

# Journal of Contemporary European Research

Volume 9, Issue 5 (2013)

Reflections

## Could and Should Britain have Joined the European Exchange Rate Mechanism in 1979? A Personal Memoir

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### **Citation**

Franklin, M. (2013). 'Could and Should Britain have Joined the European Exchange Rate Mechanism in 1979? A Personal Memoir', *Journal of Contemporary European Research*. 9 (5), pp. 759-766.

First published at: [www.jcer.net](http://www.jcer.net)

In 1985, the annual Ditchley Foundation lecture was given by Giscard D'Estaing, the former French President. Its title was "The ECU and its Contribution to the Stability of the International Monetary System". Together with German Chancellor Helmut Schmidt, he had been the prime mover in the creation of the European Monetary System (EMS).<sup>1</sup> The lecture was chaired by James Callaghan, who had been British Prime Minister at the time. During the discussion that followed the lecture, Sir John Hunt, who had then been Cabinet Secretary made the remark that in fact he had been in favour of British entry. Callaghan shot back: "I wish you had told me at the time". As I had then been Head of the European Secretariat in the Cabinet Office and hence adviser to both Hunt and Callaghan I felt that the comment equally applied to me. I have long wondered whether in fact we had done our duty and whether we could have altered in any way the decision that was taken at the end of 1978 not to join the key part of the EMS, the exchange rate mechanism (ERM).<sup>2</sup>

There have already been two excellent accounts of the history of the second half of 1978 when much of the discussion and decision making about the EMS took place, both in Brussels and in London. Peter Ludlow's book *The Making of the European Monetary System: a Case Study of the Politics of the European Community* (1982) came out soon afterwards. Later, in 1994, Edmund Dell, who had been a member of Callaghan's Cabinet gave his version of the story in the *Contemporary European History* journal. Between them they provide a valuable record of what was a key period in UK/EU relations.

The account I want to give starts with the decision of Schmidt and Giscard to appointment a 'secret committee' to begin preparations for some kind of monetary system which could replace the system which rather loosely linked some European currencies, the so-called 'snake'. Schmidt nominated Horst Schulman, the Chancellor's principal economic advisor and the French Bernard Clappier, Governor of the *Banque de France*. Callaghan was invited to send a representative. Ken Stowe, his Principal Private Secretary, suggested either Sir Kenneth Couzens, Second Permanent Secretary for Overseas Finance at the Treasury, or Kit McMahon from the Bank of England. The Prime Minister chose Couzens and in many ways he was the obvious choice, although in fact he had spent most of his Treasury career dealing with domestic public expenditure and had only recently come to deal with international financial matters. Edmund Dell says he brought to the party a sceptical mind imbued with memories of past UK devaluations and of the attempt in 1972 to link sterling to the snake. The very first evaluation Couzens produced for the PM contained eight 'cons' and two 'pros'! Ludlow says it was a mistake appointing a Treasury official and "not counteracting his scepticism" (1982: 109). The outcome might have been different if the choice had fallen on Kit McMahon - Deputy Governor of the Bank of England, Clappier's opposite number, a professional economist, personally emollient and fully conversant with the subject. There were indeed other choices that could have been made: to mirror Schulman's position in the Chancellor's office, the UK representative might have been John Hunt, myself or someone else from the Cabinet Office. At the FCO, Michael Butler, the Deputy Under Secretary for international economic affairs, had all the right credentials. Harold Lever, at that time Paymaster General and someone from whom Callaghan subsequently sought advice on the EMS, was another possibility: indeed Schmidt apparently suggested his name to Callaghan once Couzens had dropped out (Ludlow 1982: 112). Whoever had been appointed, they would have had a difficult relationship with the other two since both Schmidt and Giscard were determined to press ahead whereas Callaghan was cautious to say the least. According to Dell, Couzens had strict instructions not to agree to anything. It is thus not surprising that Schulman and Clappier refused to go on working with him, and when the committee produced its report for the European Council meeting in Bremen in July, it appeared over their two signatures alone.<sup>3</sup>

Study of the initiative proceeded in great secrecy. The first meeting the Prime Minister called on 4th April was restricted to the Foreign Secretary, Couzens, the Governor and McMahon from the Bank and (unbeknown to me) John Hunt. Only later were the Chancellor and Sir Douglas Wass, Treasury Permanent Secretary, included. It was not until the beginning of July (Callaghan having been told by Schmidt of his "exotic idea" in March) that I became fully involved. At that point, the European Secretariat would normally have swung into action and called the necessary interdepartmental meetings. But it was not to be. Couzens was a Second Permanent Secretary and I was a rank lower, a Deputy Secretary. He refused to come to meetings in the Cabinet Office, the only such occasion during my four years in the European Secretariat. Our whole *raison d'être* was to provide a neutral forum where representatives from the various Departments concerned with a European issue could discuss their different points of view and thrash out a common line to be offered to ministers or to provide the relevant instructions to the UK's Permanent Representation in Brussels (UKREP). On every other topic this was what happened but not with the negotiations over the EMS. There were as I recall one or two meetings on the EMS, one at least of which I attended, but they were held in the Treasury under Ken Couzens's chairmanship. By then, No.10's instructions to keep matters to himself had long since lapsed. The Treasury has never been the most co-operative of departments but this was unprecedented and caused considerable disquiet not just to me and the European Secretariat but to other departments, notably the Foreign & Commonwealth Office (FCO) which, as the lead department on EEC matters, manifestly had a major interest in the EMS project which dominated EEC activity during much of 1978/9. It was not as if the Foreign Office lacked expertise: its chief economist, Jim Rollo, was well versed in EEC affairs, and Michael Butler, who headed up the relevant FCO department, was (and remains) a notable economic expert on European monetary matters. I discuss later the relationships at ministerial level but at official level there was certainly a sense of frustration at not being able to have frank interdepartmental discussion on this key issue. Looking back, what I should have done was ask John Hunt to convene a meeting or meetings, then there could have been no room for pulling rank.<sup>4</sup>

The result was that departments other than the Treasury, and notably the FCO, lacked purchase at official level on the on-going negotiations. This meant in particular that the wider political considerations in favour of joining largely went by default. It must also have made discussion of tactics – normally shared between the relevant Whitehall departments and UKREP – particularly difficult. Meetings were held in the Treasury, attended by officials from the Bank of England, sometimes by the FCO and rarely by anyone from the European Secretariat. Much of the technical discussion and exchange of papers went on between Treasury officials and the Bank of England, with papers only occasionally copied to the FCO. The general conclusion of Treasury economists was that entry might reduce inflation but would slow down growth, increase unemployment and worsen the balance of payments. Opinion within the Bank of England was somewhat divided but the majority of senior Bank officials was against the UK joining.

One important tactical decision taken early on was to make our entry conditional upon some transfer of resources to the UK, chiefly through a reduction in our excessive net contribution to the European budget (see Ludlow's detailed narrative, 1982: 170-180). This may have arisen from the Treasury's assessment that membership might be economically beneficial if *either* the scheme was altered to put more of the burden of adjustment on to the stronger currencies (i.e. Germany) *or* there was a resource transfer in our favour.<sup>5</sup> But it was also thought of as a tactical device to get the rest of the EEC to address what we had long seen as the injustice of a budgetary system which left us paying a disproportionate share of the cost. As such it was doomed to failure. There was no way that Germany was willing in the EMS context to take on the additional burden of helping out the British and the link was quietly and sensibly dropped when it became clear that we had no effective leverage (and were not going to join anyway!). But what became known as the 'concurrent studies' received a great deal of attention during the

later months of 1978 and became important in the debate about Italian and Irish membership.<sup>6</sup>

While discussions on both the terms of the EMS and the 'concurrent studies' continued in Brussels, there were frequent discussions in Cabinet. Indeed, for the reasons given, this was probably a rare case when the issues were more discussed at ministerial level than in inter-departmental discussions among officials. The subject came up at most Cabinet meetings during November and December. Back in July, the Prime Minister set up a special Ministerial Group on European Monetary Co-operation (GEN136) under the chairmanship of the Chancellor, Denis Healey. The relevant Departmental Ministers were members but, unusually for a ministerial committee, Ken Couzens was also made a member. The secretaries were myself and Peter Mountfield from the economic side of the Cabinet Office. At the final meeting of the Group on 10th October, the Prime Minister took the chair and, in addition to the usual members, Sir John Hunt, Gordon Richardson, the Governor of the Bank of England and Sir Kenneth Berrill, Head of the Central Policy Review Staff also attended.<sup>7</sup> The meeting had before it a long paper from the Treasury and a shorter paper from the Department of Industry and, notably, none from the FCO. The Treasury paper contained a brief reference to the fact that our influence within the EEC might be less if we stayed out, but essentially it was a long and detailed analysis of the economic arguments which would have left the reader in no doubt about which way the Treasury leaned. And it was accompanied by a note from the Chancellor advising that the UK should stay out unless the German position could be changed. The Department of Industry paper said British industry would benefit from membership provided there was exchange rate flexibility (which there was - and the Department wanted a 5-10 per cent devaluation on joining), strong currency countries would reflate or revalue their currencies (the Achilles heel) and the UK would have access to the European Monetary Fund (probably no problem); and ended very tellingly with the thought that "being in at the start, as well as preserving the UK position at the top table, would give us more influence over the initial constitution, the working philosophy and the subsequent development of the EMS". But the Prime Minister's summing up was adamant: "the group by a large majority felt that it was clearly not in our interests to join the proposed European Monetary System in the form it was likely to emerge" though there should be "no advance disclosure" and for tactical reasons we should "continue to play a part constructively". Ministers did however endorse the idea put forward by the Treasury that, while staying out of the ERM we could become a nominal member of the EMS. In fact this idea originated with Michael Butler in the FCO, and in particular the proposal that, although not entering the ERM, we along with the ERM members should deposit 20 per cent of central bank gold and deposit reserves to finance short term intervention in ecus. It was known rather inaccurately as the 'half way house'. It is doubtful whether it cut a great deal of ice with our partners but for those who feared that by staying out we left ourselves bare of influence, it was at least a fig leaf.<sup>8</sup>

In all the ministerial discussions leading up to the decision to stay out, the line-up of ministers was predictable. The eurosceptics, led by Tony Benn, were adamantly opposed. More surprisingly, Edmund Dell, one of the pro-Europeans in the Cabinet, was against the concept of attempting to achieve monetary union within the EEC and thus joined the opposition. The lone voice in favour of joining was Harold Lever, but he lacked any departmental backing.<sup>9</sup> It is noteworthy that, notwithstanding the advice he would undoubtedly have received from the Foreign Office, the young and recently appointed David Owen, lined up with the sceptics. He had aspirations to lead the Labour Party and may have been anxious to ingratiate himself with the left of the Party by not appearing to be too pro-Europe. Even if he had spoken up strongly in favour of joining, he would have been no match for the heavyweight Chancellor of the Exchequer. Healey himself in his autobiography (1989) says that he began by being fairly agnostic but then turned against it, concluding that the way it would work in practice would only serve to help Germany keep the DM competitive. His position would have been reinforced by the advice of the Treasury.

As to the Prime Minister himself, Edmund Dell claims that he had decided early on against joining on the grounds that to enter would split the Labour Party, but kept up the pretence of an open mind to avoid what he feared would be a sterling crisis if the UK failed to join. Dell's testimony must be somewhat suspect given his opposition to the whole project. Callaghan certainly proceeded cautiously, but if it were the case that he had already decided against, he managed to conceal it for quite a long time: in April he was still reported as hoping that if anything came of the ideas, the UK would be associated with them. It is possible that he genuinely wanted to keep his options open. There is no doubt that he blew hot and cold, often tactically but also probably because he was genuinely in doubt. Callaghan's biographer's assessment is that, as time went on, Callaghan "became somewhat more enthusiastic about joining ... than were his Cabinet colleagues, although not by a great margin" (Morgan 1997: 615). The evidence, however, rather points in the opposite direction i.e. that he showed interest in the idea at the beginning and gradually cooled towards it. Indeed, he apparently said to Healey in September that he was "cooling off on the whole business". When he met the Commission President in early November, he did not contradict Roy Jenkins's impression that the UK would stay out. (Callaghan's comment at Ditchley might suggest that in later years, however, he came to regret his decision).

The Opposition was more positive. The majority of the Shadow Cabinet led by Geoffrey Howe was in favour of British entry but there were several sceptics including, it would appear, the Leader of the Opposition, Margaret Thatcher. Nevertheless, when it came to the debate in the House of Commons she declared that failure to join was a sign of Britain's economic weakness and of Labour's divisions and "a sad day for Europe" (in Moore 2013: 381).

And so I come to the two questions in the title of this essay: could and should we have joined? As to the first, Dell's case that it was politically impossible is a powerful one. The majority of the Cabinet was against and there was strong resistance within the Labour Party. The Government's position in the Commons was weak. Without the support of the Chancellor it is doubtful whether the Prime Minister could have carried the day even if he had given a strong lead. There is a plausible case to be made that, had we had a more open minded representative in the group of three, with a more positive remit from the PM, he might have been able with the help of Clappier to secure terms for the EMS which were less deflationary and therefore less objectionable to the Labour Party. In that event, the Chancellor might have come out in favour of joining and thus swung the balance within the Cabinet, including the Prime Minister, to a more positive view. However, it was not to be. The evidence is that, if not impossible, the domestic political cards were heavily stacked against our joining at the outset. Ludlow cites as reasons for our failure to join: the indecision of the Prime Minister; the lukewarmness of the Conservative Party; the failure of the Foreign Office to "insist that the political case for membership should be decisive" (1982: 295); and the Treasury's "want of imagination and a surfeit of prejudice" (1982: 296). It is indeed hard to quarrel with his overall conclusion that the key to our policies towards the EMS was both "political and psychological" (Ludlow 1982: 256-7).

But should we have joined? As Healey had concluded, there was no doubt that as the negotiations proceeded, the system emerged in a way that put more of the burden of adjustment on the weaker currencies and gave the stronger currencies the upper hand. It is therefore hardly surprising that a Labour Government should have been nervous about joining a monetary system with a built-in deflationary bias. But this argument may to some extent have been based on the mistaken belief that it would have meant locking sterling irrevocably to a strong DM.<sup>10</sup> Throughout the negotiations, however, it was clear that the system would not be a fixed rate system but both legally and in practice a fixed but variable one, providing for realignment between the currencies albeit by agreement.<sup>11</sup> This would have allowed Britain to devalue against the DM as France did and it is at least arguable that had Britain joined the ERM at the outset and taken

advantage of the possibilities of realignment during the succeeding years, we would have ended up in 1990 with a more realistic rate than the one chosen by Nigel Lawson when the then Conservative government decided to join in October of that year, thus avoiding the debacle of Black Wednesday.<sup>12</sup> Nor should it be overlooked that the economic assessment offered to Ministers by the Treasury bore all the hallmarks of the Couzens scepticism.<sup>13</sup> It was widely rumoured at the time that Sir Douglas Wass, the Permanent Secretary at the Treasury, thought the economic arguments were finely balanced. It is not without significance that, a few years later and after Couzens had left, the Treasury, under Lawson, was arguing strongly for entry into the ERM.<sup>14</sup> One can perhaps also detect in the EMS discussion a common failing in our dealings with the EU: continuing to address the intrinsic merits of a policy even after it had been decided.<sup>15</sup> From the middle of 1978 it was clear that there was going to be an EMS: and instead of continuing with the analysis of the scheme per se, the only question for us to address was should we be part of it as it was likely to emerge.

If the economic case for joining was more balanced than might have appeared, there is a strong case for saying that, for the reasons I have given, the wider EEC considerations which would have favoured joining were not given their due weight in the final decision. Here was another example of the UK wanting to go it alone, and failing properly, and in a timely fashion, to assess the merits and demerits of failing to join a system which, like it or not, was going to form a key part of the European project. By the countries which favoured the EMS, and notably Germany, we were perceived as both opportunist and obstructive. It did nothing to foster the belief that we were fully committed to the European enterprise and may have made our ability to get our way on other important issues, notably the UK's excessive contribution to the budget, that much more difficult. Conversely, had we shown a more positive attitude towards the EMS project, if not with the crusading enthusiasm of Schmidt at least with the hard-headed realism of Giscard D'Estaing, the subsequent inevitable battle over our net contribution might have been less traumatic than it turned out to be. As it was, our reputation as a semi-detached member was confirmed. Secondly, we lost an opportunity, long the dream of many of us, to enter an equal partnership with France and Germany. Schmidt and Giscard's offer to Callaghan at the outset of the EMS concept was genuine and we chose in effect to turn it down.

And so we are left with the question I have to address: might Callaghan's position have been different had he received powerful advice from the Cabinet Office which – to use Ludlow's expression – counteracted Couzens's scepticism? He had received advice not just from the Treasury and the Bank but from other quarters including Ken Berrill and from Bernard Donougue, Head of the Policy Unit in No.10 (the former marginally in favour and the latter hesitant and wanting the PM to postpone a decision until after the election) but never, so far as my memory goes, a considered assessment from the Cabinet Office bringing to the fore the wider arguments for Britain to be a founder member of this important EEC development. Thus Callaghan's admonishment with which this essay began can be said to have been justified, though whether it would have altered the outcome must be highly doubtful.

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## ACKNOWLEDGEMENTS

I am grateful for help from Sir Stephen Wall and Sir Michael Butler in the preparation of this essay. Much of it is based on my personal recollections with some limited research in the archives of the Bank of England and the National Archives.

**NOTE FROM THE EDITOR**

From 1977 to 1981, Sir Michael Franklin was head of the European Secretariat in the Cabinet Office. Before that he was a Deputy Director General for Agriculture in the European Commission and subsequently Permanent Secretary of the Board of Trade and then of the Ministry of Agriculture, Fisheries and Food. After retirement from the public service he was a non-executive director of Barclays Bank, Whitbread plc and other companies. Among his publications are *Britain's Future in Europe* (1990), *The EC Budget: Realism, Redistribution and Radical Reform* (1992), *EU financing, 2007-13: 'I want my money back'* (2005) and, as editor, *Joining the CAP: The Agricultural Negotiations for British Accession to the European Economic Community, 1961-73* (2010).

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<sup>1</sup> Roy Jenkins, the President of the European Commission, made up a triumvirate, thanks to his position and his enthusiasm for monetary union as presciently set out in his Jean Monnet lecture 'Europe's Present Challenge and Future Opportunity' given at the European University Institute in Florence on 27 October, 1977.

<sup>2</sup> The exchange rate mechanism (ERM) was the key part of the European Monetary System (EMS). As discussed later the British Government made the gesture of joining the EMS but decided to stay out of the ERM.

<sup>3</sup> Known as 'the Bremen Annex'.

<sup>4</sup> John Hunt did eventually chair a meeting of Permanent Secretaries, but only in September of 1979 when the new Prime Minister, Margaret Thatcher, called for a reappraisal of Britain's EMS membership.

<sup>5</sup> Healey adopted this line when he gave dinner to Commissioner Ortoli on 5 September, 1978.

<sup>6</sup> The communiqué following the Bremen summit called for "concurrent studies of the action needed to strengthen the economies of the less prosperous members in the context of [EMS]". At that time, Britain claimed to fall into that category. The eventual outcome was meagre although one notable British achievement was to persuade the Commission to produce a table showing the net contributions of each member state, something which up to that time they had strenuously resisted.

<sup>7</sup> Dennis Healey, David Owen, John Varley, Edmund Dell, John Silkin and Harold Lever

<sup>8</sup> For the Minutes of this meeting see National Archives CAB 130/1047.

<sup>9</sup> Although he did get some informal briefing from Michael Butler (personal information).

<sup>10</sup> This misconception seems to have been widespread. For instance, speaking about the EMS in a House of Lords debate in November, 1978, Lord Roberthall, a former Government Economic Advisor, disliked the idea of being "committed to a fixed rate" (Jones 1994:179).

<sup>11</sup> There were in fact eleven parity changes or realignments during the life of the EMS, seven during the first four years and four in the subsequent four years. Between 1979 and 1987, the Italian lira depreciated by 45 per cent against the DM. The most notable adjustments were between the DM and the French franc in April 1986 and again in January 1987.

<sup>12</sup> 16<sup>th</sup> September, 1992.

<sup>13</sup> That his reluctance to see Britain join persisted is perhaps exemplified by a later incident recorded by the Bank of England (from an unreferenced document in the EMS file in the Bank of England archive). In early 1980, the question of possible UK membership could apparently be raised again. Couzens was happy to tell the Governor that he had been told by the French that they would find it "inconvenient and unwelcome if we joined at this stage". The note goes on to say that "some days previously, de la Geniere [Deputy Governor of the *Banque de France*] had told Sir Gordon Richardson the exact opposite".

<sup>14</sup> To become Permanent Secretary at the Department of Energy and later Deputy Chairman of the Coal Board. He died in 2004.

<sup>15</sup> Minuting the Chancellor on 2 October, Couzens wrote: I am clear that it would have been better for the UK on every count if this plan had never come forward!

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