/
- * CRD are arranging for some questions to be included in the next ORC survey. The results should be known before Christmas.

its present rate. Probably we should then have to halve it again within a couple of years in order to produce the requisite degree of convergence of inflation rates within 2-3 years. This would be a tough policy to follow, possibly tougher than we would otherwise wish.

16. A tougher monetary policy would have direct effects on the required size of the Government's deficit and the scope for tax cuts. Smaller money supply increases would require less Government borrowing and reduce the scope for tax cuts *pari passu*. The possible conflict with out tax goals is obvious. EMS would also mean a loss of freedom in running our monetary policy for several reasons. Its rules and procedures will be one constraint; the greater importance of reducing inflation will be another; third, and perhaps most important in the longer run, is the effect of closer integration of the separate currency systems of EMS members to which it will inevitably lead. However whether such a loss of freedom is good or bad is not obvious.
17. There is also the issue of exchange controls, which we want to dismantle. It is almost certain that doing so would provoke a once and for all outflow of sterling and a drop in sterling's exchange rate. It is obviously desirable that this step should be largely completed before we join EMS. To undertake it afterwards would not be impossible provided we could devalue, but it would be more awkward.
18. Finally there are the effects on growth and employment. These are not easy to spell out. In the short-run they are likely to be adverse to the extent that we pursue a very tight monetary policy to get inflation down; deflate to correct trade deficits; or are held at too high a parity to permit balance of trade equilibrium and acceptable employment levels to be combined. The seriousness of these effects is totally unforeseeable. It will depend above all on the latitude we have to depreciate and, as in the 1960's, the wisdom with which we exploit it. In the longer run the effects should be beneficial. Stable exchange rate relationships within the EMS area and without could be of very great long-run importance in strengthening confidence and exploiting the European market.
19. So far the analysis has rested on the assumption that the scheme works. But how durable is it likely to be? What might happen if it failed? One reason for early failure might be that it has been planned in a great hurry and will be started at a difficult time. There can be no doubt about the hurry. And with the dollar still insecure, there is the considerable likelihood of EMS being hit by a bad storm of speculation before it is properly established. A bad collapse early on would most probably be fatal. If the scheme can get off to a good start, strains could arise because the EMF has too little money to do the task expected of it, because inflation rates do not converge, or for both reasons. Whether it would then collapse or merely "se reculer pour mieux sauter" is not clear. The present snake group would presumably survive with one or two new members. It is quite possible that a further attempt to expand and develop the "snake" system might be undertaken later.
20. It is more tempting and easier to discuss the failure of EMS than to assess what the consequences and choices for the UK would be if we did not join. This is an issue which merits more space and time than is possible at present. But certain points can be made. The greater formal freedom we might enjoy outside

EMS would not necessarily be as welcome as we might at first imagine. The problems of curbing inflation and getting the economy to grow are not likely to be diminished by our acquiescing in becoming that much more of a backwater. And the prospects for the City and foreign investment in the UK could be seriously affected by our absence from EMS in the longer run, always provided it works.

EMS - Wider Aspects

21. Little attention has been focused on external aspects of EMS. These could well be important, almost regardless of the many ways in which its internal operations might be conducted. With the demise of gold and, now, the dollar, the international economy lacks a reliable means of exchange and store of value. The result is growing insecurity and anxiety amongst both public and private holders and managers of currency reserves, which consist very largely of dollars. The less the confidence in the key-currency of the system, the greater the volatility of currency flows. Each participant will feel forced to be more vigilant and active in the foreign exchange markets and seek to move a larger share of his reserves than in the past in and out of different currencies as exchange rates change.
22. A second issue is the system of floating exchange rates. Whatever theory may suggest, adjustment of international competitiveness now involves a disquieting degree of overshooting and overkill, erratic and excessive changes in parities, violent and unstable movement of "hot money" across the exchanges and great political and economic problems for Governments. A degree of intervention in the exchange markets to dampen and smooth the process is increasingly recognised to be both desirable and inevitable, and it probably demands more international coordination than it gets at present.
23. As things stand, there is no likelihood of a solution being sought to either problem. The IMF cannot and the US Government will not. The US authorities can do something about their inflation, overheating and, in the longer term, their trade deficit. But to do this - and the President's present measures may well not be sufficient - is not to recreate the required confidence in the dollar. Nor could it be expected to, since nothing can wipe the past few years of instability and decline from the historical record.
24. For its part, the EMS is intended to create both a new and stable kind of international currency in the ECU, and to manage intervention in the exchange markets. To do the latter properly will require it willy-nilly to deal in major non-EMS currencies as well as those of its members, and to devise a proper strategy for such action. It therefore possesses the potential for going some way toward solving the two problems posed above. Indeed it might be the only step in either direction which will be feasible for some time to come. Since the prospects for a world financial system capable of sustaining world trade and growth remain fragile, these wider issues should not be neglected.